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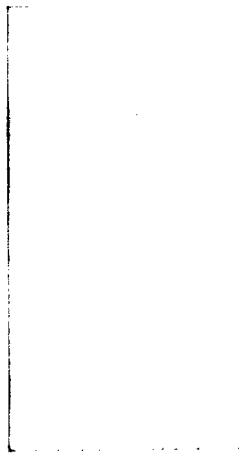
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**Wright-Patterson Air Force Base, Ohio**

AFIT/GCM/LAS/98S-8

OUTSOURCING: AN HISTORICAL REVIEW  
FOR THE PROJECTION OF  
FUTURE SAVINGS

THESIS

Leslee J. Saleck, Captain, USAF

AFIT/GCM/LAS/98S-8

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The views expressed in this thesis are those of the author  
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Department of Defense or the U.S. Government.

AFIT/GCM/LAS/98S-8

OUTSOURCING:  
AN HISTORICAL REVIEW FOR THE PROJECTION  
OF FUTURE SAVINGS

THESIS

Presented to the Faculty of the School of Logistics and Acquisition

Management of the Air Force Institute of Technology

Air University

Air Education and Training Command

In Partial Fulfillment of the Requirements for the  
Degree of Master of Science in Contract Management

Leslee J. Saleck, B.S.

Captain, USAF

September 1998

Approved for public release; distribution unlimited

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Leslee J. Saleck

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**Abstract**

Because of continuing budget and personnel limitations and the need to fund weapons modernization, the Department of Defense has increased its emphasis on outsourcing support activities. Recent studies have suggested that aggressive outsourcing of support activities by the DoD could produce billions of dollars in savings. The overriding purpose behind this research was to determine to what extent projected savings can be substantiated. To explore the potential for savings, this thesis examines the evolution and impact of outsourcing and privatization in both the private and public sectors. Next it looks at the experiences of the private and public sectors to identify characteristics of successful and unsuccessful outsourcing ventures. Finally, it examines the Department of Defense's past experience in achieving cost savings through outsourcing. The study uses the archival and historical research methods to collect, analyze, and evaluate research data. These methods were selected to provide historical and current information on outsourcing and privatization efforts.

The research revealed that savings have occurred through outsourcing. The most successful initiatives occur when the following conditions are present: (1) the work to be done is specified unambiguously; (2) several potential producers are available; (3) the government is able to monitor the contractor's performance; and (4) appropriate terms are included in the contract document and enforced. DoD's previous outsourcing experiences suggest that projected

savings from current and planned initiatives may be overstated. The DoD must continue to research and analyze the impacts outsourcing will have on its ability to meet national security commitments.

# OUTSOURCING: AN HISTORICAL REVIEW FOR THE PROJECTION OF FUTURE SAVINGS

## I. Introduction

### **Background**

The end of the Cold War was a landmark event that altered the definition of national security as well as the related missions of the Federal Government, especially that of the Department of Defense. The United States no longer faces the prospect of a long and protracted conflict with another superpower. Instead, we now look to fighting two simultaneous regional conflicts. In response, the American defense policy has changed dramatically and the defense budget has been drastically decreased. As early as the mid-1980s defense spending began to decline, and the reductions accelerated after November 1990 with the passing of the Budget Enforcement Act (GovExec, 1992). This was the beginning of the drawdown where we saw the withdrawal of troops from overseas, force reductions in both military and civilian personnel, base closures, and termination or reduction of major weapon system procurements. Then in September of 1993, Vice President Gore put out the National Performance Review expanding the administration's downsizing goals to 252,000 positions over five years and proposing the reinvention of Government. It is now 1998 and we are still

downsizing and we are still trying to figure out the best way to reinvent or reengineer Government.

### **Modernization Money**

In March 1996, the Department of Defense published a report entitled "Improving the Combat Edge through Outsourcing." It cited three major challenges that the DoD must face in the post-Cold War era: (1) readiness, (2) quality of life, and (3) modernization. These three priorities compete with each other for limited resources in light of the declining defense budget. Modernization, though, appears to be in the lead. Funding for equipment modernization has fallen from a peak of \$126 billion in FY85 to only \$39 billion in FY96, a decline of 69 percent (Defense Science Board, 1996:10A). In a February 1996 memo, Deputy Secretary of Defense White stated that the commitment to maintaining a modern and ready force will require increased funding for the modernization of our equipment and systems (White, 96). Specifically, Secretary of Defense Perry called for a \$60 billion increase in modernization efforts. Though Congress may potentially pay for approximately \$40 billion, this leaves the services to cover \$20 billion or about \$7 billion per service. The current environment dictates that the Defense budget will not be increased to accommodate this priority, thus the money must come from within the existing budget.

For fiscal year 1997, the DoD estimated that about two thirds of its budget, approximately \$146 billion, would be used for operations and support activities

(GAO, Challenges Facing, 1997:1). These activities include maintaining base facilities, health care, repairing equipment, and buying and managing spare parts inventories. "DoD recognizes that its support structure is inefficient and that its costs continue to absorb a large share of the defense budget and diverts funding that could be used for modernization" (GAO, Challenges Facing, 1997:1). The Defense Department has implemented various initiatives in the past to reduce costs, such as base closures, the National Performance Review, and the Defense Management Review. Most recently, the Defense Science Board and the Commission on Roles and Missions have made outsourcing and privatization the foundation of their proposed initiatives.

According to Colonel Michael Collins, Chief of the Air Force Office of Outsourcing and Privatization, the Department of Defense "needs a revolution in business affairs to support the evolution in military affairs" (Collings, 1996:1). Outsourcing and privatization is the proposed "revolution" for the Defense Department and has been publicly accepted by the Clinton administration as the way to offset the shrinking defense budget and the cost of required force modernization.

### **Current Policy**

It has long been a general policy of the DoD to rely on the private sector to supply the goods and services needed when the private sector can provide them more efficiently. Outsourcing and privatization offer the prospect of lowering costs and improving performance across a wide range of support activities. We

must make use of the competition inherent in these markets to foster improved quality and increased efficiency.

In October 1996, the Defense Science Board stated that the military can save \$7 to \$12 billion annually by utilizing outsourcing and privatization and suggested that any support service that is not conducted in front-line battlefield military operations should be considered for privatization (GovExec, Oct 1996). Thus the Air Force, and all of the DoD, is currently undertaking an effort to expand its use of outsourcing and privatization by obtaining more of its support services from outside sources.

At the beginning of fiscal year 1996, DoD officials estimated 37% of its workforce associated with commercial activities had been outsourced. The Air Force, Army, and Navy estimated that they had outsourced 64, 32, and 31 percent, respectively, of their commercial activities workforce. Through the year 2003, the services plan to study the following positions for potential outsourcing (GAO, 1997a: 5-6)

Air Force	60,000
Army	26,000
Navy	80,000
Marine Corps	5,000

### **Problem Statement**

In an era of reduced defense spending and limited resources, the Department of Defense must look for ways to improve efficiency and cut costs

while maintaining capability to support critical national interests. Under these circumstances, the DoD is looking to outsourcing and privatization as the avenue to accomplish this task.

Outsourcing and privatization, however, involve much more than a simple shift from in-house performance to contractor performance. There needs to be an efficient process by which to evaluate and accomplish the transfer. There should also be some type of measurement to evaluate the savings incurred through this process. Currently, the Office of Management and Budget mandates that the DoD use the cost comparison process covered by its A-76 Circular. However, there is nothing in place to determine if, in fact, organizations are receiving the same level of service after conversion to contract. Additionally, there is no mechanism to consistently measure cost growth that may occur after contract award.

This study examines the existing literature to determine if the data and analysis on past efforts provides sufficient support to believe that the estimated cost savings will be realized as more efforts are outsourced or privatized. It is imperative, because of the rapid rate at which outsourcing is progressing, to determine if it is truly the most cost effective way of doing business.

### **Research Objective**

The primary research objective is to review studies and analyses of past and present outsourcing and privatization efforts as a means of concluding

whether or not the increased use of outsourcing and privatization will produce the needed savings for modernization and increase operating efficiency.

The research investigation consists of a literature review of both historical and current information related to the use of outsourcing and privatization in the private sector, the public sector, and the Department of Defense. This study investigates the potential of achieving the proposed savings.

### **Investigative Questions**

Investigative questions were designed to focus the research effort on past, present, and future trends in the use of outsourcing and privatization. The literature review will examine the following aspects of the issue:

1. How has the practice and utilization of outsourcing and privatization evolved in both the private and public environments?
2. What are the characteristics of successful and unsuccessful outsourcing ventures in the public sector?
3. To what degree can the advertised savings be substantiated by past DoD outsourcing efforts?

### **Definition of Terms**

To allow for a common basis of understanding, definitions of the following terms are provided:

Commercial Activity. A commercial activity is an activity that provides a product or service obtainable from a commercial source. A commercial activity is not a governmental function (AFP 26-12, 1992).



Inherently Governmental Function. An inherently governmental functions is “a function that is 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 judgments in making decisions for the Government” (OFPP Policy Letter 92-1, 1992).

Outsourcing. The Government retains ownership and control over operations of the activity through surveillance of the contract. The primary method of outsourcing activities is through cost comparison procedures designed to determine the most efficient and cost effective operation.

Privatization. The process of changing a public entity or enterprise to private control and ownership. It does not include determinations as to whether a support service should be obtained through public or private resources, when the Government retains full responsibility and control over the delivery of these services (OMB, 1996: 37).

## **Chapter Summary**

Because of continuing budget and personnel limitations and the need to fund weapons modernization, the Department of Defense has increased its emphasis on outsourcing support activities. Recent studies have suggested that aggressive outsourcing of support activities by the DoD could produce billions of dollars in savings.

This thesis discusses the development and implementation of outsourcing and privatization in the private sector, the public sector, and the Department of Defense. Additionally, it examines past and present practices of the DoD in order to determine to what extent projected savings can be substantiated.

