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OMB'S CIRCULAR A-76 AND ITS IMPLICATIONS FOR MUNICIPAL CONTRACTING

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Abstract

Circular A-76 sets out an extensive, detailed, and pragmatic methodology for federal government contracting. This paper reviews, critiques, and suggests how A-76 can be applied to contracting out at the municipal level. It then presents two case studies that employ the methodology in a municipal contracting-out setting.

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Municipal government leaderships face agonizingly tough choices during this period of budgetary stringency. Administrations, aware that current decisions will permanently affect the quality of life in their localities, are under intense pressure to act judiciously. Hence, municipal councilors and managers must implement cost-cutting measures that have more than a surface attractiveness, and whose long-term consequences will not overwhelm the short-term advantages.

Contracting out, if implemented thoughtfully and on the basis of the appropriate model and relevant data, can yield short-run savings as well as longer-term improvements. No one should deny that significant benefits can be achieved by using private sector resources to supplement or replace municipally-provided services. At the same time, one should avoid the knee-jerk reaction that claims that contracting out will *always* prove more efficient and more effective than services provided by the municipality itself (see Prager, 1992). Contracting out must be implemented with the precision of a surgeon's scalpel, not with the brute force of the butcher's cleaver. This article aims to provide some general considerations as well as a more focused methodology to guide municipal authorities as they move forward with their privatization initiatives. The key point that emerges from this study: *Proper contracting out decisions require a methodology that focuses on and appropriately interprets private sector-public sector cost-effectiveness comparisons.*

Accurately comparing potential service suppliers with the existing delivery mechanism is

central to the methodology elaborated in this study. That, in turn, is a two-stage process: (1) analyzing the whole range of costs associated with current practice in comparison to the total costs of contracting out while maintaining or improving the quality of service, and (2) gaining a true understanding of the differences that emerge. It should be evident that undertaking cost comparisons is a complex task that requires the assistance of technical skills from a variety of fields, including but not limited to economics and accounting. That is especially true in the area of social services, for comparisons mandate introducing quality-of-service measures, which are often difficult to pin down. For policy-makers, however, the crucial decision will come after the numbers are provided by their staff. They will have to understand that the data conceal as well as reveal, and that while sometimes the decision is self-evident, at times it would not be inefficient to continue with more expensive internal service provision even though contracting out appears more economical.

The methodology used by the U.S. government to evaluate contracting-out options is outlined and evaluated in the following section, while section II revises this methodology, insofar as it is appropriate, for use by municipal authorities. Section III examines in detail the problems encountered by the authors in attempting to undertake an in-house versus contract cost comparison in a city department, while Section IV explores an actual case. The final section summarizes and concludes.

I. The Federal Contracting-Out Methodology

The most extensive and complete methodology for evaluating whether a government entity should contract out or retain operations in house is provided by the federal government's Office of Management and Budget Circular A-76 and accompanying documents. A-76 is not

only ably conceived, but also about as complete and pragmatic a document as is likely to appear. Municipal authorities who in recent years have focused more attention on contracting out as an alternative service delivery mechanism can greatly benefit from understanding and applying the A-76 methodology.

A. Cost Criteria in Contracting Out Decisions

Table 1 summarizes the highly sophisticated cost comparison procedure OMB expects a federal agency to undertake prior to contracting out when in-house provision is either underway or is equally feasible.

TABLE 1: IN-HOUSE VS. CONTRACT PERFORMANCE COST CALCULATIONS

In-House Performance Costs	Contract Performance Costs
Personnel	Contract price
Material and Supply	Contract administration
Other specifically attributable costs	Additional costs
Overhead	One-time contract conversion costs
Capital	Gain (loss) on disposal/transfer of assets
Additional Costs	Federal income tax deduction
Total	Total

Source: U.S. General Accounting Office,(1994), Appendix II, pp. 17-18. This table is based on U.S. Office of Management and Budget (1983), *p. IV-4.*

Many of the items are self-explanatory; some require comment.[1] Clearly, the contract price is the amount to be paid to the contractor. But A-76 correctly recognizes a host of additional charges that ought to be considered when calculating the full cost of contracting. All costs associated with the contract process itself, including letting and monitoring, which would

be superfluous when the service is provided internally, are added under "Contract administration." "Additional costs" addresses unusual or special circumstances, while "one-time contract conversion costs" are the transitory outlays associated with changing from in-house provision to contracting out. Any gains or losses that result from assets no longer needed subsequent to the contracting out must be calculated. Finally, the sum that the federal government will collect from the contractor in taxes must be subtracted from the contract payment in order to determine the government's net contract costs.

On the in-house side, personnel costs include direct employee outlays as well as the fringe benefits that are assignable to the service in question.[2] Materials and supplies used by the government operation must be included, as are "attributable" costs, which encompass depreciation, rent, maintenance and repair, utilities, and, in lieu of insurance, an estimate for insurance losses. To these overhead items that are directly related to the function in question must be added a proportion of the general operations and administrative overhead.[3] Cost of capital refers to new investments that would be required by in-house provision, while "one-time conversion costs" deals with such expenses as training, office expenses, and other outlays that would accrue from discontinuing an existing contract or expanding internal operations. Any usual expenses are included in "additional costs."

The decision then fundamentally revolves about comparing these two estimates and selecting the least costly option.

The essence of A-76. Some points deserve emphasis. *First*, not every government operation should be privatized. A-76 distinguishes between "inherently government services" and other types of government service provision. The federal government's Office of Management and

Budget's Policy Letter on Inherently Governmental Functions (*Federal Register*, 1992) defines such a function as one:

> so intimately related to the public interest as to mandate performance by Government employees. These functions include those activities that require either the exercise of discretion in applying Government authority or the making of value judgements in making decisions of the Government. Government functions normally fall into two categories: (1) The act of governing, i.e., the discretionary exercise of Government authority, and (2) monetary transactions and entitlements.

