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THE SERVICE ECONOMY AND INDUSTRIAL CHANGE

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

NINETY-EIGHTH CONGRESS

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APRIL 4 AND 11, 1984

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THE SERVICE ECONOMY AND INDUSTRIAL CHANGE

WEDNESDAY, APRIL 4, 1984

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 10:05 a.m., in room SD-562, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senator Jepsen.

Also present: Robert Premus, professional staff member.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. The committee will come to order.

The importance of the service industries to the Nation's prosperity is not fully appreciated. Many misconceptions abound regarding the nature of services and their importance to the economy. The problem is that these misconceptions may lead to poorly designed public policies.

Intangible services account for about two-thirds of the Nation's output and jobs. The export of services has become big business for the United States. No other industrial nation can match the United States in the growth of its service sector.

However, many advocates of industrial policy claim that the service sector offers only dead-end, low-paying jobs. They characterize intangible services as inferior and claim that America is deindustrializing

Critics of industrial policy take a different view. They see the service sector as necessary for economic growth and the revitalization of the manufacturing sectors. In their view, both the goods and services sectors play a strategic role in our modern economy, and any attempt to play one sector against the other is counterproductive and damaging.

Our hearing today will help us learn more about the strategic role of the service industries in the American economy, and clear up any misconceptions that may exist. We are fortunate to have before us a panel of nationally recognized experts on the service economy. Gentlemen, on behalf of the committee, I would like to thank each of you for taking the time to prepare your testimony and appear here today. We look forward to hearing your testimony.

At this point, I will introduce the panel. From your left to your right and from my right to my left, we have Earle Williams, president of BDM International, Inc.; Gerald Faulhaber, director, Fishman-Davidson Center for the Study of the Service Sector, Wharton School, University of Pennsylvania; Edward Wolff, professor, Department of Economics, New York University; and Ronald Shelp in the empty chair there, who probably because of the rain and the traffic which gave me some problems this morning myself, is going to be a little bit late. He is vice president and director, American International Underwriters Corp.

We will begin with you, Mr. Williams. Welcome and thank you for coming and you may proceed. Your prepared statement will be entered into the record as if read and you may proceed in any manner you so desire.

STATEMENT OF EARLE C. WILLIAMS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BDM INTERNATIONAL, INC., McLEAN, VA, AND REPRESENTING THE PROFESSIONAL SERVICES COUNCIL

Mr. WILLIAMS. Thank you, Senator. It is a pleasure to be here today. I have been present on a number of occasions when Mr. Shelp has talked about this subject. I deliberately designed my presentation this morning on the assumption that he would be saying some things in advance and I did not want to repeat them. I may be putting in some things now that you will hear again from him, but I will try to avoid doing so.

I am here today not only as the president of BDM International, but also representing the Professional Services Council, which is an organization of contract professional services firms working mostly with the Federal Government. I welcome the opportunity to talk here today about the service sector and a very important component, the professional and technical services industry. I have submitted for the record a prepared statement which I will not repeat this morning.

These hearings are most timely and very important because there are major national policy considerations involved and the policies themselves are likely to become issues in the forthcoming election debate.

As you indicated, the services sector has become a major element in U.S. economic activity. In 1983, the services industry, including the Government, supported 73 percent of all U.S. workers and contributed 69 percent of the gross national product in 1982. The service industries created over 52 percent of the new jobs in the 1980–82 timeframe.

It is our view, and our experience, that intelligent use of the service sector's capabilities in the four goods producing sectors of agriculture, manufacturing, mining, and construction will ensure their competitiveness internationally, will enhance their contributions to our Nation's economic life, and will foster their economic viability. What I am suggesting certainly supports your point of view that they are all complementary parts of the economy.

The American services dominated economy should be seen as the most advanced stage of economic development progress the world has as yet known. This, of course, is directly contrary to the Marxist point of view that services industries are essentially parasitic in nature. It is another example of where the Marxist view of the economy has gone wrong.

National policymakers need to cast aside the patterns of the past and their biases and their prejudices about services. They need to recognize that the United States is a service economy and that there is nothing wrong with this. We hear people asking what kind of a nation is this going to be if we all make our living by shining each other's shoes. This is a very elementary and superficial analysis of the situation and one which is bound to lead to erroneous conclusions about what is really going on in the services industry.