## II. Methodology

### **Chapter Overview**

This study is concerned with the Department of Defense's initiative to greatly increase the use of outsourcing and privatization to perform commercial activities. Chapter I provided the general background for the current emphasis on this practice and introduced the purpose of the research. The initial literature suggests that the use of outsourcing and privatization will produce great cost savings for modernization and allow the Department of Defense to operate more efficiently. This study, through the use of qualitative methods, attempts to investigate the basis for the idea that these savings will be realized. This chapter, the methodology, describes the research process that was carried out to meet the research objectives defined in Chapter I. It reports the methods of research selected to satisfy the research objective and provides justification for choosing these methods. In addition, it takes the reader through each step of the research, or data collection process, giving a step-by-step account of how information was gathered.

The chapter begins with the research approach. Here, the research strategies used to collect and review data for the thesis are explained. Two strategies were chosen to meet the research objectives: archival and historical analyses. Both analyses acquaint the reader with what is being analyzed. Following the approach is the justification, which explains why these particular research methods were selected.

The third part of the methodology is the data collection process, which describes how the research was carried out. It discusses the steps taken to gather information on outsourcing and privatization, present it, and report any significant findings. It ties each section together, presenting a summary of the investigation process used to assess the state of the current outsourcing and privatization initiative.

### **Research Approach**

Another way of referring to this section is the research strategy. This strategy represents the approach taken toward selecting different sources and types of information so that questions can be answered through research. "The most important condition for selecting a research strategy is to identify the type of question being asked" (Yin, 1989:19). In this case, the types of research questions being asked are explanatory in nature and elicit qualitative responses.

Qualitative research, as defined by Strauss and Corbin, is "any kind of research that produces findings not arrived at by means of statistical procedures or other means of quantification" (Strauss and Corbin, 1990:17). They emphasize that qualitative research is not the quantifying of qualitative data gathered by means of interview or observation. Rather, qualitative research is a "nonmathematical analytical procedure" that results in findings from data gathered through a variety of means, including document analysis, interview, observation, etc. (Strauss and Corbin, 1990:18).

Creswell states that qualitative research is descriptive in nature with the researcher focusing on process, meaning, and understanding gained through words or pictures (Creswell, 1994:145). He adds that qualitative researchers use this method to explore a topic when the variables and theory base are unknown (Creswell, 1994:146). Additionally, he quotes the following characteristics of a qualitative research problem from Morse (1991):

(a) the concept is "immature" due to a conspicuous lack of theory and previous research; (b) a notion that the available theory may be inaccurate, inappropriate, incorrect, or biased; (c) a need exists to explore and describe the phenomena and to develop theory; or (d) the nature of the phenomenon may not be suited to quantitative measures.

According to Creswell, the nature of the problem and the amount of existing information are important factors in deciding whether certain problems are more suited for a quantitative or qualitative method. He provides the following guidelines in helping to decide on a particular approach:

For quantitative studies the problem evolves from the literature, so a substantial body of literature exists on which the researcher can build. Variables are known, and theories may exist that need to be tested and verified. For qualitative studies the research problem needs to be explored because little information exists on the topic. The variables are largely unknown, and the researcher wants to focus on the context that may shape the understanding of the phenomenon being studied. In many qualitative studies a theory base does not guide the study because those available are inadequate, incomplete, or simply missing. (Creswell, 1994:10)

The use of qualitative technique in this study is most appropriate because these methods can contribute to practical problem solving, decision making, action research, policy analysis, and organizational development (Patton,

1990:94). Furthermore, qualitative research can evaluate the problems, identify the areas that can be influenced by the policy maker, and show the consequences of policy intervention (Marshall and Rossman, 1989:16).

Thus, the research conducted was qualitative research that focused on how the commercial activities program evolved in the past, what its status is today, and where the program is headed. By organizing the research around past, present, and future outsourcing and privatization issues, a strategy for the research process was developed. There are several different types of qualitative research strategies. To meet the research objectives of this thesis, however, the selection was narrowed to two qualitative strategies: archival analysis and historical analysis. The reason these strategies were selected above others is directly related to the overall historical qualities of the thesis. Theories linked to choosing these strategies to meet research objectives are described below.

Archival research is any research in which a public record is the unit of analysis (Dane, 1990:169). The use of this method involves collecting information concerning research objectives. By selecting archival analysis, the researcher could explore various public records and government documents. The exploratory nature of an archival analysis is appropriate for this research task (Yin, 1989:17). Congressional reports, General Accounting Office Reports, Inspector General Audits, and budget studies serve the purposes of archival analysis to the extent that they contain information on policy, programs, and trends that explore what has happened of significance in the development of outsourcing and privatization. The archival analysis proved to be an important

and productive research strategy, as the answers to the research questions substantially drew upon information contained in public record and historical sources.

Historical research involves the process of collecting relevant historical data and examining their inter-relationships. Interrelationships are appraised and, through the process of synthesis, key elements of data are combined into a coherent document that clearly describes past events to meet research objectives (Social Science Research Council, 1954:157-159). The historical method involves searching public record, literature, documents, reports, and any other medium that contributes relevant information (Dane, 1990:169).

The historical analysis is a valuable approach to conducting qualitative research for this thesis, as it seeks to trace events over time in a descriptive and explanatory manner (Schmitt and Klimoski, 1991:122). Since these events are a part of history, they can only be described, not changed. The researcher, therefore, has little flexibility using this strategy. Nevertheless, a historical approach is instrumental in uncovering past events to chart the evolution of outsourcing and privatization. In addition, a historical analysis provides an accurate account of how outsourcing and privatization practices have unfolded. It accomplished this objective by examining the relationships among events and creating a timeline for progress. The current status of outsourcing can be better understood by tracing this timeline of events, because each new program, policy, legislation, or practice introduced over time has influenced the nature of outsourcing and privatization today.

The method of research used to gather information on historical and current outsourcing and privatization issues, as well as soliciting facts and opinions about the future of this practice is the literature review. Various texts, reports, periodicals, briefing documents, handbooks, manuals, magazines, pamphlets, Internet sources, and regulations were consulted. A study of pertinent information sources disclosed the history of outsourcing and privatization utilization in both the public and private sectors. In addition, this review includes a discussion of up-to-date policies and programs that are at work today influencing public sector management.

The practice of combining methodologies to study the same phenomenon or program is known as “triangulation” (Patton, 1980:187). Usually, the motivation for using triangulation in a study is to strengthen the approach or design. The research conducted for this thesis incorporated data triangulation, which occurs when a diverse number of data sources are used in the study (Patton, 1980:187). Data triangulation involves using both primary and secondary sources to meet the research objectives. Primary data sources are original or first-hand sources of information such as original documents, eyewitness accounts, public records, and personal interviews. Secondary sources are described by Mozden as “studies done by others as either historical accounts and interpretations or as contemporary views” (Mozden, 1964:15). Primary sources provide the majority of the historical research, while secondary sources provide understanding of events and possible interpretations of primary sources. Examples of secondary sources include industry publications,



research reports, and various periodicals that relate to the topic. The data sources used for this thesis reflect a wide variety of both primary and secondary sources.

### **Justification**

The literature review research method was selected to provide both historical and current information on outsourcing and privatization, including past practices, and current policies and programs. Another reason for choosing this method was to forecast the utility of using outsourcing and privatization to produce the needed savings for modernization and increase operating efficiency.

As mentioned in the research approach, the research questions driving the overall investigation of outsourcing and privatization were exploratory in nature, and therefore anticipated qualitative responses to the questions. A strategy was developed to answer the research questions which utilized a thorough review of the literature. Further justification for selecting this method is presented in the next few pages.

The literature review discovered an abundant variety of sources on outsourcing and privatization issues. These sources include reports on outsourcing of commercial activities, Rand research reports, recent DoD statements made before Congress, Congressional Budget Office Studies (CBO), Inspector General reports, unpublished DoD briefings, trade journals, and the 1997 Quadrennial Defense Review.

Both the history and the current status of the Commercial Activities Program came into focus by conducting research in this fashion. A broad range of issues was explored to fully investigate the prospects of generating significant savings for the modernization account. Examples of these issues include step-by-step guidance on performing and monitoring A-76 cost comparison studies; references that chart DoD usage trends of cost comparisons; publications that discuss similar efforts in the private sector; and General Accounting Office reports that describe past DoD outsourcing efforts and their results.

### **Data Collection Process**

Collecting data “involves reducing accumulated data to a manageable size, developing summaries, looking for patterns, and interpreting findings” (Emory, 1991:89). Primary and secondary sources containing information on outsourcing and privatization efforts from the inception of the Commercial Activities Program to the present were collected and studied to assess the likelihood that outsourcing and privatization will produce the needed savings for modernization and increase operating efficiency.

The initial search for published resources specifically related to outsourcing and privatization was conducted by scanning the Internet and using on-line catalog systems for both Air Force and local university libraries. In addition, weekly, monthly, and quarterly publications were routinely reviewed for current data relating to the topic. As the resources were collected and reviewed, they were arranged in a chronological fashion which allowed the historical

literature review to be consistent with the development of outsourcing in the private sector and the Commercial Activities Program in the Department of Defense.

### **Summary**

The research for this thesis required a qualitative methodology. Archival and historical analyses were selected as research strategies for the thesis. Both strategies facilitated the research effort, as they helped reveal both the building blocks and the framework of outsourcing and privatization. All of the information that was extracted from source documents gathered during the literature was organized around past, present, and future trends in the use of outsourcing and privatization within the Department of Defense.

### **III. Literature Review**

#### **Chapter Overview**

The purpose of this chapter is to trace the evolution and impact of outsourcing and privatization in both the private and public sectors. The chapter begins with an explanation of core competencies--what they are and how they affect the outsourcing decision. Next it looks at the experiences of the private and public sectors. Finally, it examines outsourcing and privatization in the Department of Defense.

