

# SOURCING A MULTI-SECTOR WORKFORCE

BY

CHAPLAIN (COLONEL) DAVID W. SMARTT  
United States Army

DISTRIBUTION STATEMENT A:

Approved for Public Release.  
Distribution is Unlimited.

USAWC CLASS OF 2010

This PRP is submitted in partial fulfillment of the requirements of the Master of Strategic Studies Degree. The views expressed in this student academic research paper are those of the author and do not reflect the official policy or position of the Department of the Army, Department of Defense, or the U.S. Government.



U.S. Army War College, Carlisle Barracks, PA 17013-5050

The U.S. Army War College is accredited by the Commission on Higher Education of the Middle State Association of Colleges and Schools, 3624 Market Street, Philadelphia, PA 19104, (215) 662-5606. The Commission on Higher Education is an institutional accrediting agency recognized by the U.S. Secretary of Education and the Council for Higher Education Accreditation.

# REPORT DOCUMENTATION PAGE

*Form Approved*  
*OMB No. 0704-0188*

Public reporting burden for this collection of information is estimated to average 1 hour per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing this collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden to Department of Defense, Washington Headquarters Services, Directorate for Information Operations and Reports (0704-0188), 1215 Jefferson Davis Highway, Suite 1204, Arlington, VA 22202-4302. Respondents should be aware that notwithstanding any other provision of law, no person shall be subject to any penalty for failing to comply with a collection of information if it does not display a currently valid OMB control number. **PLEASE DO NOT RETURN YOUR FORM TO THE ABOVE ADDRESS.**

<b>1. REPORT DATE (DD-MM-YYYY)</b> 14-05-2010		<b>2. REPORT TYPE</b> Program Research Project		<b>3. DATES COVERED (From - To)</b>	
<b>4. TITLE AND SUBTITLE</b>  Sourcing a Multi-Sector Workforce				<b>5a. CONTRACT NUMBER</b>	
				<b>5b. GRANT NUMBER</b>	
				<b>5c. PROGRAM ELEMENT NUMBER</b>	
<b>6. AUTHOR(S)</b> Chaplain (Colonel) David W. Smartt				<b>5d. PROJECT NUMBER</b>	
				<b>5e. TASK NUMBER</b>	
				<b>5f. WORK UNIT NUMBER</b>	
<b>7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES)</b> Colonel Alan Phaneuf Department of Distance Education				<b>8. PERFORMING ORGANIZATION REPORT NUMBER</b>	
<b>9. SPONSORING / MONITORING AGENCY NAME(S) AND ADDRESS(ES)</b> U.S. Army War College 122 Forbes Avenue Carlisle, PA 17013				<b>10. SPONSOR/MONITOR'S ACRONYM(S)</b>	
				<b>11. SPONSOR/MONITOR'S REPORT NUMBER(S)</b>	
<b>12. DISTRIBUTION / AVAILABILITY STATEMENT</b> Distribution A: Unlimited					
<b>13. SUPPLEMENTARY NOTES</b>					
<b>14. ABSTRACT</b> The Department of Defense (DoD) has pursued competitive sourcing initiatives to reduce costs, improve services, and to insure the government does not usurp the private sector in performing government functions. Recently, the tide has shifted from outsourcing to insourcing as abuses and cost overruns have come to light. Outsourcing has provided both the government and the private sector a viable sourcing option promising efficiencies and quality improvements. However, it is clear that there are important reasons to retain in-house some functions that are inherently governmental. The principles of transaction cost economics such as asset specificity, service complexity, uncertainty, frequency, and operational necessity have further informed the discussion on what services would make good candidates to outsource and what services managers should retain in-house. Taking this into consideration as well as the multiple risks associated with contracting functions, DoD has adjusted policy with greater emphasis on insourcing. With this new direction and with a balanced approach, program managers and leaders can potentially gain efficiencies, increase quality, and enhance mission success by effectively utilizing a multi-sector workforce.					
<b>15. SUBJECT TERMS</b>  Outsourcing, Insourcing, Transaction Cost Economics					
<b>16. SECURITY CLASSIFICATION OF:</b>			<b>17. LIMITATION OF ABSTRACT</b>  UNLIMITED	<b>18. NUMBER OF PAGES</b>  28	<b>19a. NAME OF RESPONSIBLE PERSON</b>
<b>a. REPORT</b> UNCLASSIFIED	<b>b. ABSTRACT</b> UNCLASSIFIED	<b>c. THIS PAGE</b> UNCLASSIFIED			<b>19b. TELEPHONE NUMBER (include area code)</b>



USAWC PROGRAM RESEARCH PROJECT

**SOURCING A MULTI-SECTOR WORKFORCE**

by

Chaplain (Colonel) David W. Smartt  
United States Army

Topic Approved By  
Colonel Alan M. Phaneuf

This PRP is submitted in partial fulfillment of the requirements of the Master of Strategic Studies Degree. The U.S. Army War College is accredited by the Commission on Higher Education of the Middle States Association of Colleges and Schools, 3624 Market Street, Philadelphia, PA 19104, (215) 662-5606. The Commission on Higher Education is an institutional accrediting agency recognized by the U.S. Secretary of Education and the Council for Higher Education Accreditation.

The views expressed in this student academic research paper are those of the author and do not reflect the official policy or position of the Department of the Army, Department of Defense, or the U.S. Government.

