STATEMENT OF

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"THE COSTS AND IMPACTS OF CRISIS BUDGETING"

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HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

COMMITTEE

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Mr. Chairman, Senator Coburn, Members of the Committee. Thank you for the invitation to testify before you this afternoon. On behalf of the Professional Services Council's[1] 360 member companies and their hundreds of thousands of employees across the nation, thank you for taking the time to shine a light on an often ignored, but nonetheless critically important, issue. As Professor Joyce made clear in his testimony and in his excellent report[2] for the IBM Center, budget uncertainty and instability has very real, deleterious and costly impacts on government and the federal contracting community alike. Thus, the ability of the Congress and the Administration to return to a semblance of regular order would be a great benefit and service to the American taxpayer and to the federal agencies that do so much to support us.

At the outset, let me be clear: PSC takes no position on specific funding levels that should or should not be pursued as solutions to our nation's very real fiscal challenges. We recognize and respect that such decisions are within the purview of the Congress and the Administration. We have, however, expressed our opinion about the tactics used to impose such funding level reductions. Just two weeks ago, we published an "Open Letter" to the president and the Congress, signed by our Executive Committee and me, strongly urging the parties to come together to avoid sequestration and comprehensively address the nation's fiscal crisis. The headline of that letter sums up our view--"Time's Up. Leadership Needed Now" [3] --but nothing in my testimony this afternoon should be interpreted as advocating for any particular fiscal proposal.

That said, we do take a strong position on restoring regular order to the budgeting and appropriations processes. In fact, when our member company CEOs gathered just over a month ago to identify our top policy priorities for 2013, achieving budget stability emerged, by far, as their number one policy objective. As we later wrote in a white paper outlining our priorities:

An unclear budget picture complicates the ability of the government and industry to effectively plan for changing priorities. While budget austerity is unavoidable, the lack of predictability and consistency of federal budgets is much more detrimental than clearly articulated funding reductions.[4]

Indeed, the consensus view among our industry leaders, regardless of their party affiliation or political leanings, can be summed up in four simple words: "Rip off the bandaid." We fully recognize the realities of austerity and the need to get our nation's fiscal house in order. We realize as well that no community—contractors, civil servants, non-profits, or universities—that supports the work of the federal government will go unscathed. Within our industry, the impacts have already been felt. Tens of thousands of jobs have been lost, thousands more remain unfilled, and according to a recent, highly

[1] For 40 years, PSC has been the leading national trade association of the government professional and technical services industry. PSC's more than 350 member companies represent small, medium, and large businesses that provide federal agencies with services of all kinds, including information technology, engineering, logistics, facilities management, operations and maintenance, consulting, international development, scientific, social, environmental services, and more. Together, the association's members employ hundreds of thousands of Americans in all 50 states.

[2] The Cost of Budget Uncertainty: Analyzing the Impacts of Late Appropriations, available at: http://www.businessofgovernment.org/report/costs-budget-uncertainty-analyzing-impact-late-appropriations

[3] Time's Up. Leadership Needed Now. available at http://www.pscouncil.org/News2/NewsReleases/2013/Time_s_Up._Leadership_Needed_Now._An_Open_Letter_to_the_President_and_Congress.aspx

[4] PSC 2013 Top 5 Policy Priorities, available at: http://www.pscouncil.org/c/b/PSC_s_2013_Policy_Priorities.aspx

authoritative analysis, for the first time in years more companies are reporting reduced revenues than those that are reporting increases.

But budgetary and programmatic actions should be based on a careful strategic determination by federal agencies of how best to achieve their mission – and how to best harness all of the resources that are available to them. Unfortunately, the uncertainty and almost complete lack of predictability that has come to characterize the federal marketplace is increasingly problematic.

Of course, predictability and clarity are two of the most prized characteristics of any healthy market; the clearer and more predictable the market, the more likely it is that companies can justify investments in people, technology and other capabilities. The reverse is also true: the less clear and less predictable the less likely that companies will make those investments and bring innovation and competition to the market. Regrettably, today, it is that latter environment, the apparently new normal of uncertainty mixed with crisis budgeting, which dominates and poses a number of significant challenges, and in some cases threats, to the government.

I was asked to address the impact of those dynamics on the private sector, and principally on government contractors. But many of the most significant impacts begin with the impacts on our federal agency customers and the federal workforce that are trying so hard to meet their increasingly complex mission requirements in this unstable and uncertain environment. These impacts then flow down, in varying ways, to their implementing partners in the private for-profit and not-for-profit worlds.

The most significant impacts can be divided into four categories: (1) impacts on company investment decisions; (2) impacts on the federal procurement process; (3) impacts on the federal and private sector workforces; and, finally and perhaps most importantly, (4) impacts on agency missions and efficiencies.