#### **Background**

The DoD today is facing unprecedented change, with initiatives underway to improve performance, quality, and efficiency of DoD operations. These changes are largely due to the evolving world political situation. Threats to United States interests have changed defense strategy from preparing for a global war to preparing for smaller major regional conflicts in various regions of the world (HQ USAF, 1995:10). Furthermore, funding to support the DoD for all missions, including these regional conflicts has been reduced as well. The defense budget has been shrinking in real terms since the mid-1980s--from \$403.5 billion in 1986 to 289 billion in 1995 (in constant fiscal 97 dollars), a reduction of over 28 percent (Air Force, 1996:51). Similarly, manpower has experienced a reduction of 24% from 2,065,000 to 1,519,000 between 1986 and 1995 (Air Force, 1996:41). In spite of these reductions, the requirements to

support critical national interests in various regions of the world remain. In response, some have called for the DoD to adopt management practices of successful American businesses (Pyles and Cohen, 1993; GAO, 1996).

American businesses are undergoing a similar upheaval in the environment in which they operate. Market competition has become global and companies are faced with rapidly changing and increasingly complex business forces. U.S. companies have taken many steps to remain competitive including downsizing, rightsizing, or reengineering their organizations. Normally, such reorganization calls for a reduction in personnel either through reducing layers of management or by letting contractors provide functions rather than in-house personnel. This strategic use of outside providers to perform activities traditionally handled by internal staff and resources is commonly known as outsourcing (Outsourcing Institute, 1998:1). The ongoing global revolution in commercial business practices is encouraging organizations to outsource much of what they used to do in-house and to focus their in-house activities on the things that, strategically, matter to them most -- their core competencies (Camm, 1996:2).

### **Core Competencies in the Private Sector**

During the 1980s, top executives were judged on their ability to reengineer or rightsize their organizations. In the 1990s the focus has shifted to their ability to "identify, cultivate, and exploit the core competencies that make growth possible" (Prahalad and Hamel, 1990:79). Core competencies are areas where

a company can “achieve definable preeminence and provide unique value for customers” (Quinn, Doorley, and Paquette, 1990:79). These are areas where the company performs best and which the company should cultivate to become or remain an industry leader. According to the Outsourcing Institute, a professional association founded in 1993 in response to corporate America’s growing need for objective and timely information on the strategic use of outside resources, an organization must first define its core competencies and those functions of the business that are not core. The organization should then outsource its non-core functions so that it can focus on its core competencies (Outsourcing Institute, 1998: 3). The key point is that the core competencies must be identified and then remain within the company to achieve future success.

To define, or identify, which competencies are core to an organization, Prahalad and Hamel offer three criteria. First, a core competency should provide access to a wide variety of markets. Second, the core competency should make a significant contribution to the perceived customer benefits of the end product. And third, a core competency should be an activity that is difficult for competitors to imitate (Prahalad and Hamel, 1990:83-84). Few companies will identify more than five or six of these fundamental competencies (Prahalad and Hamel, 1990: 84).

Quinn and Hilmer studied both successful and unsuccessful corporate examples and identified seven characteristics of effective core competencies:

1. Skill or knowledge sets, not products or functions. Competencies tend to be sets of skills that cut across traditional functional lines which allows the organization to consistently perform an activity better than functional competitors and to continually improve on the activity as markets, technology, and competition evolve.
2. Flexible, long-term platforms, capable of adaptation or evolution. Companies must consciously build dominating, flexible skill sets in areas that the customer will continue to value over time.
3. Limited in number. A company cannot be best in every activity in the value chain, thus managers should specify a few core competencies that are most critical to future success.
4. Unique sources of leverage in the value chain. Organizations must find openings in markets where the company's unique qualifications can be used with the most effectiveness.
5. Areas the company can dominate. The core competency will be an area where the company can bring more assets to the market and consistently make more money than its competitors.
6. Elements important to customers in the long run. At least one of a firm's core competencies should normally relate directly to understanding and serving its customers.
7. Embedded in the organization's systems. Maintaining competencies cannot depend on one or two talented stars. Instead the firm must convert

these into a corporate reputation or culture that outlives the stars. (Quinn and Hilmer, 1995:45-47).

Core areas, identified using these criteria, will be kept in-house and refined. These few areas form the central knowledge of the company. They will not be outsourced because these activities offer the firm long-term competitive advantage and thus must be rigidly controlled and protected. To release knowledge of the core competency is to lose the ability to differentiate the company from the competition.

Because senior managers may not be able to devote as much attention to non-core activities, internal service and support activities often act as monopolies, with little incentive to improve their productivity or achieve world-class performance standards (Blumberg and Blumberg, 1994:9). This situation creates a presumption in favor of outsourcing (or introducing external competition) for activities that are not core competencies, particularly if the organization can gain access to world-class performance from an outside provider (Pint and Baldwin, 1997:24).

### **Private Sector Outsourcing**

Traditionally, outsourcing assisted many businesses in reducing costs, improving business focus, and freeing management from day-to-day operations. It still does this, but the nature of outsourcing is undergoing a transformation in both its use and its impact. The scope of the activities that are outsourced has broadened and the corresponding frequency of outsourcing has increased in



recent years (Winkleman, 1993:52). Companies are using outsourcing to gain long-term flexibility, consistent best practices, and new skills. It is helping firms change corporate culture, gain access to premium thinkers, and implement superior capabilities and technologies (Outsourcing Institute, 1998:2). This trend began as a tactical approach that many companies adopted to reduce the size and/or cost of their operations. Today, the drivers are often more strategic in nature and focus on carrying out core value-adding activities in-house (Tarsh, 1997). Companies found that there are advantages (besides cost reductions) to not having all of their work accomplished by employees of the company. By outsourcing non-core functions, the company can concentrate on that which it does best, its core competencies. This strategic action, in turn, frees additional resources to further support development of the core competencies for competitive advantage.

Quinn and Hilmer present four ways in which organizations leverage their resources by outsourcing. First, returns on internal resources are maximized as they are used to concentrate on what the firm does best. The outsourcing firm which is saving money can reinvest the capital in improving itself. Second, resource savings may be used to improve the core competencies. These better funded and developed core competencies then become barriers for competitors to overcome. When reinvestment capital is available and used correctly, it will make the company less vulnerable in the market. Next, through outsourcing there is full utilization of the external suppliers investments, innovations, and specialized knowledge. For a specialized purchase the smaller supplier will likely

be able to deliver it more cheaply. On the other hand, purchases from a large supplier take advantage of the economies of scale that the larger supplier has developed. Last, in rapidly changing markets, outsourcing gives a firm greater flexibility to enter or leave these markets (Quinn and Hilmer, 1994:43).

While commercial firms have found advantages in managing their resources through utilizing outsourcing, there are some areas of concern. One of the drawbacks for most firms considering outsourcing is the fear of loss of control over that portion of their organization (Bardi and Tracey, 1991:14). While in-house functions may be quick to respond to changes in operations, the contractor may not have resources available to accommodate them. The contractor will likely provide only what was written in the contract or charge additional fees for changes. Another drawback to outsourcing is the loss of skills critical to the organization. Once a particular function is outsourced there may be no internal knowledge of the function left in the organization. Without this knowledge, future planning is difficult and it is hard to recover in-house wisdom once the decision is made (Quinn and Hilmer, 1994:52). Outsourcing under these circumstances may place more reliance on the contractor than the purchaser is comfortable with.

### **Public Sector Outsourcing**

As with the private sector, outsourcing and privatization in the public sector is not a new concept. The gradual process of turning government functions over to private entities has been occurring throughout the world for the

last 15 years (Shoop, 1995:17). The debate over public versus private provision of service effectively dates from 1971 (Savas, 1987:122). Subsequent research and writing in the mid-1970s resulted in media interest and a response from the public-employee union, but little activity occurred. Numerous publications continued into the late 1970s. Then, in the 1980s, there was an explosion of interest in privatization, at both local and national levels in the United States, and in the form of denationalization in Europe and in developing countries. In local governments throughout the United States, the impetus was a result of budgetary pressures and reduced federal grants (Savas, 1987:122).

The economic realities of the 1990s have again brought forth renewed interest in the "public versus private" debate and on the possibilities of outsourcing and privatization. The public sector as a whole is encountering many of the same problems as the Federal Government. They too are asking "How do we do more with less?" In the face of rising costs and declining revenues many city, county, state, and even federal officials are turning to the private sector in an attempt to maintain the scope and quality of public services that taxpayers expect. They have allowed businesses of all sizes to take over many of the services formerly performed by civil servants and even some of the facilities traditionally built, owned, and operated by governments (Holzinger, 1992:20). Additionally, competition between the public and private sectors is being more heavily utilized by many state and community governments to take advantage of its benefits. They have often found that competition improves

services and lowers cost (DoD, 1997:1). Thus the potential for extensive outsourcing and privatization within the public sector is growing rapidly.

According to Savas, outsourcing in the public sector is feasible and works well under the following set of conditions: (1) the work to be done is specified unambiguously; (2) several potential producers are available, and a competitive climate either exists or can be created and sustained; (3) the government is able to monitor the contractor's performance; and (4) appropriate terms are included in the contract document and enforced (Savas, 1987:109).

This concept is supported by the considerable amount of research that been devoted to the theoretical differences in motivation and performance of public and private organizations. Niskanen, Allison, Borcharding, Wolf, Bailis, Downs, Rainey, Meyer, Fitch, Drucker, and Bennett and Johnson are among the many who have considered the matter. Their results are summarized as follows:

1. In the public sector there is little incentive to perform efficiently, and management lacks effective control over human and capital resources; in the private sector there generally exist both carrots, in the form of raises and promotions, and sticks, in the form of demotions and firings.
2. Because operating and capital budgets are arrived at through separate processes in the public sector, the opportunity to make tradeoffs between the two is limited; for example, it is more difficult to make coordinated investments in labor-saving equipment.
3. Whereas a private firm generally prospers by satisfying paying customers, a public agency can prosper (i.e. get a bigger budget) even if

the customers remain unsatisfied. In fact, paradoxically, sometimes the budget grows even as customer dissatisfaction grows; in this respect a rising crime rate is good for a police department, a housing shortage is good for a housing agency, and an epidemic is good for a health department (Savas, 1987:112).