Thus, the federal government will not consider contracting out the criminal justice system or armed force or police powers. Similarly, A-76 recognizes that contracting out may not be feasible in some circumstances, e.g., the unavailability or unreliability of potential providers.[4] *Second*, A-76 examines the total cost of contracting out, not merely the price charged the federal government. Consequently, the cost comparisons include items that increase the cost of contracting out, such as contract administration, as well as those that reduce its cost, such as taxes paid by the contractor. *Third*, A-76 rightly focuses on *marginal costs*, the additional costs or savings that would accrue from taking a decision. Hence, administrative costs would be disregarded if contracting out of a specific service could be handled by the existing administrative apparatus. *Fourth*, A-76 can be utilized on a variety of levels, from eliminating an entire operation such as military base passenger transport to contracting out a more limited aspect of the service such as routine vehicle maintenance. *Fifth*, the time dimension of the contract needs to be considered. A-76 insists that planned and anticipated costs due either to negotiated contracts or potential inflation be included in the cost estimates. *Sixth*, A-76 recognizes the inevitable imprecision of all calculations that involve an element of uncertainty. Hence, the in-house estimate is accepted over the contractor's bid unless the latter is more than 10 percent below the former.

Finally, A-76 is very sensitive to insuring that equivalent services are being compared. Indeed, this consideration is so critical that it merits further comment.

B. Quality Comparisons

Quality has a number of dimensions. Some of them can be readily measured, others are more subjective in nature. A-76 requires that Performance Work Statements (PWS) be generated by the agency management, which fundamentally set the standards desired for both in-house and contracted performance.[5] Quantitative measures of work performance, where such can be applied, facilitate not only the writing of the contract but become the standards against which performance is evaluated. Thus, a PWS that mandates picking up children in a bus that meets government safety requirements and is operated by a driver who is properly trained and licensed and that limits the maximum amount of time from pickup to delivery to one-half hour not only provides the detailed information needed by the contractor to calculate its bid but also enables the agency to monitor performance after the contract has been awarded.[6] Far more troublesome are qualitative PWS, which, because of the service nature of many types of government operations, cannot be avoided. How does one calculate and then assess the performance of contracted medical services? Surely, the easily measurable "patients seen per hour" can be a counterproductive standard, since the presumed objective is obtaining optimum patient care, not mere throughput. Similarly, input measures such as "pupils per teacher" are easy to obtain but fail to capture the desired objective, namely, educational quality. On the other hand, "ensuring appropriate medical care" or "producing well-rounded, intelligent, and articulate pupils" are far too vague performance standards. Hence, a good deal of thought needs to be applied by those drawing up PWS to insure that the actual PWS are consistent with the desired outcomes and yet are sufficiently objective to

provide contractors with an appropriate base for calculating their bids.

It cannot be overemphasized that cost comparisons and hence the contracting out process cannot get off the ground without a clear PWS. Moreover, it would be absurd to evaluate the proposal of one party, adhering to one specification, against the proposal of a second party, responsive to a second set of standards. A-76 insists that a single quality standard apply to all parties involved in the bidding process, be they in-house providers or outside suppliers.

C. Flaws in A-76

Time flows. A minor flaw that needs to be pointed out will become relevant in the next section but needs no elaboration here. Although A-76 adjusts in-house expense calculation for future known and anticipated costs, it does not explicitly take into account potentially differing time flows. Since employees must be paid in regular intervals, while payments to contractors depend on contract terms and are likely to be more irregular, quite possibly contracting involves an implicit interest cost saving that ought to be subtracted from the total cost of the contract.

Low cost versus efficiency. Far more serious is the fault that underlies the entire A-76 methodology and is clearly reflected in Table 1: Low-cost service delivery alone is the criterion for contracting out. This standard may lead to woefully inappropriate policy decisions by failing to distinguish between cost and efficiency or productivity criteria. That they are not the same is marvelously driven home in the following purported review by an efficiency expert of Schubert's Unfinished Symphony:[7]

> All twelve violins were playing identical notes. This seems unnecessary duplication and the staff of the section should be drastically cut.... No useful purpose is served by repeating with horns the passage that has already been

> handled by the strings. If all such redundant passages were eliminated, the concert could be reduced from two hours to twenty minutes. If Schubert had attended to these matters, he would probably have been able to finish his symphony after all.

To which we may add: And at a considerably reduced cost! But clearly no one interested in music would take this seriously.

Economists view efficiency as an optimal relationship between inputs and outputs. An efficient production method is one that uses the least *physical* units of input -- be it people, machines, or a combination of the two -- to obtain a given quantity and quality of output. Since efficiency is a measure of physical input related to physical output, costs and prices are irrelevant. Thus, firm A that uses 3 workers and a 20-ton vehicle to collect 40 tons of solid waste on a given route per day is by definition as productive as firm B that employs a 2-person crew operating a 30-ton vehicle to collect the same quantity of waste in the identical time frame. Both are more efficient than firm C, which operates with three workers using a 30-ton garbage truck to pick up 40 tons per day. To be sure, comparing physical inputs often degenerates into the apples vs. oranges dilemma, and monetary values need to be introduced when evaluating which collection method shall be selected. In any case, choosing A or B will be the efficient, lowest-cost decision; the choice among them will depend on whether labor or truck usage is cheaper. On the other hand, firm C will never be more efficient than either of the others nor can its operation cost less in terms of resource use. When A, B, and C compete openly, then the nature of competition dictates that the inefficient will be weeded out and the most efficient survive. Hence, it is correct to presume that the low-cost bidder will be the most efficient bidder. It further follows that when competition prevails, the government is able to

achieve both a broader objective of stimulating economic efficiency and its narrower target of minimizing budgetary outlays.