U.S. Army War College  
CARLISLE BARRACKS, PENNSYLVANIA 17013



## **ABSTRACT**

**AUTHOR:** Chaplain (Colonel) David W. Smartt  
**TITLE:** Sourcing a Multi-Sector Workforce  
**FORMAT:** Program Research Project  
**DATE:** 14 May 2010    **WORD COUNT:** 5,810    **PAGES:** 28  
**KEY TERMS:** Outsourcing, Insourcing, Transaction Cost Economics  
**CLASSIFICATION:** Unclassified

The Department of Defense (DoD) has pursued competitive sourcing initiatives to reduce costs, improve services, and to insure the government does not usurp the private sector in performing government functions. Recently, the tide has shifted from outsourcing to insourcing as abuses and cost overruns have come to light. Outsourcing has provided both the government and the private sector a viable sourcing option promising efficiencies and quality improvements. However, it is clear that there are important reasons to retain in-house some functions that are inherently governmental. The principles of transaction cost economics such as asset specificity, service complexity, uncertainty, frequency, and operational necessity have further informed the discussion on what services would make good candidates to outsource and what services managers should retain in-house. Taking this into consideration as well as the multiple risks associated with contracting functions, DoD has adjusted policy with greater emphasis on insourcing. With this new direction and with a balanced approach, program managers and leaders can potentially gain efficiencies, increase quality, and enhance mission success by effectively utilizing a multi-sector workforce.





## SOURCING A MULTI-SECTOR WORKFORCE

Sourcing the Department of Defense (DoD) workforce has become a highly competitive and complex process. Finding the right balance of contractors and DoD employees has strategic implications and can significantly affect the government's ability to perform at an optimum level. Government leaders have a clear responsibility to provide the best possible services at the lowest cost to the taxpayer when deciding whether to make or buy a product or service. Additionally, a long-standing principle that the government should not displace or compete with the private sector for services readily available in the market lends itself to careful scrutiny on the necessary functions the government should source from within the private sector. Yet, there are some services that are so closely associated with the government's ability to function that they are intrinsically linked to effective performance and leaders may consider them "inherently governmental".<sup>1</sup> Determining what services the government can and should contract with the private sector to provide and what functions the government should retain in-house is clearly a challenge.

The goal is to optimize both arenas thereby achieving the best services at the lowest price while supporting private industry and the in-house workforce. Government policy on sourcing has varied somewhat over the past several years as leaders have made efforts to attain equilibrium in sourcing government functions. Outsourcing has unmistakable advantages such as accessing new technologies and processes without the cost of research and development as well as providing the flexibility to accommodate surges in demand for certain functions. This can lead to cost savings and

improved quality. However, it is not always the best course of action for every function and can lead to higher costs and even jeopardize the government's ability to perform its core missions.

An economic theory, transaction cost economics (TCE), offers a conceptual framework within which to explore some of the cost dimensions to workforce sourcing. TCE holds that transaction costs would have significant bearing on whether the firm would choose to make or purchase a product or service in the market and that there are multiple human and market dimensions to the transaction that will affect that decision. Proponents of TCE believe there is more to the sourcing decision than comparing costs and functions and that government leaders should consider transaction cost elements as well.

In short, effectively and efficiently sourcing government functions is clearly a challenge requiring an assessment of both the direct costs to the government as well as the indirect and often hidden costs not easily captured by cost benefit analyses. Therefore, to gain perspective on this challenging task, it is important to explore past and present sourcing efforts and policies, arguments from both sides of the sourcing debate, and the features of transaction cost economics that offer insight into the multiple dimensions of sourcing this multi-sector workforce.

### Past Trends in Sourcing the Workforce

There have been major momentum shifts over the last three decades in how the government has approached sourcing the workforce. With Army Transformation, the momentum for competitive sourcing initiatives gained strength as Army leadership undertook the task to change the organization and structure of the Army. They sought to modernize its strategy and equipment to meet post cold war demands for a leaner,

more mobile force able to respond quickly and effectively to modern threats.<sup>2</sup> The forces that drove competitive sourcing efforts existed both within and without the Army's organization. Internal agency program managers grappled with restrained resources in search of ways to maximize combat readiness within budget constraints without elevating work force end strength caps set by Congress. From without, contractors offered tantalizing proposals promising lower costs and improved services. Additionally, government leaders sought best business practices such as outsourcing as a formidable management mechanism to reduce costs and improve quality.<sup>3</sup>

While competitive sourcing ramped up with Army Transformation, it had slowly been gaining support even prior to the Vietnam era. The impetus for this movement was Office of Management and Budget (OMB) Circular A-76 (1983).<sup>4</sup> This document was first issued in 1966 with multiple revisions through 1999 when the government issued a revised policy and a supplemental handbook that outlined the procedures for managing competitions.<sup>5</sup> The following excerpt from the circular identifies the government's conceptual basis for outsourcing:

In the process of governing, the government should not compete with its citizens. The competitive enterprise system, characterized by individual freedom and initiative, is the primary source of national economic growth. In recognition of this principle, it has been and continues to be the general policy of the government to rely on commercial sources to supply the products and services the government needs.<sup>6</sup>

This principle insists that it is incumbent upon the federal government to use the private sector for those goods and services not deemed inherently governmental. In essence, it was held that the government should not compete against its citizens by providing goods and services in-house when they are readily available in the market. Additionally, the leadership assumed that the government had the capacity to effectively

conduct fair competitions and that these competitions would not require government oversight. The market itself would ultimately determine what is the most cost effective and efficient sourcing activity.<sup>7</sup>