Theoretical analyses that predict private firms would be more efficient and effective than public agencies can be supported by several examples. New York City, for instance, was losing as much as \$2 million a year on the five golf courses it owns before it turned their management over to American Golf Corp. in 1983. Through the use of standard business solutions, each course now generates up to \$200,000 a year in rent for the city, depending on its annual revenue (Holzinger, 1992:21).

Fairfax County, VA has been saving transit dollars since 1990, when it contracted with ATE Management & Service Co. Inc. to provide bus service to three stations on the Metrorail rapid-transit system serving the Washington, D.C. area. Previously, the county had been served exclusively by busses operated by the Washington Metropolitan Area Transit Authority (Metro), a government agency created by the District of Columbia and surrounding jurisdictions. Now the county provides ATE Management with buses, a maintenance facility, fuel, insurance, and planning and marketing support; ATE operates and maintains the fleet. Buses owned and operated by the regional transit authority cost about \$4.85 per mile, while the buses owned by Fairfax County and operated by ATE cost about \$2.60 per mile--a figure that includes the county's costs as well as

ATE's. This difference represents an almost 50 percent cost savings (Holzinger, 1992:21).

Generally, savings from outsourcing or privatization average 25 percent, according to E.S.Savas, management professor at Baruch College in NY and an internationally recognized expert on the subject (Holzinger, 1992:22). According to top Indianapolis officials, a city recognized for its notable privatization efforts, competition in the marketplace rather than privatization per se produces the greatest results. They found that the primary advantages of outsourcing include reduced costs, improved services, improved employee morale, and increased innovation (GAO, 1997c:9).

What must public officials do in order to reap these outsourcing benefits? On the basis of a GAO literature review, the views of a panel of privatization experts, and work with six selected governments, GAO identified six lessons learned in implementing outsourcing/privatization initiatives (GAO, 1997c:5):

- (1) Privatization can best be introduced and sustained when a political leader champions it.
- (2) Governments need to establish an organizational and analytical structure to implement the privatization effort.
- (3) Governments may need to enact legislative changes and/or reduce resources available to government agencies to encourage greater use of privatization
- (4) Reliable and complete cost data on government activities are needed to assess the overall performance of activities targeted for privatization, to

support informed privatization decisions, and to make these decisions easier to implement and justify to potential critics.

(5) Governments need to develop strategies to help their workforces make the transition to a private-sector environment.

(6) More sophisticated monitoring and oversight are needed to protect the government's interests when its role in the delivery of services is reduced through privatization.

### **Defense Outsourcing**

During World War II, the Department of War (now DoD) took over capabilities that the private sector had previously provided. At the time, these changes made sense because the entire nation was devoted to the war effort. The Navy, for example, organized private civilian engineering contractors into construction battalions, known as Sea-Bees. This appropriation of ownership allowed increased control over construction efforts in combat. After the war, the DoD continued to perform this function as well as others that the private sector could have provided. The desire to maintain these capabilities heightened with the beginning of the Cold War. For the first time in the history of the United States, large, standing armed forces remained active during peacetime.

Budget Bulletin 55-4, published in January 1955, established the basis for the Office of Management and Budget's (OMB) Circular A-76, "Performance of Commercial Activities." As reflected by Secretary Cohen in the Defense Reform Initiatives Report, his document stated: "It is the general policy of the Federal

Government that it will not start or carry out any commercial activity to provide a service or product for its own use if such product or service can be procured from private enterprise through ordinary business channels” (DoD, 1997:2). Thus, Federal agencies have been encouraged, since 1955, to obtain commercially available goods and services from the private sector whenever they determine it is cost-effective (GAO, 1998a:2). In 1966, the OMB issued Circular A-76, which established federal policy for the government’s performance of commercial activities and set forth the procedures for studying commercial activities for potential contracting. Specifically, it stated that:

the Federal Government shall rely on commercially available sources to provide commercial products and services. In accordance with the provisions of this Circular, the Government shall not start or carry on any activity to provide a commercial product or service if the product or service can be procured more economically from a commercial source. (OMB, 1983:1)

This document initiated the Federal government’s endorsement of outsourcing and privatization and served as a catalyst for DoD to begin shifting its support services, depot level maintenance, and weapons procurement to the private sector. In 1979, OMB issued a supplemental handbook that spelled out the procedures for competitively determining whether commercial activities would be most economically performed in-house, by another federal agency, or by the private sector. OMB revised this handbook in 1983, and most recently in 1996.

Despite this well-defined policy framework, DoD outsourcing has occurred on a relatively modest scale (Robbert, Gates, and Elliot, 1997:1). The military services and defense agencies have, over the past several decades, completed



over 2000 cost-comparison studies. Activity was heaviest in the early 1980s where the number of A-76 studies conducted increased rapidly from nearly zero in 1978 to over 300 per year in 1983 (cite). Decline came in an equally dramatic fashion and by the mid-1990s, the level of effort was less than ten studies completed per year (Robert, 1997:2). It should be noted that statutory restrictions played a significant role in this abrupt decline of A-76 actions. For example, in the mid-1980s, Congress removed depot level maintenance from the jurisdiction of A-76 (Defense Science Board, 1996). Then in 1989 Congress directed the Secretary of Defense to delegate to base commanders the sole authority to commission A-76 cost comparison studies (10 USC 2468). Since base commanders are often reluctant to initiate actions that could result in the elimination of government jobs under their command, this statute had an immediate effect on the number of public/private competitions undertaken by the Military Services. A final example of legislative influence on outsourcing activities is Public Law 102-484, section 312, October 23, 1992, and Public Law 103-160, section 313, November 30, 1993, which established a moratorium that stopped the awarding of service contracts resulting from cost comparison studies under Circular A-76 for 17 months (DoDIG, 1995:7).

The Defense Performance Review, Chief Financial Officer's Act, and Government Performance and Results Act all generate policy and legislation that requires measurement of efficiency in DoD operations (Ciccotello, Green, and Hornyak, 1997: 27). This call for improved efficiency provided the impetus for the DoD, in 1995, to give outsourcing renewed attention. The Commission on Roles

and Missions of the Armed Forces (CORM), an ad hoc study group formed in accordance with Section 954 of the National Defense Authorization Act for Fiscal Year 1994, recommended a reversal of the recent decline in A-76 activity and gave a central role to expanded outsourcing of support services (Camm, 1996:2).

Specifically, the commission noted in its May 1995 report:

We recommend that the government in general, and the Department of Defense in particular, return to the basic principle that the government should not compete with its citizens. To this end, essentially all DoD "commercial activities" should be outsourced, and all new needs should be channeled to the private sector from the beginning. (CORM, 1995:3-3)

The commission further stated in its report that, notwithstanding policies favoring outsourcing, DoD continues to employ at least 250,000 civil service personnel in commercial activities (CORM, 1995:3-3). Citing typical cost savings of 20 percent when "meaningful competition" is introduced into the selection of sources for performance of these activities (CORM, 1995:3-2), the CORM advocated withdrawal of Circular A-76 and repeal or amendment of various legislative restrictions (CORM, 1995:3-5). Furthermore, the commission placed such faith in the private sector that it advocated elimination of the requirement for cost comparison studies as being "inconsistent with the basic policy preference for private enterprise" (CORM, 1995:3-5).

The commission recognized the importance to DoD of the revolution in business practices under way in the commercial sector today. Firms are rapidly learning to apply information technologies in new ways to increase their responsiveness to customers and at the same time reduce their costs. The Commission believes that DoD can gain direct access to the products of this

revolution by contracting for a larger fraction of its support functions. More subtly, the Commission anticipates that DoD can emulate successful commercial firms by outsourcing non-core activities now conducted in-house. If the Commission is correct, expanded outsourcing of support activities will help DoD adjust to a falling budget and a new world environment without giving up the quality of support that it needs to ensure an adequate national defense (Camm, 1996:2-3).

Shortly after the CORM report was issued, its chairman, John P. White, was appointed Deputy Secretary of Defense. In that capacity, he initiated a comprehensive review to identify and act on additional outsourcing opportunities within DoD (DoD, 1996:4). To increase funding for equipment modernization, DoD must shift resources from support to procurement. DoD can achieve this transfer of resources only by discarding its traditional reliance on in-house support and implementing an aggressive strategy to outsource most support services (Defense Science Board, 1997). Furthermore, outsourcing would presumably help DoD to focus in-house on its "core" military concerns and harness the power of private enterprise to provide more cost-effective support services (Camm, 1996:2).

In 1996, the Deputy Undersecretary of Defense for Acquisition and Technology released a report entitled "Improving the Combat Edge through Outsourcing." The goal of this report was to hasten outsourcing of service and support activities. The report outlines three conditions an activity must meet to be considered for outsourcing:

First, private sector firms must be able to perform the activity and meet our warfighting mission. DoD will not consider outsourcing any activities which constitute our core capabilities. Second, a competitive commercial market must exist for the activity. Market forces drive organizations to improve quality, increase efficiency, and reduce costs. DoD will gain from outsourcing and competition when there is an incentive for continuous service improvement. Third, outsourcing the activity must result in best value for the government and therefore the U.S. taxpayer. Activities will be considered for outsourcing only when the private sector can improve performance or lower costs in the context of long term competition. (DoD, 1996:4)

The Department of Defense identified four areas where it hopes to create savings and improve readiness by outsourcing:

1. **Competitive Forces.** The competition created by outsourcing will drive those competing for government contracts to increase efficiency, reduce costs, and focus on customer's needs. Thus competition will lead to faster deliver of better products to the DoD.
2. **Flexibility.** DoD managers will have more flexibility to respond to the type and size of resources needed by changing the level of outsourcing purchases.
3. **Economies of Scale and Specialization.** Large firms in a particular market have many customers. As a result, they may have developed economies of scale than an individual customer could not attain on its own. Outsourcing to these firms allows the DoD to take advantage of products or services that would be impossible to acquire or too costly to produce organically.