In the real world, firm C might operate at a cost that is lower in dollar terms than A or B, and competitive bidding would reinforce C's advantage. Bear with the following strange assumption for a moment: C is a subsidiary of the garbage truck manufacturer and has been provided the vehicle at no cost, enabling the less efficient C to underbid its more efficient competitors, A and B. Efficiency and lowest-cost provision are no longer synonymous when C prevails. This same outcome occurs in a more realistic and familiar scenario when we assume C hires less expensive labor and thus is able to undercut A and B. The less efficient C nevertheless emerges as the winning bidder.

As a matter of fact, budget-conscious administrators will not be sensitive to this distinction. They are likely to ignore economic niceties that have little applicability to hard-nosed financial managers and focus instead on the bottom line. If C costs us less, contract out to C!

Their concern only with competition at the service level and not at the input level might prove inappropriate on both economic and equity grounds. The economic issue is relatively straightforward, for the crucial issue in this scenario is: What is the correct market cost of labor? If labor organizations so dominate the market and are able to obtain above-market returns for their members, then the lower wages of the nonunionized workers more closely approximate true competitive wages. Avoiding high wage employees, then, represents a procompetitive policy that leads to more efficient production now and ultimately to lower-cost output as well. On the other hand, if employers have the upper hand and are able to exploit

workers by paying them below-market wages, then an efficient allocation of resources dictates that the higher-cost workers. For ultimately, such decisions will restore the primacy of the competitive market and benefit the contracting agency in the long run.

This academic argument, however, is not terribly appealing to administrators facing hard budget choices now.[8] Moreover, officials contemplating contracting out are not privy to the internal operations and hence the efficiency of their potential contractors. They are simply faced by bids that presumably reflect a process that encourages efficiency. Nevertheless, they should be more sympathetic to a second economic issue that is relevant: the relationship between labor costs and labor quality. Much recent economic analysis had contended that compensation and labor quality are closely interrelated. (See Stiglitz, 1987) Indeed, the reason that employers are willing to offer higher wages and benefits stems from their perception that the employees they attract with these better terms are qualitatively superior. Public sector labor unions, who contend that contracting out will lead to the replacement of higher-paid unionized government workers by lower-paid non-union workers and that consequently service quality will deteriorate, are naturally sympathetic to this argument. They claim that low personnel costs inevitably are accompanied by low efficiency, and hence are not truly cost-effective.

The validity of this argument hinges partly on economic analysis and partly on empirical grounds. It can be formulated in a direct question: Does quality suffer when contract workers replace municipal employees? On the conceptual side, the argument revolves about market power. There is little reason to presume that quality and pay are positively related when the higher compensation results from the exercise of employee market power. Similarly, when lower wages follow from employer exploitation of employees, it is reasonable to

presume that quality will suffer as the incentive to produce efficiently is suppressed. On the other hand, the positive relationship is likely to hold when both employers and employees respond to market forces. Hence, deciding whether the higher wages are correlated with higher quality requires responding to the more abstruse economic issue of competition in labor and other input markets raised earlier. But it has a very practical application: *The possibility of quality-shading mandates that the contracting agency devote additional resources to monitoring.* (See Paroush and Prager, 1994.)

Virtually no studies deal scientifically with the empirical issue of whether higher-cost municipal labor compensation correlates with higher-quality output, although impressionistic literature is not lacking.[9] The exception is Stevens's oft-cited study (1984) of municipal versus contract costs, which found per hour labor costs of both government and contractor workers similar for similar-quality output but lower municipal contractor costs. Stevens attributed the lower contractor costs at least in part to the greater absenteeism rates of the municipal workers. But Stevens's definition of absenteeism encompasses not only employees missing for unjustified reasons but also those on vacation. Since government workers were entitled contractually to more vacation days than their contractor counterparts, their costs per function were also higher. Stevens' data demonstrates at least that the improved labor terms did not lead to higher quality output. However, even this conclusion needs to be qualified partly because of some methodological questions as biased sampling and partly because the major costs differences between contracted and municipally-provided services had more to do with organizational and managerial practices than labor costs (Prager, 1992).

This observation reflects, too, on the equity issue. Are fewer benefits, although cost-

reducing, fair to the worker?[10] Public labor unions defend their collective bargaining achievements by arguing cost considerations alone are too narrow a base for awarding contracts. The fundamental gains in pay and benefits, in reduced working hours, and in improved working conditions of unionized workers have become part of the nation's social conscience. It is unfair to undermine these gains by turning to contractors whose employees work under poorer conditions.[11] Of course, the counter argument points out that civil service unions have used their political muscle to obtain benefits far in excess of community fairness standards, so that the status quo cannot be taken to represent an optimal social contract. The point here, however, is not to engage in this debate, but to bring into the open an issue that is camoflagued by apparently objective cost comparisons.

This distinction between efficiency and low cost is not dealt with in the A-76 methodology, which includes contract price as a single entry. It does not mandate the agency to inquire further as to the source of the contractor's price submission.[12] Indeed, most Americans will be sympathetic to the federal government's position of limiting imports of foreign goods that are made with prison labor or the agitation to prevent the inflow of products made with child labor even though the products are, not surprisingly, considerably less expensive. The distinction between union and nonunion labor costs may be less blatant, but is merely a matter of degree, not kind. Less apparent are costs attributed to equipment and material, which may be obtained from a variety of low-cost sources that do not comply with accepted social norms and may even violate stated policy. Simply put, cost comparisons play a vital role in the contracting-out decision. But government decisions transcend financial considerations, since in its very essence government embodies the public will and needs to

consider certain basic elements of fairness.

Government employment policies may also encompass a social dimension. Government employment may provide a dignified substitute for welfare payments, may be more consistent with minority hiring goals and career advancement, and may provide for community stability by fostering financial security. Again, these are irrelevant when comparing costs and evaluating efficiency and are ignored in A-76 comparisons. But surely they are germane when the final decision must be taken.