Initially, resistance to privatization prevailed as DoD agency managers were reluctant to pursue certain outsourcing initiatives such as the managed competitions defined by OMB Circular A-76. Instead, they used reengineering, reinvention, and consolidation to achieve cost savings.<sup>8</sup> With the passing of the Federal Activities Inventory Reform (FAIR) Act of 1998, Congress insisted that government agencies' administrators provide OMB with a list of all positions that were not inherently governmental for consideration for outsourcing.<sup>9</sup> The view of DoD leaders was that these positions were in essence commercial activities and therefore subject to competitive sourcing and privatization. However, at that time, the leadership did not act on the issue beyond compiling a list.<sup>10</sup> The Bush administration added more emphasis as depicted in the President's Management Agenda (2002), which laid-out specific targets to implement outsourcing and to ensure that the government made competitive sourcing a priority.<sup>11</sup>

In this document, the President reinforced the need for all government agencies to engage in competitive sourcing. The primary reason was the belief that competition would breed innovation, increase quality, and lowers costs. Additionally, government leaders believed that because managers of government agencies do not face competition, they might lack sufficient motivation to achieve the cost savings and quality improvements one would expect of civilian agencies in a competitive market.<sup>12</sup> These actions and assumptions led the way for unprecedented expansion of outsourcing as

the private sector mobilized with creativity and enthusiasm seeking lucrative government contracts.

Clearly, the most convincing argument contributing to the momentum of outsourcing in the federal government was a reported record of cost savings for those organizations that had outsourced non-inherently governmental functions.<sup>13</sup> In 1996, a DoD report showed that the government had saved \$1.5 billion annually due to outsourcing and that an additional 600,000 military and civilian positions could be outsourced to produce even more savings and dollars for defense.

Researchers in a study by the CNA Corporation, a non-profit research organization, found that between 1974 and 1994, over 98,000 jobs were subjected to competitive sourcing studies leading to a 31% savings for the government. In a later study, looking at sourcing initiatives from 1995 to 2000, researchers found a 44% savings over previous costs.<sup>14</sup> Using data like these, some believed that if OMB could get half of the positions identified as non-governmental and subject to outsourcing to compete under the OMB A-76 competitive sourcing rules, the government could save as much as \$14 billion annually.

OMB estimates for 2003 show that the government anticipated savings of about \$1.2 billion from federal government competitive sourcing actions for a cost savings of 15%.<sup>15</sup> With similar actions accomplished in 2003 and 2004, the President's Management Council Report indicated that the federal government had subjected 30,000 positions to competition leading to an expected savings of \$2.5 billion over 5 years.<sup>16</sup> Leaders anticipated signified improvements in management, process reengineering, workforce realignments, and technological advancements. Assertions

such as these certainly got the attention of leaders and lawmakers alike as the global war on terror continued to consume scarce resources and as the Army transformed into a leaner, more mobile fighting force.

### Current Trends

In the past two years, the tide has turned appreciably in favor of insourcing rather than outsourcing government functions. Many leaders have come to believe that outsourcing is not the panacea managers had hoped. They have found that, while there are some positive results, outsourcing has not always led to increased government efficiency and effectiveness. Since 2008, program managers have had good reason to question the claims of cost savings and improvements associated with outsourcing. This has caused DoD leaders to rethink how best to manage a multi-sector workforce comprised of both contractors and an in-house workforce of military and civilian employees.

Clearly, there has been solid Congressional and public support for reducing the size and reach of the federal government by privatizing some functions.<sup>17</sup> However, the previous years of heavy emphasis on outsourcing has not always proven to be in the best interest of the government. Because of this, the current administration has implemented new guidance as stated by the Director of OMB:

Contractors provide vital expertise to the government and agencies must continue to strengthen their acquisition practices so they can take efficient and effective advantage of the marketplace to meet taxpayer needs. At the same time, agencies must be alert to situations in which excessive reliance on contractors undermines the ability of the federal government to accomplish its missions. In particular, overreliance on contractors can lead to the erosion of the in-house capacity that is essential to effective government performance. Such overreliance has been encouraged by one-sided management priorities that have publicly rewarded agencies for becoming experts in identifying functions to outsource and have ignored the costs stemming from loss of institutional

knowledge and capability and from inadequate management of contracted activities.<sup>18</sup>

Indeed, the momentum has shifted and now government agencies are actively seeking to insource rather than outsource. Program managers are meticulously scrutinizing current contracts for conversion to DA Civilian job requirements.<sup>19</sup>

The National Defense Authorization Act for 2008 required the Under Secretary of Defense for Personnel and Readiness to provide guidance on how to manage the workforce more effectively with renewed flexibility on hiring government employees to replace contractors.<sup>20</sup> This was widely accepted as a positive step in the right direction to insuring the government workforce was adequately staffed with the right skills and capabilities to support the needs of DoD, but with renewed emphasis on using in-house employees.