<u>Investment Impacts</u>

By definition, investment decisions are made on the basis of a risk-reward analysis. Of course, risk is defined on many levels and includes the timing and likelihood of receiving a return on that investment as well as the level of that potential return. Higher risk investments are typically result in higher returns while lower risk investments generally result in smaller returns. Needless to say, one key measure of risk is clarity and the less clarity that exists the higher the risk quotient. In the government market today clarity is largely elusive, returns are in greater question than ever and program plans, and even routine decision processes are constantly shifting.

What does this mean in practical terms? It means that companies in the government market face increased levels of risk with almost any investment, and certainly any substantial investment. The government market is a very expensive market in which to compete—certainly far more so than the commercial marketplace. It is also a market in which returns, or profits, are most often well below returns that are realized in the commercial marketplace. As such, companies must be exceptionally disciplined in their investment decisions—be they focused on people, on technological or other advancements designed to support the government, or even on decisions on whether or not to bid on a given procurement. Obviously, those challenges are magnified many times over when there is little to no stability in the market to can help define and contain within reason the risks involved.

As a result, today's unstable environment has many companies thinking not twice, but four or five times, about virtually every aspect of their investment decisions, including when and where they even participate. As always, they want to know that when they bid on a specific procurement they can bring to the table the best and most innovative solutions and that when they expend increasingly precious bid and proposal resources, there is a reasonable chance of winning an award. Today, they also have to make exceptional difficult judgments as to when, if ever, an award will actually be made.

Clearly, if a federal agency customer is uncertain about the availability and/or timing of their funding, the company's level of confidence will also be affected. When companies do not have that kind of confidence it can cause them to simply not bid, with the almost inevitable result being reduced competition—and reduced options—for the government. The irony, of course, is that competition is the best guarantor of higher performance and greater efficiency; thus, when competition is reduced, so too is the level of certainty that the government is getting the best solutions. And that can often result in sub-optimized performance today followed by likely increased costs down the road.

Today, there is a broad agreement that procurement lead times—that is, the time between issuance of a request for proposals and the award of a contract—has stretched to almost unprecedented lengths. Agencies have delayed awards not just for a few months, but in some cases for several years, as they try to grapple with the realities of resource uncertainty. One agency recently told the bidders on one of its large procurements that award decisions would be further delayed until June of this year. That will mean that, for this procurement the earliest the award will come is THREE YEARS after companies were required to submit their initial bids.

Unfortunately, this is not the only case of its kind. Almost universally, our member companies report that when they compare the volume of bids they have submitted against the volume of awards that have actually been made, they have never seen it so heavily weighted to the former. The system, they tell us, is suffering from unprecedented bottlenecks. As is true throughout the commercial world, time is money; and when awards are so significantly delayed it naturally results in increased cost and risk to those bidding. Today, those costs and risks are higher than we have seen them in many years. And in the end, the government customer, like any consumer, will end up paying a good portion of those costs, either in the form of higher prices or reduced competition as some companies simply exit the market. After all, if one cannot gauge with any reasonable accuracy when a return on investment might occur, and cannot ensure that the return finally received will be fair and reasonable, those companies that have other options have little choice but to pursue them. In fact, a number of our member companies are aggressively and actively looking to new markets for their services, largely out of concern that the instability of the federal market is becoming untenable.

Procurement Process Impacts

The uncertain and unstable budget environment also has numerous effects on the quality and nature of federal procurement. As I stated earlier, we take no position on specific funding levels to address the nation's fiscal challenges. That point was also made very clearly in a report we submitted to then-Secretary of Defense Panetta, at his request, on the impacts of expected budget reductions.[5] In that report we reiterated our view that while we certainly have an interest in the levels of spending available for any agency, we recognize that those are decisions for others to make. Therefore, our concern was principally on how the available funds were to be spent, rather than on how much was to be spent.

[5] Defense Executives Assess Business Impacts of Major Budget Cuts available at http://www.pscouncil.org/PolicyIssues/IndustrialBase/ServicesIndustrialBaseCompetitivenessIssues/Industry_Task_Force_Paper.aspx

In that light, we surveyed our membership to get their assessments of the impacts they were seeing. Without question, the single greatest concern that emerged was the government's growing and unhealthy reliance on what are known as lowest price/technically acceptable awards. There is, of course, no question that the government should never overpay for anything it buys. Nor is there any question that, for many commodities acquired by the government, buying from the lowest price provider makes sense. But for its many more complex needs, buying on the cheap is self defeating and counter productive. In those cases, technical proficiency, proven performance, and other non-cost discriminators are essential components in a smart acquisition decision. Unfortunately, we are seeing today an almost total focus on price with far less attention than is appropriate and healthy on other important factors.