There are changes and new realities which have to be accepted. Most importantly is the concept of intellectual property; acceptance of the fact that information and knowledge are assets with a dollar value to be traded in the marketplace. No one has much problem with the idea of patent rights on machines and equipment. No one has trouble with the idea of copyrights on books. But the idea of intellectual processes and intellectual output being a property, which is subject to sale and purchase, is something that the Nation is having a great deal of trouble with. These assets, information and knowledge, have a dollar value.

In the past, the service sector was generally conceived of as being comprized of distributive services, consumer services, financial and insurance services, government and nonprofit services, and professional and technical services; the last, professional and technical, being, relatively speaking, the smallest element in terms of economic contribution.

Today we find that the impact of new technologies is giving greater emphasis to the professional and technical services industry as a growing and developing element in the services sector. The industry has not yet fully evolved nor is it fully appreciated by the policymakers, the private sector, nor the media. The industry is not simply comprised of consultants, study houses or think tanks, although these functions are a part of the industry's total approach.

In the case of my company, we have grown about 30 percent per year for the past 10 years and in 1983 we had sales of $150 million. I laugh when some people refer to us as big business. In the professional services industry, we do tend to be a big company. But it is important to note that of the 610 contracts that BDW was awarded in 1983, 515 or 84.4 percent were $250,000 or less. That is small business, I think, any way you choose to look at it, 61.5 percent of our sales dollars were in contracts for $2 million or less.

What we really have in this company is a conglomerate of entrepreneurs working in individual elements much like small businesses do. This is quite different from what you find in the ordinary manufacturing company.

This new professional and technical services industry is an industry where ideas are the product and where knowledge is a valuable property. It involves the application of information, knowledge, and thinking to a system or process in order to improve or resolve operational difficulties being experienced by a client in the public or private sector. It is a synergistic approach to answering questions confronting clients and the application of new technologies to the products and equipment of the smokestack or mature industries to make them once again economically viable. It brings together people with expert knowledge with sophisticated equipment and laboratories and modern facilities in order to apply their total capability to solve a client's problem with a degree of expertise that he could not afford to keep on as permanent employees and should not try.

People understand things primarily by experience. Because the Nation, industry, Government have very little experience with this new professional and technical services industry, people do not have immediate understanding of what the phrase means when you say it to them. This is the problem we are faced with in trying to get across the concept of this new industry. The policymakers have failed to understand the new services economy and its capabilities and needs, and this failure has inhibited the transformation of our economy in a manner which would strengthen all of the sectors of the economy.

We find that private companies increasingly are beginning to turn to the professional services firms for assistance in solving their problems. This is true in the industrial, agricultural, and business processes. While this is occurring to some extent at the Federal level, it is not nearly enough and, as a matter of fact, there are counterproductive policies in force.

Senator Tower's recent farewell statement to the Senate Budget Committee concerning congressional micromanagement, particularly in the area of defense, captures the frustrations felt by many of us who work with the Federal Government. Congress itself has been responsible for the enactment of measures which seriously reduce and discourage the use and capabilities of the private professional and technical services sector by Federal program managers.

Policymakers face a serious challenge with respect to the service sector as a whole. Policy focus has been on the international side with little attention to domestic issues. The needs of the manufacturing and processing industries have been the focus of attention. There is an abominable lack of reliable data and statistics on the service sectors to assist policymakers to make intelligent decisions.

The Government standard industrial classification does not contain an adequate or proper code description for the professional and technical services that BDM has been offering for about 20 years. You begin to get a little frustrated when you find that there is no breakdown in these codes that really describes the nature of your business so that the Government and other policymakers can get a handle on what is really happening.

OMB is now undertaking a full revision of the SIC codes and we hope that this revised code will provide the same detailed classification for the services sector that currently characterizes the industrial classification.

Policymakers certainly need current and meaningful data that will reflect the real role of the services economy if they are to make sensible and logical national policies.

There are a number of key issues from our perspective facing the policymakers that affect the professional and technical services industry. There are tax policies that are needed to place the services industry on an equal footing with the manufacturing industries.

We are concerned about the availability of capital. The American Business Conference has just completed a study on the cost of capital which indicates that the cost of capital in this country is about two times what it is in Japan. That problem, if you believe that analysis, and I do, is multiplied in spades for the services industry.