Among the provisions within the NDAA was the directive to provide “special consideration” for certain functions that are performed within DoD.<sup>21</sup> In other words, the government is to give added significance to using DoD employees instead of contractors under certain, rather broad conditions. This special consideration applies to the following duties currently performed by a contractor: duties previously performed by a civilian employee within the past 10 years, duties that are “closely associated” to inherently governmental functions, duties the government had awarded to a non-competitive contract, and duties managers deemed contractors to have performed poorly or inefficiently. Additionally, under this new rule, program managers give special consideration for insourcing work if the duties are similar to functions done by civilian employees or if they deem them to be similar to inherently governmental functions.<sup>22</sup>

DoD leaders have made significant strides to clear up some of the ambiguities that have existed with respect to sourcing requirements. One example is revisions made to the Office of Federal Procurement policies that redefined what functions leaders should consider inherently governmental. The policies instructed agencies to avoid becoming dependent on contractors for those functions so closely tied to the operation of the government that they were fundamental to its responsibility.<sup>23</sup> Interestingly, cost savings took on a decidedly secondary role with respect to outsourcing decisions.

One could argue that using cost as a secondary driver has always been the case or at least should have been. DoD leaders never intended for inherently governmental functions to be relegated to outsourcing based on cost savings. However, in practice, this distinction has not always insured that program managers retained in-house core and inherently governmental functions. This was due largely to inadequate costing factors and significant pressure to reduce costs as budgets grew leaner while requirements mounted with the global war on terror. Additionally, fluctuations in the definition of what constituted inherently governmental along with a wide range of interpretations gave rise to unequal application of policy. It also led to outsourcing of functions important to the operational mission, which has become problematic on multiple levels.

### The Outsourcing Insourcing Debate

There are viable studies that have explored the benefits and risks of sourcing a multi-sector workforce. On the one hand, both the government and businesses in the private sector have experienced some success by outsourcing certain functions. Business leaders embraced outsourcing as an answer to the competitive market while government leaders saw it as a means to garner efficiencies and reduce costs.



However, what appeared to be a widely accepted fact has more recently come under scrutiny in a debate on the merits of contracting functions previously held by in-house employees.

Outsourcing presumes to promise increased efficiency and reduced costs due to the competition in the market that culls out inefficient companies.<sup>24</sup> Outsourcing can lead to the use of new technology and innovation as well as new processes and equipment that will enhance performance and effectiveness. The most notable benefit of outsourcing is the competition and incentives the competitive market provides in contrast to the government's in-house employee structure that has limited rewards for increased performance and lowering costs.

In a study by Pricewaterhouse Coopers (2004), researchers surveyed 1,400 Chief Executive Officers (CEO) from organizations that span globally about the current business climate and emerging practices to help organizations build value.<sup>25</sup> The results reflected that CEOs favor contracting and are inclined to outsource core business functions. The study showed that 56 percent in 2003 favored outsourcing, which is an increase over 2001 where 46 percent of CEOs surveyed favored it. Additionally, 73 percent of the CEOs indicated that outsourcing was now an integral part of their business strategy. To the extent that DoD had made significant strides to benchmark with private industry for process and performance improvements, this study along with others led DoD to pursue outsourcing with fervor.

However, more recently, the debate has shifted and insourcing is now commanding prominent attention both within the government and across the business sector. The most convincing argument is the emerging perception that outsourcing may

have not delivered on its promises as stated in a recent Government Accounting Office Report (2008). The report stated, “Although DOD justified its logistics outsourcing initiatives based on the assumption that there would be significant cost savings, it is uncertain to what extent cost savings have occurred or will occur.”<sup>26</sup> Contracting functions have not only failed to produce the guaranteed savings and quality improvements forecasted, but in some cases, they have even led to government failure to perform its basic functions. Additionally, because many in the private sector have failed to achieve revenue goals, business leaders have begun to rethink their management of priorities for sourcing their workforce.<sup>27</sup>

In the private sector, while many still see outsourcing as a viable business practice, there are those who take issue with claims that touted outsourcing as the answer to increased efficiency. A consulting service for corporate information management found that the higher performing firms with much higher return on equity also tended to have a much lower outsourcing ratio while lower performing firms tended to engaged more heavily in outsourcing.<sup>28</sup> The service concluded that outsourcing was not a significant factor determining if a firm will be profitable and that the complexity of outsourcing, if not properly managed, could offset and void any gains made from any workforce labor savings.

Evidence is mounting that shows the government has not realized the cost reductions anticipated for outsourcing initiatives as well. In a December 2004 report by the Department of Energy, officials concluded that outsourcing efforts have proven more costly than anticipated. In 1997, administrators in the Department of Energy Acquisition Regulation initiated a make-or-buy program to enhance acquisition efficiency. However,

the 2004 report stated that, "... the make-or-buy program is not delivering the value to the Department commensurate with the costs of its implementation."<sup>29</sup>

Critics of outsourcing have suggested that there are copious issues not reflected in the numbers claimed to support outsourcing initiatives. Results from a Deloitte study (2005) of 25 major organizations showed that the acclaimed cost savings and quality benefits of outsourcing have not proven realistic.<sup>30</sup> In this study, researchers found that 70% of survey respondents reported negative experiences with outsourcing. Almost half, 44%, failed to gain the cost reductions they had anticipated and one out of four organizations reinstated the in-house function. Additionally, 38% of the respondents reported paying unexpected, obscured costs not considered in the original contracts. While most respondents were seeking improvements in quality along with cost savings, 31% reported that contractors who claimed improvements became complacent after the contract was implemented and failed to deliver the high performance promised. Additionally, managers found that they lost the flexibility of their in-house program and that, in numerous cases, contractors overstated their capabilities and could not perform at the level expected.