In short, when operational efficiency between alternate delivery sources favors one option -- be it public or private delivery -- economic efficiency criteria dictate that the method using the least inputs to obtain the desired output be selected. That on occasion efficiency may conflict with budgetary criteria suggests that adhering to narrow budgetary criteria -- while it may be in the immediate financial interest of the decision-maker -- is not necessarily in the best interests of the economy. At the very least, decision-makers should be aware of this distinction, for it may open their eyes to broader community considerations. That is especially true when indirect budgetary considerations such as tax revenues or unemployment costs are ignored.

II. Adapting the Federal Contracting Methodology to Municipal Governments

In many respects, the contracting issues facing municipalities differ little from those facing the federal government. Hence, the A-76 methodology is applicable to a large extent to their contracting out decisions. Indeed, the Performance Work Statement is a *sine qua non* for undertaking comparisons between in-house suppliers and outside contractors. However, some adjustments are needed, primarily because options open to local citizens and government suppliers

on the local level differ from the federal government's national focus.[13]

The fundamentals. Table 1 sets the basic framework at the municipal level as well. Clearly, the contract price is the starting point, although the caveats of the preceding section need to be kept in mind. Contract administration costs come next. In this connection, it becomes crucial to ask: Does the locality already contract out a significant share of its operations so that a contracting mechanism is already in place? If so, will the existing mechanism suffice to *effectively* handle new contracting initiatives?[14]

Additional costs visualize expenses that the municipality would incur subsequent to contracting out such as the training of agency professionals to handle some of the monitoring tasks or travel costs that might arise as a consequence of using contractors (e.g., periodic travel by agency executives to meet with out-of-area contractors). Such costs that are merely one-time costs due to conversion to the contracted delivery mode are listed separately under "one-time contract conversion costs." In some instances, severance pay or retirement inducements would be included; in others, the calculations would have to incorporate one-time retraining costs as personnel is transferred within the local administration. So, too, the penalty for breaking a lease if such an action was required would be included as a one-time conversion cost. At times, conversion to a contracting mode of delivery might bring financial benefits rather than costs, as when supplies used uniquely by this agency are sold to the contractor. The same type of gain would be registered when materials such as heating fuel inventories are transferred to another City agency.

The most significant one-time charge is likely to be A-76's "Gain or loss on disposal/transfer of assets." The central idea is to account for assets that were necessary as long

as the activity was provided in-house, but will no longer be required if the activity were contracted out. For example, were the municipality to cease picking up solid wastes, the vehicles, garages, and ancillary equipment now used for these purposes would either be sold or leased to the private sector, possibly even to the contractor. These gains would reduce the costs of contracting.[15]

The final entry in Table 1, taxation, requires a more complex adjustment. The variety of taxes and fees paid by contractors -- income, licensing, real estate, etc. -- represent an income to the locality that offsets some of its contracting costs. However, not all contractors will be subject to the same type of taxes, nor the same tax rates. Often, contractors whose primary domicile is in the locality will be taxed at a higher rate than those who are resident elsewhere, and hence the reduction in costs to the municipality will be smaller in the case of the latter than the former. Similarly, the personnel used by contractors may be subject to different tax rates than those applied to municipal employees.

When considering contracting out municipal services that are either essential or critical, especially when no or only few experienced private sector counterparts exist, it might be necessary to maintain for a while some level of municipal operation. To be sure, these costs are transitional. The local government will abandon the activity to private sector entrepreneurs once the contractors prove successful at their tasks. Until that time, however, the duplication represents a cost of contracting out that must be included in the calculations.

The correct evaluation of contracting costs, then, requires the agency to calculate a host of costs and financial benefits that accompany contracting out. Only by including them all can the decision-makers obtain a true picture of the cost of contracting out.

Analysis of the in-house side would appear to be rather straightforward, since presumably the municipality knows the costs of its multifaceted activities. Unfortunately, that presumption is incorrect. Indeed, a major impediment to cost comparisons -- as will become clearer in the next section -- is the lack of appropriate data. One reason stems from the inherent conflict between an agency's budget and the budget of the activity under consideration. A New York City OMB draft cost comparison manual (1995) faces this issue squarely:

> Budgets are almost always structured in accordance with an agency's organizational units. They generally follow the agencies [sic] table of organization. These units all produce a variety of services. By contrast, most services are produced by a large number of different organizational units. Budgets are rarely organized along the lines of the actual process required to produce the service.

A related issue concerns the usefulness of budgetary data. The relevant data are actual outlays not budgeted allowances. Actual personnel outlays -- personal service costs and fringe benefit costs as well as such costs as overtime pay -- need to be calculated. To be sure, budgetary data may provide a useful starting point. No meaningful comparison, however, can be made without actual data on past outlays, actual staffing patterns, and nonpersonnel outlays, or, alternatively, accurate estimates of prospective costs.

Other specifically attributable costs include other than personnel outlays -- a smorgasbord of overhead and other operating costs. Overhead can be problematic if not properly addressed. Leases on office space, hospitals, child care centers and so on must be included only if they can be canceled or transferred to the contractor. They should not be included in the cost of internal provision if the municipality is locked in to the rental payments. The reason follows from the earlier reference to marginal costs: Only include those outlays that would be eliminated were the

operation to be transferred out of the public sector. The same applies to administrative overhead and capital expenditures that will not be reduced were the operation to be contracted out. Again, since these costs will not be reduced, they cannot be included as a measure of the savings derived from contracting out.[16] Finally, additional costs such as severance pay must also be included should such outlays be incurred upon closing down the in-house operation.