There are a number of reasons behind the government's default to low price awards, including workforce skills gaps, fear of protests, and more. But there is often a measurable difference between the lowest price and the best price; similarly, "efficiency," which in government is generally tied uniquely to price, does not equate to effectiveness. Yet, there can be no doubt that the constantly shifting sands of resources--the fundamental uncertainty that marks today's marketplace-- is among the key factors driving government activities to this imbalanced acquisition approach.

In the face of budget instability and anticipated or directed spending reductions, agencies are increasingly trying to do what they have always done, often in the same way, for less money, rather than taking the longer strategic view on how to do what they need to do differently, more effectively and more efficiently. This may not be logical and it is clearly contrary to the ways in which we, as consumers, make decisions every day. But it is, nonetheless, a dominant trend in federal procurement.

As a result, at the very time when one would want to see the government exercising extra diligence and discipline in how and where it commits funds, and when new and innovative thinking and mission execution is so essential, we are instead witnessing a procurement process that is incentivizing the kind of race to the bottom that often occurs when resources are increasingly scarce or uncertain. Companies must do whatever they can to win the available business and survive; after all, survival is generally preferable to a principled death. But in the end, the responsibility actually rests with the customer, in this case the government. Because it is the government that determines the quality of solutions it buys and it is the government that controls the degree to which innovation and excellence are incentivized and rewarded in the acquisition process.

Likewise, reasonable returns on investments, or reasonable margins, are much different than exorbitant profits. As I mentioned earlier, contrary to what many believe, profits in the federal marketplace are generally well below those in the commercial market. In another ironic twist, many government contractors accept those lower margins in return for the opportunity and privilege to work with a stable, predictable customer. Obviously, that latter quality is becoming increasingly rare.

At the same time, we are seeing margin pressures that go well beyond reasonable. Indeed, despite the admonitions of some top government leaders to the contrary, it has become commonplace for government customers to target reduced margins as tools to save money. In fact, a soon to be released annual analysis of the federal marketplace conducted by Grant Thornton will report that more than 60 percent of companies surveyed reported margins in the 0-5 percent range; just a year ago, only 35 percent of participating companies reported such low margins. As with acquisition strategies, it is true that margins should be directly tied to the nature, complexity and risk of the work being performed, and that for many commodity products and services, margins tend to be very low. But given the substantial percentage of the more than 100 companies participating in the survey that provide high end professional and technology services to the government, it is clear that we are seeing the kind of over-emphasis on margins that is not healthy for the companies or the government.

Finally, the we are also seeing a greater use of so-called “bridge contracts”—that is, the extension of existing contracts for short periods of time in lieu of new, competitive procurements, as a means of hedging against both budget uncertainty and budget pressures. Competitive procurements cost money for the government just as for contractors. And thus, anecdotally anyway, the use of bridge contracts is increasing significantly. That, too, is the kind of short sighted, crisis-based strategy that often costs the government much more in the long run.

A sound market enables reasonable returns, rewards those with the best solution at the best price and incentivizes effective outcomes. But the government market, besieged by instability and uncertainty, is trending in just the opposite direction.

Incremental or short term funding, continuing resolutions that prevent new programs from being launched when planned or when necessary, and constantly changing funding levels or expected levels, all contribute to this trend. This often results in suboptimal solutions being selected, which itself generally leads to higher long term costs, Furthermore, the extraordinary pressures created on both overhead and margins further diminishes the ability of companies to invest in people or technology, further diluting the capabilities available to the government the next time around. This vicious cycle, this unbroken circle of impacts, serves no one’s interests, and least of all the American taxpayer.

Even as instability and uncertainty dominate, there are things that can be done to address this dynamic. This committee can play a powerful and important role in helping to reverse that trend by openly and actively empowering and supporting a beleaguered federal acquisition community and ensuring that the right kinds of tools and professional development opportunities are made available, even under the budget realities we face. Their role is simply too central to the proper functioning of government to be treated otherwise. This committee can also play a powerful role in explicitly encouraging, even directing, agency program offices to work in true partnership with their implementing partners to collaboratively identify sustainable program savings.

Unfortunately, despite the efforts of both OMB and DoD leadership to encourage such behaviors, there is little pressure on the system to do so and little incentive or reward for the civil servants charged with executing and managing federal acquisition. This lack of awareness of the dynamics of the market and the impacts of such behaviors, indeed, the threat of always being questioned for making a reasoned decision to spend a little more for a better product or service, let alone truly collaborate with your vendors as is routinely demanded in the commercial world, contributes mightily to the tendency of the federal procurement process to follow the path of least resistance and lowest risk. We all want to see risk limited to the extent possible; but it cannot be eliminated.

<u>Workforce Impacts</u>

As I noted earlier, many of the effects of budget uncertainty and instability start with the agencies themselves and then flow down to the ecosystem of companies, non-profits, universities and others who help execute the government’s missions. This is also true when looking at the workforce impacts that result.