There are also unresolved issues leaders must consider about the use of civilian contractors in support of deployed operations in overseas theaters. Among the concerns surrounding contractors in conflict situations are issues of trust, confidence, and the building of a mutual understanding and partnership for the mission. Such features are intangible and difficult to measure. Because the statement of work in a contract is by design comprised of measurable performance functions, these intangible aspects are difficult to capture in a standard contract.

Additionally, DoD might risk reliability and quality within the workforce when excessively contracting functions. A Government Accounting Office Report (2008) indicated that the government had relied too heavily on contractors for core mission functions that contributed to government failures such as leaders experienced with the Hurricane Katrina emergency response.<sup>31</sup> In such situations, the vendor can default and may be less responsive to emergencies than in-house service providers. In addition, once the government no longer provides the service, the function and the knowledge base to support it go away. This can ultimately lead to higher costs and can result in lower quality performance. The government risks losing its competitive leverage and becomes dependent on the contractor to provide a service the government is no longer capable of providing.

One of the key strengths of insourcing is that the government retains better control over the function and the workforce providing it.<sup>32</sup> With outsourcing, there can be a relative lack of effective oversight to insure the government is receiving the product or service to the appropriate standard for which it contracted. In many respects contracting a function effectively leads to loss of governmental control. When the government outsources a function, leaders can lose direct supervision of the activity only monitoring performance as it relates to the statement of work. If the contract's statement of work is insufficient or poorly written, it can lead to under performance, confusion, and inferior quality. While the government can regain control by increasing oversight and training of program managers and commanders to better monitor contract performance, this adds to the cost of the contract.

Additional considerations for insourcing are the extent to which a contractor may be held legally liable for their activities and who is responsible for the costs associated with addressing that liability. Unlike contractors, the law automatically covers with “sovereign immunity” all DoD civilians and military personnel.<sup>33</sup> The US government handles any lawsuits and assumes responsibility for claims and damages that might arise due to employees’ performance of duties. Contractors, on the other hand, do not have the same privilege and must seek coverage against any such liabilities. This can add expenses not captured by direct cost comparisons. Additionally, while the government might hold the contractor fiscally responsible for damages, one could argue that the government will find it difficult, if not impossible, to pass to the contractor damages to the US public image. Some will blame the government in spite of the fact that the perpetrators were contractors. Because they were working for the US government, by default, the public will see them as extensions of the government’s workforce.

Examples of apparent contractor abuse are numerous. The most notorious might be the activities of Blackwater in Iraq. This contracting firm had supplied security services for diplomats and others during and after the Iraq war. In 2007, some of their employees were blamed for the deaths of 14 unarmed civilians and many others wounded. Though the firm recently changed their name to Xe Services, once again they made the headlines in 2010, this time for sexual abuse charges. Because of this, the Iraqi Interior Minister, Jawad Bolani, recently expelled 250 of their employees.<sup>34</sup> This firm had provided a workforce under contract, but the US has paid a significant public relations price for their actions both at home and in the Arab world.

## Sourcing Informed by Transaction Cost Economics

To better frame the discussion, it is important to explore workforce sourcing within the context of a conceptual paradigm that can serve as a foundation for understanding the multiple dimensions of the sourcing decision. Transaction Cost Economics (TCE) offers insight into the sourcing decision of an organization and how that decision can help or harm the ability of the organization to compete in the market. It lays the foundation for understanding that there are numerous contingencies beyond direct costs that leaders must take into account as they consider sourcing multi-sector workforce that comprises DoD.

The basic intent of the theory is to explain why firms exist and why they choose certain governance structures in light of the transactions in which a firm will engage to conduct business.<sup>35</sup> TCE assumes that managers and business owners will behave in rational ways, but with limitations. It further presupposes that individuals will act in ways that contribute to their self-interests even to the point of exploitation under certain conditions. In fact, opportunism will take over as individuals take advantage of situations where they can exploit another person or organization if given the opportunity.<sup>36</sup> This lays the basis for assumptions one can make with respect to the sourcing decision and how firms will act and react given market conditions and the bounded rationality of those seeking profit.

One of the key principles of TCE that has important implications for governmental sourcing is asset specificity. This principle is defined as the extent to which a product or service is highly differentiated.<sup>37</sup> Highly differentiated products or services normally indicates that there is little competition for their procurement and that they are not widely available in the market. Such assets are not generic or routine functions but have

limited application across the market so there are few producers. If outsourced, the impact on the organization may initially be minimal. However, the organization can lose leverage in the bargaining process and become dependent on the producer or contractor for the product or service. Additionally, the government is susceptible to the possibility that the contractor will default or fail to deliver in a timely manner and “hold up” the process. When the contractor has the leverage, they can control delivery of the service and demand the price they determine. Due to opportunism and the potential for hold up problems, the producer of this unique item has the advantage. The organization can find itself at the mercy of its supplier, paying a higher price and with the risk of reduced quality.<sup>38</sup>

Additional elements of TCE are uncertainty, frequency, and how closely related the function is to the core mission of the organization. The principles of TCE demonstrate that these elements are critical cost factors. Where the service is closely tied to the core mission of the organization, is required consistently, and is subject to change, outsourcing may not be the best course of action.<sup>39</sup> An example may be some Information Technology services which are highly specialized, complex, and required regularly to perform the government mission. On the contrary, if the service rarely is needed, not subject to change, and the potential for mission failure is low if the service is performed poorly, as with some custodial and maintenance tasks, the risk to the government is minimal.