In fact, "additional costs" are one of the entries that require further adjustment, although it is easier to describe them than to calculate them. Much depends on the future of the released municipal workers. Few financial consequences follow if they are either absorbed by the contractor, can easily find similar-paying positions in the locality, or leave the area entirety.[17] On the other hand, repercussions on the economy of the area cannot be dismissed when the economic environment is bleak, emigration is not likely, and the contracting firm imports its own people. This is even more problematic when the dismissals encompass a good share of the employees in the area, and the income of the new employees is significantly less than that of the replacements. Some estimateable proportion of the newly-unemployed labor force will become a drain on municipal resources. Certainly a large number of unskilled, marginal workers will require various forms of public assistance. To be sure, much of the cost of the social safety net will be borne by the federal and state governments. Nevertheless, the cost to the municipality needs to be considered in calculating the costs of the contracting out decision.[18] Moreover, insofar as the contractors do not employ local residents, the amount of spending by employees with the locality falls, which may reduce local tax revenues.[19]

The multiplier effect. The administration must also pay attention to the multiplier effect when contracting takes on a significant proportion of the municipality's budget and employment. Total

spending power is likely to fall whether employment is cut or whether paychecks become smaller as a result of lower wages and benefits that follow service provision by outside contractors.[20] Unfortunately, as employee disposable income declines, so, too, will employee spending, and so begins a chain reaction of reduced outlays throughout the municipal economy. While any single employer and even a single municipal agency can ignore the multiplier effect, the municipality's budget as a whole cannot. The slowdown, if not the reduction in the spending chain will be reflected in a decline in local income and sales tax revenues, offsetting to an unknown, but estimateable effect the savings from contracting out.

The role of time. The typical contracting out case replaces ongoing municipally-produced services with external providers. One major difference between payments made to in-house personnel and contractors involves their timing. Compensation to municipal employees occurs either weekly, biweekly, or monthly, and must be paid on time. Contractors, however, are compensated at best for work in progress, although many contracts for finite projects leave the bulk of payment after completion and verification. Moreover, payment delays are not unknown. These two distinct cash payment patterns enable the municipality to save interest -- either by not borrowing or maintaining larger deposit balances -- under contracting out. The size of this saving, of course, varies with the difference in the flows as well as with interest rates.

The error margin. Finally, the municipality, too, realizes that these calculations are fundamentally inaccurate. The other costs on the contractor side of Table 1 as well as all of those on the in-house side are based on calculations that may themselves be partly flawed and on error-prone projections. Moreover, the contracting agency must take into account the possibility of "low balling," the practice whereby contractors submit unsustainably low bids to win the contract only

to request contract renegotiation at a higher compensation once the contract has been awarded.[21] Consequently, the municipal administrators must decide whether to rely on contractors' bids nonetheless or whether to adopt the federal government's practice of favoring the in-house provider. If the local leadership opts to grant an advantage to the existing municipal delivery mechanism, it must further decide whether to adopt the 10 percent margin of the federal government or select a different number. In light of the budgetary repercussions that are normally not addressed when calculating costs on an agency or department level and in light of fairness considerations, the authorities might want to consider a larger number.

III. A Case Study: Considering the Contracting Out of Group Homes

The authors were involved in a preliminary study undertaken to compare the costs of contracting out foster care services in a large urban city. The municipal government is responsible for providing care for children whose parents are unable or unsuitable to tend to them, and it does so through foster homes as well as via a variety of group residences. Some of the agency's activities are conducted exclusively through contracts with the local nonprofit sector, while others are performed in house as well. The objective of this study was straightforward: Would the locality save money by contracting out all of its foster care services? The study was to consider all costs in line with A-76, not merely the direct costs that the municipality would pay the contractor, but would not deal with nonagency repercussions. Fundamental to answering this question, of course, was the need to calculate the costs of the nonprofits vis-a-vis in-house provision. This section outlines the procedures used in this pilot study, for they may not only prove useful in themselves but also, in outlining the problems that were encountered, may lead other municipalities to revise their information systems and so obtain the comparative data with relative

ease. Clearly, no conclusion as to comparability can be reached if proper cost comparisons cannot be made, which, in fact was the unfortunate consequence of this still-born study.

We understood at the outset that defining efficiency would be a significant problem. For example, how should we interpret the significantly higher caseload of in-house social workers? Did that indicate greater municipal worker efficiency or, conversely, poorer municipal effectiveness? After all, we were seeking to evaluate costs *for equal quality care*. Moreover, how were we to understand the different compensation arrangements? Did the lower compensation paid by the nonprofits to their professionals represent exploitation and hence poorer quality inputs or were the higher-paid, organized municipal workers merely extracting a rent without providing any better quality? Were differences in the quality of the personnel such as education and prior experience sufficient to explain compensation differentials?

The quality of care issue. We decided that we could limit the problems associated with quality by choosing populations that at least on the surface were comparable. Hence, we selected as our sample small group residences housing no more than 12 teenagers, who were directly supervised by a cadre of house care personnel regularly supplemented by social workers and other professionals. Although we realized that no two children are alike and no two settings are precisely comparable to each other, nevertheless we felt that matching homes subject to identical objective parameters entitled us to presume that the two data sets would refer to reasonably comparable groups. Moreover, we presumed that any discrepancies in the quality of care were bound to be minor, since both the nonprofit-administered homes and those operated by the municipality were subject to state supervision, including rules that detailed number of children per caretaker and social worker (and even number of social workers per social work supervisor),

space per child, allowances for food, clothing, and personal expenses, and so on.[22] Nonfinancial audits of the nonprofits by outside consultants hired by the municipality supported this contention; criticism of the care provided was minor.