4. **Better Management Focus.** By concentrating on its core competencies and outsourcing functions that only support the core competencies, the DoD will free resources to be used on the most important tasks. (DoD, 1996:5).

The perceived benefits of outsourcing support functions are similar to those of the private sector. Both the DoD and private sector companies seek cost reductions and improved efficiency. However, any organization considering outsourcing must first understand its core competencies and make certain that outsourcing is occurring for the right reasons. In an effort to accomplish this task DoD will evaluate [the] entire military and civilian workforce by 1999 to identify which functions are commercial in nature and could be opened up for competition under the A-76 process (DoD, 1997:1).

#### **The Commercial Activities Program in Practice**

Because outsourcing influences management and monitoring costs, long-term investment needs, and the strategic focus of the organization in addition to the short-term direct costs, its overall cost and benefits must be carefully evaluated (Quinn and Hilmer, 1994). Due to the building momentum for the substantial expansion of DoD outsourcing, it is important to examine DoD's track record in the Commercial Activities program. Secretary of Defense Cohen states that A-76 competitions in the DoD have reduced annual operating costs by 31 percent (DoD, 1997:2). "Improving the Combat Edge Through Outsourcing," issued by the DoD also states outsourcing has reduced operating costs by 31

percent. The Congressional Budget Office estimated in 1995 that between 20 and 40 percent cost savings could be achieved through outsourcing (CBO, 1995). The Defense Science Board Task Force suggests that DoD can realize savings of 30 to 40 percent by outsourcing support services traditionally performed by government personnel (Defense Science Board, 1996:6A). These are a few examples of the claims made by proponents of outsourcing. But to what degree have these savings been substantiated? It is interesting to note that the Heritage Foundation, a private source, estimates potential savings from outsourcing at 10 to 20 percent (GSA, 1998:1). Numerous studies, GAO reports, and audit reports have been accomplished on the DoD's use of outsourcing to date. These studies provide the basis for discussion of DoD's past experience in achieving cost savings through outsourcing.

Contract Cost Increases and Effects on Savings. Often there are concerns that contractors tend to increase contract costs in the years following conversion to contract, resulting in higher costs to the government. A 1985 GOA review of 20 DoD contracts found that all but one had contract cost increases, but savings were still realized on 17 of the functions. Savings were not realized on two functions and they could not determine whether savings were realized on one function (GAO, 1985:2-3). Most, if not all, of the projected savings were realized on 5 of the 20 functions with cost increases resulting primarily from additional work and authorized wage increases (GAO, 1985:3). In this case, cost increases would likely have occurred had the function remained house. For 12 of the 20 functions, or 60 percent, savings were reduced because of contract errors

or ambiguities and additional costs resulted from recompeting contracts; however, some savings were still realized (GAO, 1985:3).

In an August 1981 report on 18 conversions to contract, GAO reported that where contract price increases occurred, they seemed justified. Generally, price increases resulted from such factors as wage increases required by the Department of Labor and new work requirements. With one exception which involved contractor performance problems, contract price increases did not exceed the estimated savings by contracting out (GAO, 1981).

A 1990 DoD Inspector General report examined the procedures used to monitor commercial activities' functions after conversion to contract. The report concluded that the military services were not effectively managing contractor work load after conversion to contract operations, and therefore, anticipated savings were not always realized. The audit estimated that the services would obtain some savings on 37 of the 41 contracts reviewed. However, the services would not realize the total \$94.9 million anticipated savings to be achieved by contracting out. Rather, the services would spend \$63.4 million more than the estimated cost of retaining the functions in-house. The report recommended the revision of DoD Instruction 4100.33, "Commercial Activities Program Procedures," 9 Sep 85, to include written policies and procedures for managing the postaward phase of the commercial activities program; develop and periodically review performance work statements that clearly define contract workload; and require the resolicitation of contracts when costs exceed DoD in-house cost estimates. The Principal Deputy Assistant Secretary of Defense

(Production and Logistics) nonconcurred with the need to revise the DoD Instruction to include policies and procedures for managing the program after conversion from Government to contract operations. In mediation, it was agreed upon to track cost escalation of contracts awarded as a result of cost comparisons and those with abnormal cost escalation would be referred to appropriate officials for evaluation and action (DODIG, 1990).

The National Defense Authorization Act for FY 1995 required that the DODIG again look at commercial activities after conversion to contract. Specifically, this report examined cost growth in commercial activity contracts. The review of 20 Army, Navy, and Air Force contracts, which were negotiated at \$522 million, determined that the contract had a net cost growth of \$108 million. In some cases, cost growth was due to one time costs associated with Desert Shield and Desert Storm operations. The other sources of growth were Department of Labor mandated wage increases and increased work requirements. The report states that the change in work requirements would likely have caused similar increases to an in-house operation as well; however, it warns that the change in requirement, though within scope, may render the original cost comparison invalid (DoD IG, 1995:5). While increased mission requirements may cause similar increases in both in-house and contractor operating costs, changes in work requirements resulting from inadequately written performance work statements will affect only the contract costs. Changes of this nature have occurred frequently in DoD contracts and usually result in cost increases, thus reducing the potential savings (GAO, 1997a: 9).



Cost growth may also occur when the scope of work on a contract is increased, as funding becomes available, to restore a level of service that had previously been reduced due to resource constraints. For example, work increases may be required to remedy the effects of postponing maintenance and repair activities caused by a reduction in funding (GAO, 1997a:11). Though this represents a legitimate change, it will still increase contract costs and serve to minimize potential savings from outsourcing.

Source of Savings from Outsourcing. Personnel costs are generally an important element in comparing the cost of in-house versus contractor performance, especially in labor intensive service activities. Therefore, the number of employees and wages and fringe benefits paid to employees may be instrumental in the decision to contract out or keep the function in-house.

In April 1981, GAO reported that estimated cost savings in 12 DoD functions contracted out were generally attributable to contractor plans to use fewer employees and to pay lower wages (GAO, 1981). A 1984 report revealed that the contractors could perform the work at less cost than the government primarily because (1) the contractors used fewer employees and (2) the contractors' pay scales, generally based on Department of Labor wage rates under the Service Contract Act, were lower than the government's (GAO, 1984).

The A-76 competitions performed between fiscal year 1978 and 1994 primarily involved low-skilled work such as family housing and grounds maintenance, custodial services, food services, and commissary operations. For the most part, these functions required little capital investment, unskilled labor,

and could be defined by relatively simple and straight-forward work statements. The studies generally yielded abundant competition and about 50 percent of the 2,100 competitions remained in-house. Thus savings from competed functions occurred regardless of whether the government or a contractor was awarded the work. These savings were largely personnel savings which resulted from figuring out how to do the job with fewer people (GAO, 1997a: 8). An April 1996 Center for Naval Analyses (CNA) report cited similar results. In their specific case, competitions resulted in approximately 40 percent of the functions remaining in-house while 60 percent were outsourced. CNA concluded that competition, not outsourcing, was the key to savings as the winner generally used fewer people to perform the work (GAO, 1997a: 8).

GOA has also examined the effect of military to civilian conversions. Data suggest the potential for significant savings by converting military support positions to either civil service or contractor positions (GAO, 1996b). The April 1996 CNA report revealed an average of 50 percent savings when activities performed solely by military personnel were competed. These type of efforts may be hampered, though, by difficulties in changing funding between two different appropriation accounts--a centralized military personnel account and an installation's operation and maintenance account. The current budget and appropriation process can require up to two years to convert the funding from one account to another. Furthermore, the ongoing civilian drawdown and the lack of consistent funding for the hiring of the civilian replacements has impaired such conversions (GAO, 1997a: 15).

Ability to Monitor Savings. Several recent studies--DoD's 1993 Bottom-Up Review, the 1993 National Performance Review, DoD's 1995 report from the Commission on Roles and Missions of the Armed Forces, and the 1996 report of the Defense Science Board Task Force on Outsourcing and Privatization--concluded that DoD could realize savings of between 20 and 40 percent by outsourcing support activities (GAO, 1997a:4-5). The GAO has examined many of these studies and found that the estimated savings drew heavily from the initial projections in DoD's commercial activities database. This database provides savings that represent the difference between the cost of operations at time of award and the cost of the winning bid. While the services are required to track these savings for the first three years after a study is completed, the databases do not generally reflect savings actually attained beyond 3 years. As previously noted, the cost of operations projected at the time of outsourcing may be subject to substantial change over time due to modifications in the contract (GAO, 1997a: 9).

"Although DoD's commercial activities database provides an initial projection of savings from outsourcing competitions, few studies have been done to determine actual savings realized over time" (GAO, 1997a: 9). Reasons given by headquarters and installation officials for failure to perform such studies include time and resource constraints and the inability to maintain a common baseline for comparison over time (GAO, 1997a: 9). GAO's 1990 evaluation of DoD's reported cost savings revealed that the figures were incomplete and inaccurate. For example, DoD estimates expected cost savings on the basis of

standardized assumptions rather than basing savings on the actual operating costs of the individual installation. Furthermore, DoD does not routinely collect and analyze sufficient cost information, such as changes in contract administration staffing and true costs of a revised in-house organization, to monitor actual operations after a cost comparison study. Finally, DoD's system does not capture the cost associated with conducting A-76 cost studies (GAO, 1990:2-4). GAO concluded that neither DoD nor OMB has reliable data "on which to assess the soundness of savings estimates or knows the extent to which expected savings are realized" (GAO, 1990:3).