However, when the service is needed frequently, there is significant chance for variability, and if the mission will fail if performed improperly, there is high risk to the government. Outsourcing may not be the best approach. As with asset specificity, these

elements can lead to opportunism, incomplete contracting, and hold up problems that mitigate potential cost savings. Additionally, it can lead to lower quality and even government failure particularly to the extent that the contractor may have overstated their ability to perform and if there is insufficient oversight and monitoring of performance. In the aftermath of September 11, 2001, it was revealed that the Federal Aviation Administration (FAA) had delegated responsibility for airport security to the nation's airlines, which in turn had hired private firms that failed to provide an adequate level of security.<sup>40</sup> Outsourcing this key function is no longer considered viable.

Assuming the principles of TCE are valid, it is clear that outsourcing a highly technical or specified skill that is a core capability needed frequently and with high uncertainty may not produce the cost savings anticipated. If the skilled labor pool is limited and there are few competitors offering the service, the government will find it necessary to negotiate in a position of weakness with the private sector. When the organization outsources the skilled function and no longer retains the capacity to grow the skilled laborers in-house, it will be at the mercy of the supplier who has clear profit motives. With little leverage and because the service is vital, the government must pay the price the supplier dictates which can lead to increased costs and decreased quality.

This is particularly evident when a sole contractor is used for critical services. Evidence is plentiful, but a particularly noteworthy sole sourced contract drew public and political attention for alleged abuses. In 2006, it was reported that the Army's sole source contract with Halliburton Corporation was being discontinued amid reports of abuse and over charging for services.<sup>41</sup> Halliburton had been awarded a \$7.3 billion contract to provide a variety of logistical support services to the soldiers in Iraq. Clearly,



there were few companies with the capability to provide this vital service on such notice. Audits revealed up to \$1 billion in costs billed to the government that were out of line with reasonable expectations. The Army's position was stated, "...officials defended the company's performance but also acknowledged that reliance on a single contractor left the government vulnerable."<sup>42</sup>

Logistics services are highly complex functions with multiple dimensions. Complexity is an important consideration for a contracted function not always captured by cost comparisons.<sup>43</sup> Highly complex tasks can be outsourced and can provide the organization with skills they cannot produce in-house. However, it is often a challenge to encapsulate all of the elements of highly complex tasks. In addition, when competing for sourcing, the contract may initially appear less costly, but there may be tasks and functions performed by the in-house workforce not fully encompassed within the statement of work. Outsourcing such tasks can lead to additional unforeseen costs as program managers identify the elements not previously identified and add line items to the contract to meet the mission requirement.

The Government Accounting Office found that the government has not realized expected cost savings from outsourcing some logistics functions. A Government Accounting Office Report (2008) indicated that outsourcing depot maintenance has not provided the savings anticipated stated the following:

We noted that in the absence of a highly competitive market, privatizing unique, highly diverse, and complex depot maintenance workloads that require large capital investments, extensive technical data, and highly skilled and trained personnel would not likely achieve expected savings and could increase the costs of depot maintenance operations. We also questioned the Defense Science Board's projections of \$30 billion in annual savings from privatizing almost all logistics support activities.<sup>44</sup>

While direct cost comparisons may have encouraged privatization from the outset, the effects of transaction costs likely diminished the projected savings.

It is evident that comparing direct costs alone is only a part of the critical elements to assess when considering a sourcing decision. TCE offers a framework within which to explore additional strategic and peripheral nuances of sourcing that go beyond a cost benefit analysis. Program managers cannot always capture all the costs associated with a sourcing effort because of the second and third order effects and the strategic implications that can emerge within the context of a make or buy transaction. These elements may be less obvious than accounting data in determining cost factors, but they clearly have significant bearing in the final analysis.

### The Way Ahead

As the 2008 Government Accounting Office Report indicated, competitive sourcing initiatives, particularly with respect to logistics, services may have gone too far by privatizing some government functions that would have been better to retain in-house.<sup>45</sup> Government leaders have responded by placing more stringent limits on outsourcing initiatives. Competitive sourcing policies had expanded outsourcing rapidly without fully exploring the multiple costing dimensions beyond direct costs. While it is important to insource those functions that are inherently governmental, leaders must also consider the dimensions of transactions cost such as asset specificity, uncertainty, frequency, and mission importance as well. The tenants of TCE offer important insight for organizations that might choose to outsource a function affected by these dimensions. In effect, for functions at risk of high transaction costs, outsourcing can lead to loss of leverage in the competitive bidding process, which, in turn, can lead to reduced quality, and higher costs.

These principles have taken hold as government leaders are becoming less inclined to allow direct costs savings alone drive sourcing decisions. An example of this shift in thinking is reflected in a recent DoD instruction. This instruction stipulates that alleviating risk is a higher priority than achieving cost savings in determining the proper workforce mix of private sector contractors and in-house DoD employees. This includes risks to oversight and control, command and control, and fiscal responsibilities.<sup>46</sup> For those functions that are considered commercial activities and non-inherently governmental, cost is still the deciding sourcing factor. However, unlike previous guidance, government instruction emphasizes a workforce mix that minimizes risk as a higher priority than cost savings.