Nevertheless, our evaluation of quality was inadequate and only appropriate as a starting point. Had we been able to obtain useful cost data, we would have undertaken more than this surface verification of our presumptions. We would have examined more carefully variables that reflect a more sophisticated view of quality, for example, personnel turnover.[23] We would have had to refine the state's minimal standards to reflect actual practice.[24] Perhaps most important in light of the objective of foster care, we would have had to examine the differing providers' success rate at family reunion or adoption. Our conclusions would certainly have had to reflect, if indeed true, that one service delivery mechanism demonstrated a better adoption record insofar as that could be attributed to care delivery rather than external factors.

The data. Outlays by the nonprofit providers on both personnel and other expenditures were readily available, for the contractors, who are reimbursed by the municipality and (indirectly) by the state, are required to provide extensive detail on their outlays. We were able to obtain annual data for each facility, and presume (though we never reached this step) that we could relate the expenses both to the numbers of staff and the number of children in each home.[25] We were able to distinguish between those costs directly related to child care such as house parents and social workers and two types of overhead: overhead related to each group home (e.g., staff not directly associated with child care, rent, and insurance) and overhead related to the central administration of the nonprofit organization that ran the home. Overhead allocation decisions would have been relatively straightforward, keeping in mind that we would be concerned only with avoidable

overhead costs.

Our next step in calculating the cost of contracting out required that we examine the cost of operating the municipality's contract administration, being cognizant of the question we were facing: How much more, if anything at all, would it cost to expand contract administration to handle these extra group homes effectively? The key term here is "effectively." While it was not difficult to determine the costs of the contract administration unit, the critical problem was to determine the effectiveness of that process. Specifically, while contract writing, bidding, and letting procedures leave little room for flexibility -- after all, the contracts have to be composed and committed -- contract monitoring is open to greater discretion in timing and intensity. Indeed, adequate monitoring appears to be the exception, rarely the rule (Prager, 1994, pp. 181 - 182). In this particular instance, there was good reason to believe that the status quo reflected inefficient monitoring, primarily as a result of previous budgetary tightness that had led to disproportionate cuts on contract administration.[26] Hence, we began from an inappropriately low starting point, with, for example, contract monitoring personnel not related in any discernable way to the desired amount of monitoring.[27]

In truth, the small numbers involved in this pilot study in all likelihood would not have increased contracting costs. They could have been absorbed by existing staff, so that the marginal costs would have been immaterial. On the other hand, a more serious quantitative issue would emerge were the pilot study expanded to include a broader range of social services to be contracted out. An expansion in the contracting unit would be inevitable insofar as personnel and equipment are concerned, possibly space as well.

To turn to the in-house costs, the municipal budget office was able to provide us with

actual expenses for group homes in a variety of useful categories: rent, utilities, etc. However, running a group residence is heavily labor intensive, requiring 24-hour staffing, so that 75 - 80 percent of outlays are labor costs. The budget office could not provide us with actual outlays at the group residence level because the MIS consolidated expenses at a higher structural level within the agency. At best, we could obtain budgeted outlays and the budgeted staffing pattern, which listed the maximum expenditure and personnel. But we could not ascertain whether the maximum was exceeded as budgeted items not infrequently are or whether less was actually spent as some budgeted posts remained unfilled for any variety of reasons. Using budgeted data on the municipality side and actual spending and staff numbers on the nonprofits' side unfortunately would have led to meaningless apples-and-oranges comparisons. Even unsophisticated analysis runs aground without usable data.

The alternative of studying contracting out at a higher level of aggregation would have resolved the financial data problem, but it would have led to a no-less perplexing conundrum. Aggregate cost data are useful only were the policy-makers to consider eliminating the entire division with its multifaceted functions. One would then have to find suitable nongovernment agencies that provide similar services or, more likely, a variety of agencies that provide one or a few of the to-be-contracted services. Their cost and quality of care data somehow would then have to be synthesized into a meaningful comparable aggregate, a challenge that might well prove overwhelming.[28]

In short, cost comparisons can be made in principle, but not always in practice. They are more straightforward when the output is a physical commodity or one whose quality dimensions are relatively easy to specify. That is why studies of private-public cost comparisons in electricity

and solid waste are not difficult to find [e.g., the studies cited in Boardman and Vining (1989), Borcherding, *et. al.* (1982), and Domberger and Piggot (1986)]. Few have grappled with service provision where the output involves a significant subjective component. Yet, the very essence of many governmental functions especially in the social service area require comparisons predicated just on such subjective measures of quality.[29] Unfortunately, political ideologues have a field day when researchers cannot provide a plausible answer.

That is not to claim, however, that research in contracting out methodology has little to offer. The case study in the next section suggests that adhering even to simple principles can save municipal administrators from serious contracting errors.

IV. Erroneous Methodology: A Case Study

The case in this section is based on adjusted numbers to preserve the anonymity of the agency and city in question. It is a marvelous example how well-meaning municipal bureaucrats, following a form that apparently they did not understand, overstated the costs of in-house provision. Thus they violated one of the more obvious principles of the first section of this study, the focus on marginal costs, those costs that would be eliminated were the project to be contracted out.

Essentially, the contract to be let involved data entry onto a tracking system for child support. The RFP would specify types of data to be entered, the time frame within which entry must be completed, a security and quality assurance mechanism to be provided by the contractor, and a 3-year contract duration. A cost analysis was prepared to provide the municipal administrator with the costs of maintaining the data entry system in-house. Personnel presently involved consists of 13.2 full-time staff at annual total salaries of $331,278. Personnel costs rise

to $420,723 when fringe benefits of $89,445 are added, and when adjusted by a two percent salary increment, total $429,137 for FY96, the first year of the contract. Adding 2 percent for each of the next 2 years brings the 3-year in-house total personal service costs to$1,313,332.[30]

The calculation form breaks down the personal service estimates into 3 components: (a) staff currently performing the function who would be discharged under contracting-out, (b) administrative support staff performing the function who continue to be required even when the function is contracted out, and (c) staff that would have to be hired to meet, in-house, the productivity standards required of the contractor.