GOA cites limited post-award reviews of contracted activities for its disbelief that these previously outsourced functions "provide a basis for projecting with reliability the magnitude of savings achieved over time" (GAO, 1997b: 10). However, there is enough data to suggest some potential for continuing savings. Two examples noted include a 1989 Army Audit Agency review which found that 9 out of 10 large contracts audited were still saving money after several years of operation and Naval Audit Service reviews which found that savings were realized over the life of the contracts, although not as great as initially estimated (GAO, 1997a: 10).

Recently, OMB revised its A-76 supplemental handbook to improve the administration of the A-76 process and the way government cost estimates were developed. This revision resulted in the change or establishment of several standard cost factors, including the requirement that government overhead costs be calculated based on a standard rate of 12 percent of direct labor cost.

Furthermore, the handbook directed DoD to develop a separate overhead rate for military personnel (GAO, 1998b:3). The requirement to include overhead cost in in-house cost estimates existed prior to adoption of this standardized rate; however, DoD and OMB officials reported that "overhead costs, particularly general and administrative costs, were often not included in the government's estimates because they were difficult to quantify and allocate to specific activities" (GAO, 1998b:3). Furthermore, when GAO examined available data from the Air Force, it found that only 12 of 109 in-house estimates included overhead costs. Ten of the estimates used overhead rates of 1 to 3 percent and two used rates of 9 to 12 percent (GAO, 1998b:4). Exclusion of overhead from government bids may be another case of overstated savings estimates on the part of the DoD.

Recent legislative and management reform initiatives have emphasized the need for better information, including cost data, to support federal decision-making and measure results of program operations. In an effort to aid said initiatives, the Federal Accounting Standards Advisory Board (FASAB) was the development of federal cost accounting concepts and standards which became effective 1 Oct 97. One part of this effort was the development of managerial cost accounting standards which require that federal agencies provide reliable and timely information on the full cost of federal programs, their activities, and outputs (GAO, 1998b:6). This requirement should eventually lead to better cost data throughout the federal government; however, "cost accounting systems typically are not now in place and able to provide reliable cost information to

support A-76 competitions” (GAO, 1998b:7). Furthermore, as reported in the 1997 high-risk report, financial statement audits by GAO has “consistently identified significant problems with the comprehensiveness and accuracy of DoD’s cost information” (GAO, 1998b:7). This deficiency affects DoD’s ability to fully identify savings from A-76 cost comparisons. While DoD is working to conform to the standards issued by FASAB, it “will likely be many years before these systems are in place and can provide the type of information DoD needs to estimate costs for A-76 purposes” (GAO, 1998b:6).

### **Chapter Summary**

Understanding the history and development of outsourcing and privatization as a management tool is important in assessing current activities within the Department of Defense. This literature review first explored the concept of core competencies. The following sections provided an overview of the use of outsourcing and privatization in the private sector, the public sector, and the Department of Defense. Through historical accounts of outsourcing ventures, including why they were initiated, one can comprehend the nature of the process and gain greater insight into the possibility of potential savings for the DoD’s modernization efforts.

The public sector, to include the Federal government, has found that competition, not merely contracting out, has produced the greatest savings from outsourcing. When placed in a competitive environment, an organization must analyze its current structure and identify inefficiencies and excess capacity to

submit its best proposal. In addition, competition fosters innovation in the ways that a given function is accomplished. Furthermore, low-skilled, easy to define functions which require little capital investment tend to generate a large amount of competition. And up to a certain point, the greater the number of suppliers, the greater the potential for savings.

Another factor that strongly affects the ability to realize savings from outsourcing is the extent to which contract cost increases can be controlled. Some cost growth stems from uncontrollable, justifiable sources such as wage increases required by the Department of Labor and changes in mission requirements. Other sources of growth, however, result from poorly defined requirements and inadequately and/or ambiguously written performance work statements. Changes of this nature are usually accommodated by the contractor; but, there is always an associated cost increase. These types of changes pose the greatest threat to realizing anticipated cost savings from outsourcing.

Finally, there are several conditions that represent the most feasible environment for outsourcing: (1) the work to be done is specified unambiguously; (2) several potential producers are available, and a competitive climate either exists or can be created and sustained; (3) the government is able to monitor the contractor's performance; and (4) appropriate terms are included in the contract document and enforced (Savas, 1987:109).

## **IV. Conclusion and Recommendations**

### **Chapter Overview**

The Department of Defense must reduce its cost of support services if it is to meet national security goals in the face of declining budgets. Because of deficit reduction efforts and competing national priorities, top-line defense budgets are not likely to grow in the coming years. Accordingly, additional modernization funding will have to come from DoD's existing pool of resources. In the opinion of the Defense Science Board, "DoD is left with only one practical alternative to meet its future modernization requirements: sharply reduce DoD support costs, and apply the savings to the procurement account" (Defense Science Board, 1996:9A). Increasing DoD's use of outsourcing and privatization is one opportunity to reduce support costs.

This chapter reviews the results of this study with respect to the investigative questions introduced in Chapter I. First, it discusses the evolution of outsourcing in the public and private sectors. Next, common characteristics of successful and unsuccessful outsourcing initiatives are identified. Finally, it examines past DoD outsourcing efforts and determines whether the projected savings can be substantiated. It must be noted that the purpose of this research was investigative in nature, to determine to what extent DoD has achieved successful results from outsourcing in the past. It does not provide empirical results from analyzing specific contracts nor does it investigate the practices of individual services or bases. Nonetheless, this research provides a good look at



past experiences which will aid in the current and future outsourcing endeavors. The chapter ends with conclusions drawn from the research and recommendations for further studies.

**Question 1: How has the practice and utilization of outsourcing and privatization evolved in both the private and public environment?**

Business Experience. Over the past decade, fundamental changes have affected the U.S. economy. With increasing globalization and high rates of innovation has come a much more competitive environment for U.S. industry. To remain competitive in this ever-growing global economy, the private sector has had to restructure, reengineer, and eliminate jobs. The organizations streamlined their operations to improve efficiency and concentrated their focus on what they do best. To aid this effort, they turned to outsourcing non-core operations in order to take advantage of services and support from providers who were "world-class" in their own fields. Initially outsourcing was implemented primarily for cost minimization; but, over the years organizations have found that outsourcing provides additional, often more substantial, benefits such as access to state-of-the-art technology and specialized skills that are lacking in its own workforce.

A new industry was created to meet this growing demand for specialized services across a broad range of functions. When Eastman Kodak outsourced the majority of its information technology operations in 1989, outsourcing was a \$4 billion a year business (Lacity, Willcocks, and Feeny, 1996:1). According to the 1998 Dun & Bradstreet Barometer of Global Outsourcing, projections for

1999 place total outsourcing expenditures at nearly \$235 billion (Ozanne, 1998:S2). Clearly, outsourcing is not a passing fad and has, in fact, become an essential business tool in today's global marketplace. For an organization to reap the greatest benefits from outsourcing it must first define its core competencies—those skills and knowledge sets that truly differentiate it from its competitors—and those functions of the business that are not core. The organization should then outsource its non-core functions so that it can focus on its core competencies and utilize its limited resources most effectively. The primary issue is that the core competencies must be identified and then remain within the company to achieve future success.

The Public Sector Experience. Over the past several years, state, county, and local governments have also increased their use of outsourcing and privatization. In fact, virtually every function of local government has been delegated to the private sector at some time (Donahue, 1989:135). Though the government's reliance on the private sector for products and services has been present for over 15 years, the public versus private debate has always been controversial and use of outsourcing has been sporadic. The economic environment of the 1990s, however, brought renewed interest in the use of outsourcing and privatization by various levels of government.

Public organizations have found the primary advantages of outsourcing include cost reductions, improved performance quality, better employee morale, and heightened innovation. Most observe that competition in the marketplace, rather than merely contracting out, yields the greatest results. This is largely due

to the fact that government service "generally operates as an unrivaled monopoly, despite the fact that relatively few such services are natural monopolies" (Savas, 1987:97). This type of arrangement supports and perpetuates inefficiencies and inadequacies. However, when market forces are introduced through competition, there is an incentive to provide quality service as efficiently as possible.

In a recent study, the GAO identified six lessons learned in implementing outsourcing and privatization. These deal primarily with bureaucratic issues that must be addressed once the decision to outsource is made rather than with the appropriateness or suitability of various functions to the process. However, it is important to note that such issues exist primarily in the public sector, including the DoD. This provides a distinction from the private sector and may influence the degree to which the public sector can emulate industry successes.

The Department of Defense Experience. Policy for use of private enterprise to provide services to the federal government dates back to 1955. Since that time, federal agencies have been encouraged to obtain commercially available goods and services from the private sector when they determine it is cost effective. Despite the government's endorsement of outsourcing, its use has been relatively modest. This is due, in part, to conflicting guidance put forth by the government itself. The DoD commercial activities program occurs within a well-defined policy framework which encourages the use of outsourcing while at the same time it imposes an evolving set of exclusions and restrictions (Robbert, 1997:1). While policy from the Executive branch is clear in its predisposition

toward outsourcing, the Legislative branch tends toward policy less encouraging and restricting. This two-sided train of thought is primarily a political issue which is similar to the issues surrounding base realignment and closures. Yes, closing bases is a good idea and will save the DoD money, as long as its not a base in my state/district that will affect my constituents. Increased volatility in the political and economic environment has brought dramatic cuts to the DoD's personnel and budget resources while, at the same time, the political and military leadership emphasizes that force modernization is essential to avoid the potential of hollow forces. Since it is unlikely that the DoD's budget will be increased, various panels and commissions suggest that the DoD can generate 20 to 40 percent savings through the use of outsourcing and privatization which can then be applied to modernization accounts.

