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The Dangers of Over Insourcing

Finding higher performance at lower costs



Insourcing: A Capitol offense. Photo: Martin Jacobsen

THE 1990s ushered in a new era for the United States military. Although the Cold War ended peacefully, it was able to quickly deploy its still intact Cold War forces to eject Iraqi forces from Kuwait in 1991. Then, with no significant threats on the horizon, the United States was ready to reap a “peace dividend.” So began a significant reduction in the military force structure and in defense spending.

As a result of declining defense budgets, it was natural that the Department of Defense (DoD) would make significant cuts in its overall acquisition workforce. Congress, believing that the acquisition workforce was still too large, mandated a further cut of 25 percent in the FY 1996 Defense Authorization Act. As result of these cuts, the overall acquisition workforce fell from approximately 500,000 to around 200,000. Then, even as the defense budget began to level off and then skyrocket after the events of 9-11

and the subsequent wars in Iraq and Afghanistan, DoD’s acquisition workforce stayed essentially constant. Moreover, this post-Cold War downsizing of the DoD occurred at the same time as a government-wide trend of improving performance while lowering costs. This included an emphasis on transitioning the performance of “non-inherently governmental” functions to the competitive private sector (including many acquisition, but non-inherently governmental, functions – such as equipment maintenance, truck driving, analysis, etc.). DoD became reliant upon private contractors to perform many of the support roles critical to the success and sustainment of the military forces.

The Obama administration came into office with the belief that this trend had gone too far, and that there were too many contractors. It pledged to reform federal contracting and reduce the number of contractors. Secretary of Defense Robert M. Gates provided greater detail for the DoD in a statement explaining the department’s budget:

“A final recommendation that will have a significant impact on how defense organizations are staffed and operated. Under this budget request, we will reduce the number of support

service contractors from our current 39 percent of the workforce to the pre-2001 level of 26 percent and replace them with full-time government employees. Our goal is to hire as many as 13,000 new civil servants in FY10 to replace contractors and up to 30,000 new civil servants in place of contractors over the next five years.”[1]

The rationale for in-sourcing was based on two points. First, there was a real concern, particularly in regard to the understaffed acquisition workforce, that contractors were in fact performing inherently governmental functions. Second, even in the face of evidence to the contrary, there was a strong, intuitive belief that government employees could perform many of the contracted-out functions at a lower cost.

DoD’s initial plan was to use this “in-sourcing” initiative to remedy some of the recognized shortfalls within the DoD’s acquisition workforce. The impact of “in-sourcing” on the acquisition workforce could have been positive and significant if undertaken in a strategic manner, reducing the recognized shortages within the acquisition workforce and ensuring that contractors were not performing inherently

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governmental functions. As of March 2010, however, only one third of the positions DoD identified for in-sourcing fell into the inherently governmental or “critical skills” categories, while the remaining positions that were to be in-sourced were based on cost assessments and other considerations, as outlined by the Deputy Secretary of Defense memorandum.[2]

One can assume that cost savings were the primary motivation, since as part of the guidance provided by the DoD Comptroller, subordinate organizations were to assume a 40 percent savings for each in-sourced position. In fact, the guidance indicated that “for every contract dollar decreased, 60 percent was returned for civilian pay for the conversion and 40 percent was retained by OSD.”[3] These projected savings were based on the faulty logic of comparing the fully burdened contract cost with only the direct cost of the in-sourced civilian employees; as a result, these projected savings will unfortunately never occur.

When making cost comparisons between the different sources, one must take care to ensure that one is in fact comparing equivalent costs. Rarely is it appropriate to compare government hourly labor rates with the fully-burdened, billed contractor labor rates, or with the cost of procuring a comparable service from a contractor. To make that comparison one must also include all of the associated indirect and overhead government costs. There have been several authoritative studies that have concluded that the full cost of government employees or military personnel is at least equivalent to, if not significantly more than, the contracted support. The Congressional Budget Office, for example, when analyzing logistics support for deployed military forces, concluded that “over a 20 year period, using army military units would cost roughly 90 percent more than using contractors.”[4] Additionally, the Congressional Research Service wrote that “using contractors can save DoD money,” and “hiring contractors only as needed can be cheaper in the long run than maintaining a permanent in-house capability.”[5] The rationale behind expanding the workforce to ensure that there are enough government employees to perform all of the inherently governmental functions is sound. This should be undertaken in a strategic manner to reduce the recognized shortages within the contracting workforce (with employees that have the needed

skills and experience). For those positions that must really be performed by federal employees, cost should not be the determining factor.

Recent implementation, however, has been far from disciplined or strategic. Indications are that it has turned into a quota-driven numbers game promising unachievable cost savings. The DoD-published guidance for estimating and comparing costs of civilian, military and contract support provides some direction, but has shortcomings. For overhead costs, for example, the memorandum provides alternatives to consider, but there is no specific structure designed to be followed.[6] Further, because of the inadequacy of DoD’s internal cost accounting system, government overhead costs are difficult to adequately capture and allocate. As a result, these cost comparisons do not fully capture the full cost of the in-sourced employee to the government. When making the case for in-sourcing non-inherently governmental positions, the decisions must be based on sound analysis, examining differential performance, applicable costs, and availability of skilled workforce.

After a year of implementation, with the in-sourcing of approximately 3300 employees, the Department was not seeing the level of savings they anticipated. As a result, Secretary Gates cancelled the in-sourcing initiative; he froze the number of employees inside the Office of Secretary of Defense, military agencies and combatant commands at their fiscal 2010 levels for the next three years. Secretary Gates developed a new approach to reduce spending on service support contractors. The approach was to direct all agencies to reduce their spending on service support contractors by 10 percent in each of the next three years.

As we near the end of the first decade of the 21st Century, the United States faces a diverse set of trials that include a prolonged economic recession, significant budget deficits and continued threats to security – at home and abroad. At the same time, the United States is also struggling to transform and modernize its military forces – and their business systems –, so they can effectively provide the capabilities required for the future national security environment. The current proposals to roll back the use of contractors that support DoD’s operations are based on the notion that contracting for private sector skills

and expertise is inefficient, and in some cases wasteful. It also assumes government managers lose an element of control over their workforce. Both of these premises are false. Rolling back contractor use ignores the demographic and budgetary realities of why contractors were increasingly employed in the first place. All trends support the contrary approach – greater public-private partnering. When government organizations have partnered with the private sector firms for non-inherently governmental work, they harnessed the disciplinary power of market-based competition, and, as a result, gained significant cost and performance benefits.

Government employees, of course, are necessary for those narrowly-defined inherently governmental functions. For non-inherently-governmental functions, however, government should continue to shift from being “the provider of goods and services” to becoming “manager of the provider of goods and services,” unless government employees can do them more efficiently and effectively than their private sector counterparts (as demonstrated through public-private competitions). In fact, when non-inherently governmental work is competed between the current government workforce and the private sector, (known as “competitive sourcing”) there is a significant cost savings, even when the public sector wins. The competitive market really works – getting higher performance at lower costs. Let’s use it! ■

Endnotes

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