As recent studies[6] have illustrated, the morale of the federal workforce is at low ebb. They face continued salary freezes, increasing workloads, and must constantly grapple with the challenges of managing in the face of uncertainty and instability. They have also repeatedly faced the definition of crisis budgeting and management. Moreover, the challenges they face are significantly exacerbated by the government's extraordinary demographic challenges, including increasing retirement rates among a workforce that is already demographically imbalanced. With a four to one ratio of workers over 50 versus those under 30, a ratio that is actually seven to one among information technology workers, the government can ill afford continued instability and uncertainty in its human capital initiatives. Indeed, the government has a rare opportunity to reshape its workforce in a way that most effectively meets its needs and the realities of the future. But that can only happen if some semblance of stability returns so that agencies actually have the freedom created by stability to build and stick to longer term, forward looking workforce plans. Today, with the instability sharply limiting planning and execution horizons to the very short term, such plans, no matter how good, simply cannot be effectively executed.

For the private sector, the workforce impacts are also acute. Some are obvious: the longer procurements are delayed, the more difficult it is for companies to hold on to key talent, particularly in the technology and related fields. Companies can only subsidize non-revenue generating employees for so long; at some point they need them to be part of a productive team. Maintaining this "bench" is made even more difficult in an environment where the competitive pressures mandate that companies trim their overhead costs and become as lean as possible. As a result, they face losing talent to other contractors, or, as is increasingly the case, to the commercial sector, where there remains a shortage of qualified, technical talent and the ability to attract them. Dozens of companies have already announced layoffs of thousands of employees because of the market uncertainty and instability and the accompanying inability to risk over-investing in people. As a result, collectively we face the prospect of a brain drain away from the federal sector—whether from government or industry—to the commercial world.

Beyond the loss of key employees and a connected, potential brain drain, budget instability also has a major impact on company hiring. As but one example among many, one small business told me they have six positions that have been vacant for three months and they will likely not be filled until they have a clearer understanding of where their federal customers are heading. Another company told me that, in their efforts to trim overhead to remain competitive, they've had to reduce professional development and training – which, because it is an overhead cost, is often the first thing to go in a resource constrained environment, in both government and industry.

And as a result of the trend toward lowest price awards, companies are also finding it increasingly difficult to compete for the best talent. This challenge is exacerbated by government efforts to arbitrarily cap contractor employee compensation below that which the commercial marketplace has deemed certain skills to be worth, or to hold contractors' labor and overhead rates to levels of years past without benefit of serious analyses of the impacts such caps are likely to have.

<u>The Mission Impact</u>

All of these factors combined—reduced investments in people and technology, the trend toward award on the basis of the lowest rather than the best price, unprecedented pressures on margins that drive

[6] See for example Federal Employee Viewpoint Survey, available at: http://www.fedview.opm.gov/

them below what would be considered reasonable, and the reduced ability of both companies and government agencies to hire needed skills—pose a real threat to the effective and optimal execution of the government's missions. When programs and budgets are incrementally funded, agencies can only incrementally fund their programs and contractors. As a result, both efficiency and effectiveness are inevitably impacted, the long view gives way to the short view, investment decisions are delayed and, in the end, costs rise and/or program performance is sub-optimized.

In a recent article for the Harvard Business Review, Professor Michael Porter and two of his colleagues report on a study they have just completed of the major challenges facing American business. Among those challenges is that incentives are too often misaligned and that senior executives are incentivized to meet very short term financial goals while long term, sustainable growth and innovation require a commitment to longer-term objectives and change. I think this message should resonate as well in government. Where agency heads are required to meet instant funding reduction targets or unable to plan for program execution for more than a few months at a time, innovation and high performance become almost impossible. When agencies are unable to launch new programs they are forced to continue to rely on older, outdated systems, which are more expensive and less effective than that which is being planned as a replacement. And when the combination of uncertainty and potential funding reductions force agencies to forego planned technology refresh and/or defer scheduled maintenance and upkeep, long term costs inevitably rise and mission effectiveness suffers. No organization – whether a government agency or a company – can hope to achieve any degree of efficiency and effectiveness without funding stability.

Conclusion

To repeat, our highest priority is for clarity and predictability in both spending and program execution. Regardless of how good or how bad the news might be for any individual agency or company, that knowledge enables our member companies to plan and invest in ways that can genuinely serve the best interests of the government.

Beyond that clarity however, and in the interim, it is crucial to remember that salami slices to a budget rarely work, that so-called efficiency does not equate to cost or program effectiveness. But working together, in an environment and spirit of real partnership, there is little question that we can achieve meaningful cost savings and performance improvements. Instead of allowing an environment of uncertainty and instability to drive a deeper wedge between the many actors who make up the whole of government, it should instead be a reason for greater collaboration.

Thank you again for the invitation to appear today. I look forward to answering any questions you may have.