**Question 2: What are the characteristics of successful and Unsuccessful outsourcing ventures in the public sector?**

Though the DoD has been more active in its implementation of the commercial activities program than most federal agencies, studies reveal several issues that should be of interest as the use of outsourcing is so highly stressed. Changes in contract requirements, for whatever reason, generally increase contract costs and consequently reduce the amount of savings realized. Additionally, most savings are a result of competitive bidding, not contracting out. The ability to restructure the activity using fewer people usually determines the extent to which savings will occur. Finally, DoD has experienced problems in its

ability to determine accurate and credible costs of the services currently performed in-house. Coupled with a lack of post-contract reviews and analysis of previously outsourced activities, the DoD's ability to correctly predict future savings may be compromised. Additionally, cost comparisons between the public and private sectors are often hampered due to differing accounting structures and budgeting processes.

Many factors must be considered when contemplating a decision to outsource. This research suggests that the following conditions lay the groundwork and must be present in order for outsourcing to achieve its desired outcome:

Contract Requirements Can be Specified Clearly and Succinctly. The Government must be able to develop a performance work statement that clearly states the required service or product. The requirements should contain no ambiguous, contradictory, or inaccurate provisions and should avoid unnecessarily limiting the way in which the required service or product is provided. "Government agencies should focus on outputs and leave the configuration of input resources to the contractor in order to allow creativity and innovation in service delivery" (Savas, 1987:268).

The research indicates that changes in work requirements stemming from an inadequately written PWS often lead to contract cost growth, which in turn reduces overall potential for savings. Additionally, an unclear PWS may decrease bidder responsiveness since a contractor may not be able to provide a complete and accurate bid to inadequately constructed requirements. Finally, ambiguous

requirements are difficult to administer and enforce. If detailed contract specifications cannot be written, the contractor cannot be expected to conform, and the agency cannot monitor the contractor's performance. Only if the work to be performed is defined concisely and stated without ambiguity can a contractor and client maintain a good working relationship and achieve the established objectives.

A recent RAND report suggests several reasons for the DoD's difficulty in drafting performance work statements that fully capture the work to be done (Robbert, Gates, and Elliot, 1997:48-49). The first reason argues that either by mere oversight or by overzealous cost-cutting efforts, the PWSs understate the workload or leave out portions of the function. Thus, the first couple months of performance reveal PWS deficiencies and require contract modifications to incorporate the additional work. The end result is increased contract costs and reduced savings. A second factor that affects the quality of the PWS is the simple fact that those tasked with the PWS development lack both training and experience in compiling a document of this magnitude. Furthermore, many do not have enough expertise in the functional area to articulate and incorporate the required information. In addition, those civil service employees who do have the requisite experience are often unwilling to provide information that may lead to the loss of their job. Finally, people who are substantially involved in the PWS development become procurement officials and are subject to a two year period where they may not be employed by a competing contractor. Thus many of

these employees recuse themselves to maintain their option for employment should the function be outsourced (Robbert, Gates, and Elliot, 1997: 48-49).

A somewhat separate, but still related, issue is service specificity which deals primarily with the requirement itself. It addresses the fact that some services can be specified with little ambiguity and little chance of misunderstanding, while others cannot be specified as precisely and allow much room for reasonable people to differ significantly in their interpretations of what the service entails. It includes such considerations as complexity of the task and variability of the requirement. An example that helps differentiate these types of services is to compare street paving and education. It is relatively easy to specify and then evaluate the results of a request to *pave the street*. On the other hand, the same process becomes increasingly difficult when the request is to *educate the child* (Savas, 1987:95). The latter example is likely to elicit a wide range of varying responses that are laborious to compare with an output that is quite difficult to measure. After all, how does one precisely define educate? And how might one determine if the child is educated satisfactorily? Thus, the inherent nature of a requirement might inhibit one's ability to state it in explicit terms.

A Competitive Environment Exists. Competition is an essential element that enables the government to realize the cost savings available through outsourcing. Study after study noted that competition is key to realizing savings. Where historically the Government has operated in a climate insulated from market influences, the A-76 process requires that it compete against commercial

firms, that are inspired by a profit motive, to act efficiently and control costs. Thus, to gain the greatest benefit from outsourcing there should ideally always be many suppliers who desire to do the job. Just because an activity is commercial in nature does not guarantee that there is a competitive market for the service. Library services, for example, may be considered commercial; they certainly are not inherently governmental. However, when several Air Combat Command bases attempted to outsource this function they received minimal response. In some cases, there were no bids submitted at all. There simply was not a market for providing library services. Thus when there is a shortage of suppliers, outsourcing may not be appropriate.

DoD's experience with public-private competitions is that the majority of the savings achieved come from personnel cutbacks. Through close examination of the work to be done, all bidders attempt to propose a streamlined organization that can accomplish the work with fewer people. The DoD's ability to continue realizing such savings rest on the presumption that excess capacity currently exists. There should be some concern, though, that eight years of budget cuts and civilian personnel reductions have eliminated most of the excess and consequently have reduced much of the potential for future savings from new outsourcing initiatives.

The requirement itself can also affect the level of competition. As previously mentioned, service specificity refers to the ability for some services to be specified with little ambiguity and little chance of misunderstanding, while others cannot be specified as precisely and allow much room for reasonable



people to differ significantly in their interpretations of what the service entails. As experienced by DoD, those activities that involved unskilled labor, low capital investment, and could be defined by relatively simple, straight-forward requirement statements usually generated vigorous competition. However, as a requirement's level of complexity increases, so may the barriers to entry in any given market. This situation will effectively decrease the number of producers from whom to choose, thereby eliminating the competitive environment. A final consideration involves the level of capital investment required. If a large capital investment with a twenty year lifecycle is required for performance of a three to five year contract, it may serve to eliminate competition. This notion would be especially true as the level of uniqueness or complexity increased on the capital expenditure. If it can't be used after completion of the contract and it can't be amortized over the life of the contract, suppliers will likely avoid this type of solicitation.

A private company has incentive to provide high-quality services efficiently as the firm bears the cost of poor performance or inefficient production. If there is no market and, therefore, no competition among contractors to provide a service to the government, much of the gains of competition will not be passed on to the government by contractors; however, the costs most definitely will be passed on. The key to the advantages offered by outsourcing is not private as opposed to public performance but, rather, competition versus monopoly (Osborne and Gaebler, 1993:76).

The Government is Able to Monitor the Contractor's Performance. All contracts require some type of monitoring, that is, a process by which the Government can measure a contractor's compliance with terms of the contract. Monitoring can take many forms, such as random sampling, customer complaint, 100 percent inspection, or some combination of techniques. If a successful outsourcing project is desired, then costs of monitoring the execution of the function must be taken into account during the planning of the cost study. The importance of this step is twofold and cannot be overlooked. Oversight and administration represent part of the cost of outsourcing and therefore must be accounted for in the cost comparison if it is to be valid. Furthermore, what will be measured and how it will be measured must be included in the solicitation and incorporated into the contract if it is to be enforceable.

The DoD must be prepared to monitor contractor performance. Though monitoring does necessitate additional costs, these should be offset by the benefits received through monitoring. Efficient monitoring ensures the validation of the level of service the government receives, prevents payment for poor quality or inadequate performance, and detects and recovers inappropriate outlays. However, when the costs of managing the contract outweigh the cost of maintaining the service in-house, outsourcing is inappropriate. This is a somewhat precarious point, though, as actual costs may be difficult to estimate in advance.

Knowledgeable contract administrators are essential to the success of an outsourcing initiative as they play a crucial role in the overall monitoring process. While they do not generally inspect the contractor, they must be intimately familiar with the terms and conditions of the contract in order to process both discrepancies and incentives as reported by the inspector. Additionally, they must be knowledgeable of alternatives and remedies afforded by the contract should performance requirements change or disputes arise. Finally, to the extent that administrators can track and analyze contract data essentially represents an organization's ability to monitor savings. Thus far, DoD has not done a thorough job of this aspect of monitoring and it has affected its ability to document actual savings and to provide accurate estimates for future cost comparisons. The importance of contract administrators must not be overlooked. Consequently, sufficient training and adequate staffing are essential if the DoD hopes to optimize the potential of outsourcing its support activities. "Unless the contract is monitored and administered well, there is a long-term danger that the competitive factor will be weakened and the contract service will degenerate into a private monopoly, which would be no improvement over a public one" (Savas, 1987:271).

Appropriate terms are included in the contract and enforced. The contract is one of the primary mechanisms to ensure that expectations are realized. Effective contractual vehicles hold the key to obtaining the desired performance from suppliers. Therefore, selection of contract type and required level of specificity are important decisions. An appropriate contract type aids in the

equitable distribution of risk between the parties, a factor which may affect the level of competition and performance. If structured properly, the terms of the contract can allow the government a considerable degree of flexibility. For example, the contract could allow flexibility in adjusting the size of a program up or down in response to changing demand and changing availability of funds. Additionally, the use of meaningful performance awards and incentives for superior performance and penalties for poor performance can enhance the Government's ability to reap the greatest benefits from each particular outsourcing arrangement. There is no one best contract type. Each initiative should be analyzed on an individual basis as to what structure and incentives are most appropriate for the given situation. Because of the broad spectrum of contract arrangements available, proper analysis and careful selection should allow the government to get the best value for its money. Some requirements, due to their level of complexity or the amount of risk involved require a more loosely structured contract. These types of requirements may not be suited to outsourcing, even though they may be commercial in nature.

**Question 3: To what degree can the advertised savings be substantiated by past DoD outsourcing efforts?**

While the Department of Defense hopes to take advantage of all the potential benefits of outsourcing, it is primarily concerned with its ability to achieve significant financial savings. Depending upon the study consulted, DoD outsourcing will generate total annual savings of \$2.5 to \$12 billion by FY02. However, based upon DoD's past experience, there is substantial evidence that

savings of the magnitude projected may not be achievable. Outsourcing savings are dependent upon or highly influenced by (1) the ability to clearly define the requirement, (2) the continued existence of a competitive commercial market, (3) the ability to monitor and measure the contractor's performance, and (4) the appropriate terms are included in the contract. The DoD has demonstrated, that in many cases, it is unable to consistently fulfill all of these criteria when it outsources and has failed to achieve the originally expected savings.