Category (c) is consistent with a common PWS. The in-house provider must be judged by the same performance standard as will the external bidder. Consequently, since the agency does not now meet the criteria to be imposed on a contractor, it must calculate the costs of meeting those standards. However, category (b) is totally irrelevant to the contracting out decision. Since these workers would be retained whether or not the data entry contract is let, no savings would accrue from the more than $100,000 budgeted for them. Hence, the total 3-year cost of contracting-in -- even if all the other calculations are correct -- is not $1,346,788, but $1,246,576.

To put this differently, presume that a contractor submitted a bid for $1,300,000. The methodology used by the municipality suggests that the contract be awarded, a most unfortunate error. Were the contract to be let, the agency would be spending $1.4 million, not the presumed $1.35 million. For in addition to the contracted sum, the agency would continue to spend $100,212 on the staff that would be retained even under contracting out.

The budget-oriented mentality of many government administrators suggests that this type of error is not uncommon. A more complete comprehension of the cost comparison process

surely would help in preventing such rather elementary errors.

V. Summary and Conclusions

Municipal administrators considering contracting-out option need go no further than the federal government's Circular A-76, which provides an ably conceived, practical methodology for evaluating the desirability of maintaining in-house provision versus using external service providers. A-76 guards against inappropriate contracting by insisting that all contract costs be included, not only the price charged by the contractor. Furthermore, A-76 goes a long way in specifying those costs, and distinguishes between those (overhead) costs that would be eliminated were contracting out implemented and those that would remain in any case. Finally, it emphasizes Performance Work Statements to insure that the costs compared refer to identical services.

Nevertheless, A-76 is flawed by a serious omission. It takes the price submitted by the contractor as a given without investigating the economic or equity implications of that price. Specifically, is the contractor employing productive resources -- labor or capital -- at below competitive prices? Alternatively, is the government provider being held captive by monopolistic resource suppliers? When the contractor is exploiting its market power to, say, keep wages down, then both economic and fairness arguments can be marshaled to suggest that the government exercise extra caution in evaluating provider costs. Below market wages might adversely affect the quality of the contractor's output and might call for additional monitoring expenses. Moreover, the higher compensation paid to government employees might represent the community's notion of fair wages for working people. Clearly, rejecting socially-approved goals involves far more than financial analysis. Of course, the opposite may be equally true: government workers may be overcompensated. Then, selecting a lower-costing contractor not only eases the

financial burden on the citizens but sets into motion forces that weaken the power of the labor monopoly. In any case, financial decisions need to be taken within the proper context of the multifaceted role of government. At the minimum, the municipal authorities ought to assure themselves that not only does competition prevail among the providers who bid for the contract, but also in the resource markets in which the suppliers acquire the inputs they will use to provide the contracted service.

While the methodology of A-76 can be easily adapted to the needs of municipal authorities, a few differences emerge. The ability of the local economy to absorb the government employees released subsequent to contracting out is important, since the unemployed, should they not emigrate, will drain funds from the local social safety net budget. Moreover, depending on relative spending differences of the contractors and their employees as well as the magnitude of the contracting-out effort, the local economy may experience a net spending drain with repercussions on local tax revenues.

Two cost comparison studies were also examined in the article. In the first, the costs of foster group homes were to be evaluated in a sample that contained residences operated by nonprofit institutions as well as by the municipal authorities. In addition to possible problems relating to the quality of care, the major stumbling block that led to abandonment of the study was simply the absence of cost data on the municipality's side. Strange as it may seem, the municipality's MIS system could not provide the actual costs of operating in-house foster homes. In addition, defining and costing-out *effective* monitoring of the contractors remains an issue that local authorities must grapple with seriously. In all too many instances, monitoring of contractors is deficient.

The second study highlighted another problem -- the inclusion in the costing of the in-house alternative of activities that would continue to be undertaken by the municipality even after contracting out the basic service. Such an erroneous procedure weighs against in-house provision and consequently induces more costly decisions.

As this article has shown, public-private sector cost comparisons requires resolving both conceptual and empirical issues. Moreover, even when those tasks are completed, additional policy issues, especially equity ones, remain to be settled. Municipal authorities might find it worthwhile to perform a detailed cost comparison study on a limited number of activities that are being considered for external supply. This would provide them with a benchmark against which to consider other activities. At the very least, requiring a performance work statement would enable the authorities to assess existing performance standards. A PWS review also provides the local government with a unique opportunity to consider more precisely the performance standards that it wishes to achieve. With the benchmark study in hand and with a sense that the major input cost, labor, operates in a competitive market, the municipal authorities might seriously consider following the A-76 lead and providing in-house supply with a 10 or possibly even a 15 percent margin. Although this added margin would stack the deck in favor of the status quo, it also protects the municipality against precipitous judgements whose long-run harm could overshadow its short-term benefits.

Notes

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1. The explanations of the terms in the next 2 paragraphs are all from OMB (1983), Chapter 2.

2. Fringe benefits are calculated at 29.55 percent of salaries. Actual outlays on fringes would be a more appropriate datum for this calculation.

3. The *Handbook* recognizes explicitly that administrative savings depend on the extent of the function to be contracted out. In some instances, the overhead will remain unaffected, while in others, the overhead savings will extend a good way up the organizational hierarchy. See pp. IV-30.

4. Furthermore, no government entity would contract out vital services that might be disrupted by the bankruptcy of a contractor or the possibility of a prolonged labor-management dispute.

5. The PWS specifies "output requirements, ... performance standards and a quality assurance plan to ensure a comparable level of performance for either an in-house or contract operation." (OMB, 1983, pp. IV-1,2).

6. That, of course, does not preclude the monitor from overlooking circumstances beyond the control of the contractor, e.g., severe, unusual traffic congestion. Furthermore, other PWS specifications such as bus cleanliness are difficult to specify in measurable terms. Hence, an element of subjectivity creeps in even under apparently objective standards.