One of the key risks leaders must now consider is the possibility that a contractor rather than a DoD employee or military personnel would exercise undue influence on operational decisions. This would exceed their authority and could expose the government to exploitation. Additionally, there must be sufficient personnel trained and available to provide proper oversight of contracted personnel. There are risks to command and operational control that have to do with readiness and continuity of operations. Unacceptable risk relates to the extent that contracting might impinge negatively on the ability of the organization to accomplish its mission effectively. There are also risks to fiscal responsibilities. This is evident when the cost to engage in the contracting process exceeds the cost of employees to perform the function. In this situation, the risk is high. To mitigate this requires developing complete statements of work, carefully processing and executing the award, and conducting the proper

assessment to insure the contractor is performing in accordance with the terms of the contract.<sup>47</sup>

Because of the risks identified with outsourcing and a dubious record of increased performance quality and efficiency, the government's propensity for sourcing the workforce has shifted toward insourcing. Like many issues that seem to vacillate precariously with the political winds of change, there can be a tendency to go too far in either direction that can lead to unproductive excesses. To be effective and to insure stability within the workforce and government services, policy and practice on sourcing the workforce clearly needs stability.

The spectrum has seen the government shift from a headstrong effort to privatize reducing the number of government employees, to the current paradigm where virtually all contracts are suspect. Program managers must justify why they will outsource any function and must give special consideration to in-house production. If there is any indication that the function was previously performed by or similar to other functions performed by civilian employees, leaders must now more carefully scrutinize the value of retaining the function in-house.

There are those such as the American Federation of Government Employees (AFGE) who would argue that the policy preceding the 2008 NDAA defined by OMB Circular A-76 likely went too far in favor of the private sector.<sup>48</sup> As the principles of TCE reveal, outsourcing can lead to less than full disclosure of the true costs associated with contracting, making the government somewhat vulnerable to manipulation and exploitation. In some cases, it can open the door for excessive costs, reduced competition, and lack of control over a workforce employed by large corporations with

loyalties divided accordingly. Additionally, US strategic interests can suffer because of contractor abuses, failures, and unacceptable behavior often linked to serious tragedies as well as public relation fiascos.

In light of this, the current movement toward insourcing is promising. To the extent that some of the earlier abuses were the result of overemphasis on privatization, leaders can expect improvement. Still, program managers must keep in mind that there is much to gain from outsourcing the right functions. Properly managed, outsourcing can produce efficiencies and improvements in quality. The key will be for government leaders to avoid overemphasis on either side. Program managers must take a balanced approach, fully considering and weighing the multiple dimensions of this management tool. A workforce comprised of the right balance of both contractors and in-house military and civilian employees can provide significant cost savings and quality improvements by giving the government flexibility and access to new processes and technologies from the private sector.

The government needs both the flexibility and reliability a multi-sector workforce provides in order to address critical challenges efficiently and effectively. With improved contractor oversight and more clearly defined contractor roles, outsourcing will continue to provide a surge capacity as well as an opportunity for cost savings and quality improvements. By retaining core capabilities and mission critical functions in-house, leaders will insure consistency and dependability. They will also likely mitigate some of the challenges and failures that have undermined the benefits of incorporating the private sector. Indeed, this will hone the government's strategic edge and will help shape a workforce that is responsive and ready for the challenges ahead.

## Endnotes

<sup>1</sup> US Army Insourcing Policies. "Inherently Governmental Worksheet," June 17, 2009, <http://www.asamra.army.mil/insourcing/>, (accessed February 18, 2010).

<sup>2</sup> Peter J. Schoomaker and R. L. Brownlee, *US Army Transformation Roadmap 2003*. (Washington, DC.: US Department of the Army, 2003), IX.

<sup>3</sup> Department of Defense Report , "Improving the Combat Edge Through Outsourcing" released March 1996.

<sup>4</sup> Office of Management and Budget, "Performance of Commercial Activities" 1983 (OMB Circular No. A-76), <http://wdr.doleta.gov/directives/attach/UIPL/UIPL12-01a1.pdf> (accessed April 24, 2010).

<sup>5</sup> Office of Management and Budget, "Circulars," <http://www.whitehouse.gov/omb/circulars/> (accessed April 24, 2010).

<sup>6</sup> Office of Management and Budget. (1983).

<sup>7</sup> Valerie Grasso, "Defense Outsourcing: The OMB Circular A-76 Policy," Congressional Research Service Report for Congress June 30, 2005, <http://www.fas.org/sqp/crs/natsec/RL30392.pdf> (accessed 24 April 2010), 3-4.

<sup>8</sup> *Ibid.*, 8.

<sup>9</sup> Federal Activities Inventory Reform (FAIR) Act of 1998, Public Law 105-270, 105th Congress, (July 28, 1998), 112.

<sup>10</sup> Ronald D. Utt, "Improving Government Performance Through Competitive Contracting." *The Heritage Foundation Backgrounder*, June, 2001, <http://www.heritage.org/Research/-Reports/2001/06/Improving-Govt-Performance-Through-Competition> (accessed April 25, 2010).

<sup>11</sup> Office of Management and Budget, "The President's Management Agenda," (Washington, DC: US Government Printing Office, 2002), 18.

<sup>12</sup> *Ibid.*

<sup>13</sup> Utt. 2001.