Requirements. Cost growth of any kind, whether due to required increases in DOL wage rates or changes in mission requirements, will tend to degrade the amount of savings obtained from contracting out. Of particular concern to the DoD, though, should be its historical inability to write a clear and accurate Performance Work Statement. Contract cost growth incurred to correct or clarify the work requirement has occurred frequently in the DoD and tends to be substantial in nature because after contract award, one is a captive audience dealing in a sole source environment. In these instances, the DoD has experienced significant reductions in cost savings for its outsourcing efforts.

To date, the DoD has only modestly implemented the commercial activities program. It has primarily targeted what some refer to as *low hanging fruit*, or those functions that involve low-skilled, noncomplex types of work such as grounds maintenance, food service, and refuse collection. Yet, as the research indicates, the DoD has experienced difficulty in drafting performance work statements that fully capture the work to be done. In light of past difficulties and the fact that there is little expertise currently available to define the requirements

and develop the PWSs, it is not likely that the DoD will experience the high levels of projected savings on future efforts.

The report of the Defense Science Board (DSB) proposed that the DoD would provide only warfighting, direct battlefield support, policy and decision making, and oversight. All other activities would be done by the private sector. Furthermore, the DSB believes the "DoD could significantly improve its saving performance by outsourcing larger, more complex functions, thereby providing vendors with maximum opportunity to reduce costs and improve service quality" (Defense Science Board, 1996:32A). This idea is further supported by the CORM report which suggests the DoD outsource all current and newly established commercial-type support services. Outsourcing candidates should range from routine commercial support services widely available in the private sector to highly specialized support of military weapons. In considering these propositions, one must reflect on the Defense Department's historical inability to define relatively simple tasks. What then, happens when the requirement involved is unique, highly diverse, and complex work where requirements are difficult to define, large capital investments are required, extensive technical data is involved, and highly skilled and trained personnel are required? At the most basic level, if an organization is unable to perform a simple task, it follows that there will be little success in carrying out a similar but significantly more complex task.

Competition. The continued existence of a competitive commercial market must be present to achieve the greatest savings from outsourcing. Just

because a product or service exists in the private sector, it does not necessarily follow that a competitive market exists. If the DoD shortsightedly pursues indiscriminately outsourcing all activities that do not provide warfighting, direct battlefield support, policy and decision making, or oversight, as suggested by the DSB, it is probable that the realized savings will fall short of the expectations.

Typically, noncomplex services will be readily available in the marketplace and these do provide avenues in which the DoD can expect to realize savings. As the level of complexity increases, though, there may be fewer suppliers and greater barriers to entry. Thus the existence of a competitive environment and/or the ability to create and sustain such a market is greatly reduced. Outsourcing in the absence of a highly competitive market will not only inhibit savings but will create a situation that holds great potential for cost growth.

Another proposition of the DSB is revoking OMB Circular A-76 and the public/private competition altogether. The Board suggests instead using business case analysis to identify and assess outsourcing candidates. This recommendation implies that there are no benefits derived from the public/private competition--a direct contradiction to the findings of this research. It also presupposes that the private sector is necessarily more efficient and less expensive than the Government in all instances. This is not the case, however, since historically approximately fifty percent of functions subjected to cost comparison studies remained in-house and achieved cost savings. In most cases, it is the competitive process that allows the Government to realize savings, not the act of contracting out the function.

The Government may even hinder competition if, as previously stated, it continues to provide unclear and incomplete specifications and/or solicitations. The DoD must compete with other outsourcers for suppliers and many of the smaller companies might be hesitant to engage the volumes of bureaucratic redtape encountered when dealing with the Government especially when there is plenty of other business to go around. Additionally, if a supplier has to work too hard to determine what it is the DoD wants (due to a poorly written PWS and/or solicitation) it is likely that supplier, as well as many others, will refrain from bidding, thereby reducing effective competition.

Much of the savings achieved thus far from outsourcing have occurred in labor intensive activities and are a result of competition-induced personnel reductions. Both the government and the contractor examine the work to be done and attempt to figure out how to accomplish the service with fewer people. These competitions took place in an environment riddled with excess capacity. This level of excess no longer exists, thus much of the potential for savings through outsourcing may have been eliminated with the large amount of personnel reductions that have already occurred.

Monitoring. The DoD currently seems fully capable of providing oversight and monitoring the contractor's performance. The challenge will be in maintaining this capability in the future, especially on the more complex functions. Once an environment of total outsourcing exists, it will become increasingly difficult to acquire and sustain the technical knowledge necessary to competently monitor the contracts.



The area of administration where the DoD is lacking is in its ability to monitor the function after it has gone through the cost comparison process. The current estimates of 20 to 40 percent savings are based on past A-76 competitions and may be unreliable. As noted in the research, neither the DoD nor the OMB has reliable data on which to assess the soundness of savings estimates, past or present. Furthermore, neither knows the extent to which expected savings have been realized, since DoD does not routinely collect or analyze cost information to track savings after a cost study has been done. Clearly, the DoD is unable to accurately substantiate past, present, or future outsourcing savings. Since the direction to rely on commercially available sources includes the condition that the service or product can be procured *more economically* from a commercial source, it is imperative that the DoD be able to make that determination.

### **Recommendations**

The DoD should be cautious about wholeheartedly embracing the CORM and DSB recommendations to outsource essentially every non-warfighting activity. Though there is potential for savings through outsourcing, it is highly dependent on the existence of multiple conditions. The DoD needs to thoroughly re-evaluate potential outsourcing candidates on an individual basis in light of these conditions. It must determine not only if the activity is commercial in nature, but whether or not there is a market for that particular activity. Furthermore, the DoD must analyze the service specificity of the activity to

determine if it lends itself to clear and accurate definition. If it does not, the DoD should choose not to outsource that function regardless of its commercial nature.

In an era of acquisition reform, DoD outsourcing might be aided by providing potential contractors with overall performance objectives and then requiring them to develop the performance work statement. This approach would help to alleviate some of the difficulties DoD has experienced in its ability to clearly define the requirements.

Because incomplete information and inconsistent practices, both within each service and among the department as a whole, have hampered the DoD's ability to monitor and evaluate savings, the DoD should develop a comprehensive, systematized program to be implemented and managed on a department-wide basis. The cost identification issues are being addressed and will take some time, however, there is no reason in today's highly technological environment that contract performance cannot be consistently tracked within the DoD.

### **Recommendations for Future Research**

Several aspects of outsourcing can be explored in greater detail that may enhance future initiatives. First, it would be beneficial to identify and analyze the intrinsic differences between the private sector and the DoD. Since the private sector seems to be leading the outsourcing movement and serving as the barometer for the DoD, it would be good to know if there are any inherent differences that will prevent the DoD from achieving results similar to private

industry. Second, in light of the increasing instability in the world situation, what are the potential effects on cost savings if a contractor is required to participate in a prolonged contingency situation? Similarly, how might the level of service be affected in a long, drawn out contingency? How would a contractor handle surge capability when the required performance is highly volatile and highly variable?

### **Summary**

“Although DoD’s institutional setting differs from that of most successful commercial firms, the same factors that promote the decisions in the commercial sector relate to decisionmaking in DoD as well” (Camm, 1996:39). As such, certain conditions must be satisfied if outsourcing is to be successful. To the extent that the conditions are not satisfied, the outsourced arrangement will not be fully successful. Thus the DoD must carefully analyze, on an individual basis, the functions it intends to outsource to ensure that the requisite circumstances are present. A summary of certain findings of the 1987 President's Commission on Privatization suggests:

Contracting is likely to be most successful where the terms and measurements of service delivery are clear and easily defined, where at least several firms have the capacity to perform the contract, where the contractor does not have to make large new capital expenditures, and where the contract can be subject to renewal and renegotiation regularly. (Linowes, 1988:244)

“DoD is expecting significant savings from its current and planned outsourcing and privatization efforts. However, DoD’s outsourcing experience and the current operating environment suggest that projected savings from

current and planned outsourcing efforts may be overstated” (GAO, 1997a:6). If savings from these initiatives are not achieved and the defense budget remains relatively constant, planned weapon systems procurements may have to be delayed, stretched out, or cancelled; the force structure may have to be further reduced; and/or compromises may have to be made in military readiness (GAO, 1997b:2).

While historical information illustrates that savings are definitely possible, this information cannot be applied across the board to all commercial activities. Some functions are inherently more suited to outsourcing than others. If the previously mentioned conditions do not exist, the ability to achieve sizable savings will be hampered or even impossible. As the DoD proceeds with its current initiatives, it may be beneficial to take pause and reevaluate its plans. Commerciality is only one aspect that must be considered when deciding to outsource a function, and the DoD must ensure that it has thoroughly examined the activities it intends to turn over to the private sector. Finally, in moving toward a total outsourcing environment, the DoD must continue to research and analyze the impacts outsourcing will have on its ability to meet national security commitments.

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<b>13. ABSTRACT (Maximum 200 Words)</b> Because of continuing budget and personnel limitations and the need to fund weapons modernization, the Department of Defense has increased its emphasis on outsourcing support activities. Recent studies have suggested that aggressive outsourcing of support activities by the DoD could produce billions of dollars in savings. The overriding purpose behind this research was to determine to what extent projected savings can be substantiated. To explore the potential for savings, this thesis examines the evolution and impact of outsourcing and privatization in both the private and public sectors. Next it looks at the experiences of private and public sectors to identify characteristics of successful and unsuccessful outsourcing ventures. Finally, it examines the Department of Defense's past experience in achieving cost savings through outsourcing. The research revealed that savings have occurred through outsourcing and that most successful initiatives occur when the following conditions are present: (1) the requirement is specified unambiguously; (2) a competitive market exists; (3) the contractor's performance can be monitored; and (4) appropriate terms are included in the contract. DoD's previous outsourcing experience demonstrates that all of these conditions are not always satisfied and suggests that projected savings from current and planned initiatives may be overstated.				
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