Bankers in this country, and in fact business people in general, still worry about financing our kind of business because we have no assets. They say your assets walk out the door at night. As a matter of fact, the key assets in most companies walk out the door at night. The idea that you can go in, claim a plant, and recover your money if a company goes bankrupt may look good on a balance sheet, but in reality it seldom happens that way.

Competition in the case of those of us doing work for the Federal Government—competition by Government agencies performing services—is a problem when these services could be provided more effectively and efficiently by the private sector.

Certainly we need an effective education and training system to provide the professional and technical services industry with the skills that it requires.

We think that there needs to be a legislatively mandated national policy to provide guidelines for bold deregulation and simplification of the Government's procurement system, particularly for the procurement of professional services.

A major policy issue exists today because of commercial nonprofit organizations—and I want to emphasize the commercial nonprofit. I am not talking about the types of nonprofit organizations that do charitable work and depend upon donations and grants. I am talking about the people that go into business and classify themselves as a nonprofit organization and then get special treatment under the tax code and, indeed, in dealing with the Government procurement system. That is a real problem today.

Finally, the Government and the public need to reshape their thinking on the services economy and national policies for the 1980's and beyond. Any sound industrial policy must recognize that the United States today is a service economy and the industries in the service sector must be participants in developing that policy if our economy is to grow and be viable.

The service industries are not parasitic. They are the essential element of the dynamic economy for the future. Thank you, sir.

[The prepared statement of Mr. Williams follows:]

PREPARED STATEMENT OF EARLE C. WILLIAMS

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to appear before the Joint Economic Committee to discuss the emergence of a new and more advanced economy in the United States, the services economy. I will describe some misconceptions that affect the public's view, as well as that of policymakers, about the services economy, and consider ways that national policies need to be rethought, if we are to capitalize fully on the present strengths and future potential of the emerging services economy.

I appear in my capacity as President and Chief Executive Officer of BDM International, Inc., one of the country's fastest growing professional services firms. BDM provides a wide range of professional and technical services to government and private clients, including substantial software, scientific, engineering and technical services to the Department of Defense. These services consist primarily of the expertise of our employees, augmented by specialized equipment such as computers and, on occasion, proprietary computer programs. Since I became President of BDM in 1972, revenues have grown from $7.7 million to $151.1 million in 1983, an average increase of about thirty percent annually. I am the Past President of the Professional Services Council, an industry-wide coalition of associations and firms in the private professional services field.

The professional and technical services industry represents a relatively new but growing and significant sector of the emerging services economy. It is our industry that has ideas as its product -- the application of professional, expert and specialized knowledge to assist government and private sector clients in solving operational, technical and management problems. These services can take many different forms -- computer and computer programming applications, research and development, architectural and engineering services, laboratory analyses, system and equipment test and evaluation, special studies and management consulting advice, to name only a few. To illustrate the diversity and range of skills involved, I am attaching as Appendix A to my testimony a summary of the kinds of professional and technical capabilities BDM can provide to its clients. At Appendix B is an example of the talents available in just one area, namely systems engineering. These capabilities and skills are to be found in varying degrees in other professional services companies.

Professional services companies typically have as their work force individuals with advanced educational qualifications and practical experience in complex problem solving;

normally an interdisciplinary group will work together to solve a client's problem with an economy of time and effort and quality results. There are thousands of professional services companies in the private sector doing billions of dollars of work for public and private clients. These companies are predominantly small and highly competitive with no single firm having any significant share of the market for services.

To put the professional and technical services into the broader context of the services industry generally, it is useful to draw upon the convention of national accounting that allocates to services all output that does not come from the four goods-producing sectors: agriculture, mining, manufacturing and construction. The service sector includes, in addition to professional and technical services dealing in the application of ideas, distributive services such as wholesale and retail trade, communications, transportation and public utilities; consumer services, such as hotels and restaurants, laundry and dry-cleaning establishments; and government and nonprofit services such as national defense, the administration of justice, education and health. The significance of the service sector is clearly demonstrated in a recently issued Department of Commerce publication entitled From Hamburgers to High Tech. I have attached as

Appendix C a particularly relevant section of that document on key facts about the service sector. I have also included as Appendix D a Commerce Department breakdown of GNP showing that in 1982 services contributed 69% of GNP, and that share is still growing.