<sup>14</sup> *Ibid.*

<sup>15</sup> Office of Management and Budget, "Competitive Sourcing: Report on Competitive Sourcing Results Fiscal Year 2004" [http://www.whitehouse.gov/omb/procurement/comp\\_sourcing\\_results\\_fy04.pdf](http://www.whitehouse.gov/omb/procurement/comp_sourcing_results_fy04.pdf) (accessed April 24, 2010). 10-11.

<sup>16</sup> Office of Management and Budget, "Giving the American People More for their Money. A Report From the President's Management Council," July 2005, <http://share76.fedworx.org/>

ShareA76/docs/31%20%20Office%20of%20Management%20and%20Budget/2005%20Results%20Report.pdf (accessed April 23 2010), 6.

<sup>17</sup> Grasso, 2005, 30.

<sup>18</sup> Director, Office of Management and Budget Peter R. Orzag, "Managing the Multi-Sector Workforce," memorandum for Heads of Departments and Agencies, Washington, D.C., July 29, 2009.

<sup>19</sup> Robert Brodsky, "Administration Puts its Stamp on 'Inherently Governmental'," *GovExec.com*, March 31, 2010.

<sup>20</sup> National Defense Authorization Act for Fiscal Year 2008, Public Law No: 110-181, 110<sup>th</sup> Congress, (January 28, 2008), 291.

<sup>21</sup> *Ibid.*, 291.

<sup>22</sup> *Ibid.*, 324.

<sup>23</sup> Brodsky, 2010.

<sup>24</sup> Jacques Gansler, "Moving Toward Market-Based Government: The Changing Role of Government as the Provider," *New Ways to Manage Series*. [http://www.businessofgovernment.org/pdfs/Gansler\\_Report.pdf](http://www.businessofgovernment.org/pdfs/Gansler_Report.pdf), (accessed April 25, 2010), 15.

<sup>25</sup> PricewaterhouseCoopers, "Managing Risk: An Assessment of CEO Preparedness," 2004, <http://www.pwc.com/extweb/insights.nsf/docid/88C89FB9950B092D80256E21003B4AF3> (accessed April 20, 2010), 2.

<sup>26</sup> David Walker, "Defense Management: DOD Needs to Reexamine Its Extensive Reliance on Contractors and Continue to Improve Management and Oversight" March 11, 2008, Testimony Before the Subcommittee on Readiness, Committee on Armed Services, House of Representatives, p.27.

<sup>27</sup> Deloitte Consulting. "Calling a Change in the Outsourcing Market: The Realities for the World's Largest Organizations," April, 2005, [http://www.deloitte.com/assets/DcomLuxembourg/Local%20Assets/Documents/Global\\_brochures/us\\_outsourcing\\_callingachange.pdf](http://www.deloitte.com/assets/DcomLuxembourg/Local%20Assets/Documents/Global_brochures/us_outsourcing_callingachange.pdf), 3-5.

<sup>28</sup> Paul Strassmann, "Does Outsourcing Deliver the Goods?" *Baseline: The Project Management Center*. March 7, 2005, <http://www.baselinemag.com/article2/0,1540,1775077,00.asp> (accessed April 20, 2010).

<sup>29</sup> Federal Register, December 15, 2004. 69(240) <http://www.epa.gov/fedrgstr/EPA-IMPACT/2004/December/Day-15/i27417.htm> (accessed February 25, 2010), 75019.

<sup>30</sup> Deloitte Consulting. 2005, 3-5.

<sup>31</sup> Walker, 2008, 12.

<sup>32</sup> Brodsky, 2010.

<sup>33</sup> Christine H. Fox, "Directive-Type Memorandum (DTM) 09-007, "Estimating and Comparing the Full Costs of Civilian and Military Manpower and Contract Support" Office of the Secretary of Defense, January 29, 2010, 12.

<sup>34</sup> Al Jazeera, "Iraq Expels 250 Ex-Blackwater Staff," February 12, 2010, <http://english.aljazeera.net/news/middleeast/2010/02/2010211193234658851.html>

<sup>35</sup> Oliver E. Williamson, *The Economic Institutions of Capitalism*. (New York: Free Press, 1985), 16.

<sup>36</sup> *Ibid.*, 30.

<sup>37</sup> Francois Melese and Raymond Franck, *A Transaction Cost Economics View of DoD Outsourcing*, Acquisition Research: The Foundation for Innovation, (Monterey, CA: Naval Postgraduate School), 22.

<sup>38</sup> Sydney Shapiro, "Outsourcing Government Regulation," *Duke Law Journal*, 53, 2004, <http://www.law.duke.edu/shell/cite.pl?53+Duke+L.+J.+389>, 394-5.

<sup>39</sup> Melese and Franck, 25.

<sup>40</sup> Shapiro, 2004, 389.

<sup>41</sup> The Washington Post, "Army to End Expansive Exclusive Halliburton Deal. July 11, 2006, A1.

<sup>42</sup> *Ibid.*

<sup>43</sup> Melese and Franck, 25.

<sup>44</sup> Walker, 27.

<sup>45</sup> *Ibid.*, 30.

<sup>46</sup> Department of Defense Instruction Number 1100.22, April 12, 2010, <http://www.dtic.mil/whs/directives/corres/pdf/110022p.pdf> (accessed April 25, 2010), 12.

<sup>47</sup> *Ibid.*, 45-53.

<sup>48</sup> Grasso, 2005, 5.