7. Attributed to Lord Barneston in *The London Observer.*

8. It should be pointed out that the argument made here is far more appropriate at the federal level. (We turn to the local government in the next section.) Furthermore, this issue is rarely addressed at the national level simply because each federal agency is concerned with its budget, not with the efficiency of the entire economy nor even with that of the government.

9. However, monitoring of the results is questionable and again is more impressionistic.

10. At least part of the answer to this question hinges on financial considerations. While Circular A-76 considers the taxes paid by the contractor, taxes are also paid by workers. A savings in labor costs translates directly into less employee income, which translates indirectly -- and probably disproportionately when government relies on a rising marginal tax rate -- into lower tax revenues.

11. It is widely accepted that union busting was an implicit component of the privatization reforms of the government of Margaret Thatcher in Great Britain during the 1980s.

12. To be sure, government employees are protected against egregiously unfair competition by contractor labor, since the contractor must normally comply with minimum wage laws as well as laws regulating

overall working conditions. Moreover, on the federal level as well in some states, laws mandate contractors to pay prevailing wages. However, these protections are far from water-tight. They are not universally applicable nor does the law require that contractors' fringe benefits conform to community standards.

13. The next section discusses some of the practical problems of applying these general principles.

14. The importance of effectiveness in contract administration cannot be overemphasized. A poorly administered contract can be far more costly than internal municipal provision. And while existing staff may often be able to expand their oversight responsibilities through internal operations reforms, intensifying use of existing resources has its limits.

15. Two caveats. First, the presumption is that the assets are worth something. Possibly obsolete equipment now in use (outdated and unupgradeable personal computers, for example) that could not be sold would be deemed worthless even if, according to the accounting records, their initial cost had not been fully depreciated . Second, the cost of disposal would have to be included (e.g., brokers' fees on property sales).

16. This statement is directed against the tendency to allocate overhead among the various users of those overhead resources. Though this procedure is valid in general accounting and budgeting decisions, it is totally inappropriate in the contracting out vs. in-house decision.

17. Some contracts insist that the contractor employ, at least for a time, the workers no longer needed by the locality. The bid, however, should reflect this constraint, especially when the contractor deems it a disadvantage.

18. Certainly, the magnitude of the problem depends on the magnitude of the contracting out effort. The impact of reducing the municipal labor force by ten percent is proportionally stronger than cutting back on employment by 1/10 of a percent.

19. In a type of worst-case scenario, one can visualize the contractor replacing highly-paid local residents with nonlocals who not only reside out of the area but whose families remain at home. The contractor's employees may spend some of their income locally, but surely the bulk of it will be spent out-of-area.

20. The argument presumes that the savings will be used to reduce budget imbalances rather than distributed to local residents in the form of a tax cut. Were this not to be the case, spending by the tax cut beneficiaries is likely to largely offset the spending of the formerly employed municipal workers.

21. Savas denies the widespread nature of low balling, although he does not deny it might happen in any particular instance. Note, however, that Savas's definition differs from ours. Savas finds little evidence of "a very low bid submitted by a contractor whose intention is to win the award, make the government dependent upon him, and then raise price when it is time to renew the contract." (p. 262) On the other hand, we have no information on renegotiations during the life of a contract for which the winning bid was insufficiently high to carry the contract specifications to completion.

22. Municipal personnel claimed that their population was likely to be more difficult, since the nonprofits retained the more manageable children and passed on to them the more troublesome ones, a contention denied by the nonprofits.

23. Greater stability in personnel implies less disruption in interpersonal relationships and hence better care.

24. Costs would be higher but so would care quality if the ratios of say, space per child were greater or if board-certified physicians were used instead of less-qualified medical personnel. Similarly, staff education, both on entry and for continued training, that exceeded minimum state educational requirements would have to be accounted for.

25. Although we obtained this data from the municipality, the nonprofits were more than willing to provide it as well. They were convinced that they would prove to be the low-cost provider.

26. The decision to concentrate budgetary cuts on central administrative staff and costs as opposed to service delivery and staff that was on the line might well have been the correct one from a policy point of view. But it is irrelevant when considering how to properly calculate monitoring costs. Were this not so, why not simply shrink costs even further by eliminating monitoring entirely?

27. It may be that the nonprofits require less monitoring than do for-profits. Conversations with representatives of the nonprofits suggest that this might be so, especially since a substantial percentage of the nonprofits involved in this particular case were religious organizations imbued with a mission of providing quality care to their charges. Our point is that we have seen no evidence that any significant amount of thought has been devoted to the appropriate amount of monitoring. Indeed on conceptual grounds, the differences between profits and not-for-profits might be insignificant. See Prager (1994, p. 182).

28. Assume the agency is responsible for child care and housing the homeless. Assume also that sufficient outside contractors exist in both child care and homeless housing areas. Further assume that it costs $100 a day to care for an average child and $25 to care for an average homeless person, while it costs the municipality $145 per day for operating the division. Because each activity, however, has unique quality standards one simply cannot add the two numbers to claim that an external supplier would provide equal quality, less costly care at only $125 per day. We could not conclude that the contractor is more efficient than the municipal provider.

29. Some progress has been made in this area. See, for example, Hatry *et. al.* (1979), Mukerjee and Wine (1992), and Price, Chaffee, and Mozenter (1989).

30. The "Other Than Personal Services" cost components add another $167,280, of which $147,600 (88.2%) are supplies and materials. The estimates are based on a precedent of $850 per staff member, an apparent rule of thumb that lacks an obvious logical basis. Moreover, the entries for energy and telecommunications are left blank as is space rental and equipment cost. Are we to assume that the present data entry operations used no energy, telephones, space, and equipment? In any case, we focus on personnel costs, which account for 97.5 percent of all costs.

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