Available data of all U.S. workers suggest that today 73 percent of all workers are employees in service industries. It is my understanding economists describe a service economy as one where more than one-half of the workers gain their livelihood in service industries. By this definition, the United States became a service economy in 1940 and by 1981, even with government workers not counted, more than 50 percent of all Americans were working in private sector service industries. Appendix E contains an interesting set of tables which appeared in the President's 1984 report on The State of Small Business on the distribution of employment growth in 1980-1982. This job creation is not in the traditional industries, but rather in the new emerging industries such as professional and technical services.

This reality has the most profound implications for government policies at all levels. Yet it is disturbingly apparent in the debate over reindustrialization and an industrial policy for the 1980s that positions are being advanced based on an understanding of a U.S. economy that no longer exists.

The vision we should be acting on is that the new services economy in the United States is and can be the most advanced stage of economic development and progress the world has yet seen. If properly nurtured and developed, the U.S. can continue to be a major producer of agricultural and industrial goods. Even though the total employment in these sectors will continue to decline, total production should continue to increase. This will happen if the proper professional, management and technical skills are brought to bear to apply new technologies to old industries and to incubate new industries.

Unfortunately, all too frequently, this new reality and vision of the future is dismissed as a myth -- how can we prosper in an economy based on taking in each other's laundry? Why do so many of our business and governmental leaders have this bias against services? The simple fact is that we have a hard time philosophically and intellectually viewing ideas as property. John Naisbett in his book Megatrends charts the change in the economy from manufacturing to information and knowledge -- intellectual property. Unless we accept and understand this new reality, the country's ability to move forward will be hampered and our international economic position prejudiced.

The bias against services has caused misconceptions about the new economy and what policy initiatives are appropriate. One basic misconception is that the development of the services economy is at the expense of the manufacturing sector. The fact is that while services become more and more important, if properly utilized, they will strengthen both the agricultural and manufacturing sectors. In manufacturing more and more jobs will be in the professional, technical and managerial skill areas, and fewer and fewer in the lower skills. Another misconception is that service jobs are low-paying positions requiring lower skills. Just the opposite is generally true in a broad class of services. BDM is typical of the kinds of skills employed in the new services economy. Of our approximately 2600 full-time employees, more than 1800 have college degrees, and of that number more than half have graduate degrees. The educational degrees and degree levels represented among this work force are extraordinarily diverse as shown in Appendicies F and G. A recent study by the Computer and Business Equipment Association whose members are both high tech manufacturing and service companies shows that the normal pattern of wage-salary distribution is maintained and that there are no dramatic shifts into a two-tier wage structure or a skewing in a particular direction. A third misconception is that service businesses are primarily people and not plant and equipment. In fact, the service "factories" of the present and future are dependent on technology -- sophisticated computer equipment, advanced scientific laboratories, test and evaluation instrumentation facilities, photovoltaic and other advanced energy systems, telecommunications equipment -- all housed in modern facilities.

The failure of the Federal government to understand the new services economy and its needs and capabilities not only inhibits the transformation of the economy in ways that would strengthen all sectors ultimately, but particularly hurts the Federal government in reorganizing and utilizing improved means and methods to achieve its program missions. In an effort to increase their competitive standing in the world marketplace, many U.S. firms have aggressively moved to place more emphasis on efficient management, automate production processes whenever possible, stress the importance of continuing research and development and adopt other techniques to enhance efficiency, productivity and competitiveness. The combination of utilizing available and diverse private professional and technical service skills in applying new technologies to their industrial and business processes offers dramatic possibilities to U.S. companies. Is this same phenomenon at work at the Federal level? Some progress is occurring, but not nearly enough. All too often

Executive branch efforts to make better use of available skills and technologies are thwarted by Congressional efforts to micromanage. Senator Tower's recent farewell statement to the Senate Budget Committee captures some of the frustrations many of us who work with the Federal government feel. Senator Tower observed:

> In defense policy, the Congress -- occasionally including my own Committee -- is engaged in too much micromanagement at the expense of the broader review of defense requirements and priorities. Moreover, Congress itself is often the source of the restrictive rules, regulations and guidelines that prevent the efficient use of taxpayer dollars. The defense authorization and appropriation acts contain over 100 general provisions, many of which tell the Department of Defense what it cannot do to spend defense dollars more wisely.

Let me be very specific about this problem. Over the last five years as the new services economy was becoming more and more visible and its capabilities and potential became the subject of expert analysis and commentary, Congress embarked on a series of initiatives to limit, reduce and otherwise discourage access by Federal managers to the capabilities of the private professional and technical services sector. These Congressionally-enacted domestic barriers were advanced at the same time many members of Congress expressed indignation that foreign governmental barriers to U.S. trade in services existed or were being erected. Congressionally-imposed restrictions have hurt the Federal/private services sector relationship at the very time that foreign competitors to supply services are being specially aided by their governments.

What form have these Congressionally-inspired initiatives to create barriers taken?

- o Consistent efforts have been made to amend the budget reconciliation bills and the appropriations bills to reduce expenditures for outside professional and technical services just as overall Federal expenditures in specific program areas have been dramatically increasing.
- o Major initiatives to regulate and control the Federal use of private sources of professional and technical services have been mounted, forcing the Executive branch to institute new administrative limitations, regulations and controls, and diminishing its ability to utilize the skills of the emerging services economy.
- o Specific prohibitions on contracting out for certain kinds of services have been enacted as part of the Defense Authorization Act and other legislation.
- o A constant barrage of Congressional criticims has been levied at so-called "beltway bandits" -- the new professional and technical services industry which has been growing rapidly in the Washington area and represents some of the finest technological skills in the new services economy.

As Congress has aggressively created specific barriers to the flexible and proper use of private sector professional and technical skills, it has also chosen to emphasize the flaws in the Grace Commission's analysis of how the Federal government could reduce costs and enhance its effectiveness. Many of the Grace Commission's recommendations involve the Federal government aggressively applying modern technology and skills to close its enormous information gap and implement modern management systems. Why in the computer age with unprecedented professional and technical skills based in the new services economy should the Federal government lack knowledge about

- The total number of field facilities it occupies?
- The status, source and location of its cash?
- The cost of overhead by major expense function and subfunction?
- Performance data in such common management functions as personnel, procurement, finance, billing, payments, collections, real estate, data processing, etc.?

The net affect of this inability to use available skills is a failure to control and monitor costs effectively, resulting in billions of dollars of lost revenues.

The simple fact is that the economy has become far more complex and government's role has similarly become more complex. These complexities call for special and often unique talents if they are to be dealt with successfully. The individuals who have the skills to deal with these complex problems frequently do not like working for large bureaucratic institutions, especially the government. Such individuals prefer the independence and freedom found in the private sector. Firms that provide an appropriate working environment attract those professionally trained individuals engaged in applying new technologies to the complex problems of our society and are able to use them more productively than government.

It's no accident that In Search of Excellence has become a best seller by reminding us that those more flexible operating principles found in the private sector when properly applied stimulate creativity, innovation, commitment and quality work by highly motivated workers. All this lends force to the need for government to come to grips with how it should relate to the new services economy, both to meet its own needs and to help the country realize the potential of its new services economy.

For starters, the Congress itself needs to develop a better understanding of those capabilities to be found in the private services sector. The Congress, acting on this knowledge, should stop erecting arbitrary barriers to the government's use of these capabilities. The time has now come for Congress to concentrate on developing national policies which will strengthen the emerging services economy to better serve the nation and the world.

Let me summarize briefly policy issues requiring attention.

1. Hard statistical data and information.

The information and statistical systems used by the Federal government are simply out of date in terms of the services economy. We have no precise classifications to provide needed information about the economy as it is and as it is becoming.

Yet in the preface to the Standard Industrial Classification Manual its purpose is stated as follows:

> Industrially classified statistics are used not only to show how industries which compose the economy have done over the past years, but to indicate the emerging and rapidly growing industries. (Emphasis added.)

Nothing could be further from the facts of the matter.

OMB is embarked on a full revision of the SIC Codes in fiscal year 1987, the first such revision in 15 years. This revision must provide the same detailed classification for the services sector as now characterizes the industrial code. New emerging services industries, such as the professional services sector, must be recognized. This Committee should act to push this revision forward on an accelerated basis and assure that this revision is far-reaching enough to adequately reflect the true character of the changing economy. The urgency of this task cannot be overstated when one realizes that policymakers are using seriously flawed and inadequate data in formulating national policies.

2. <u>Tax Policy</u>.

Others who are more expert in the area of tax policy will be testifying before this Committee, but I would like to offer a few personal observations based on my business experience.

Present tax policy provides incentives for manufacturing -- investment tax credits and depreciation allowances -- but it offers virtually nothing comparable to services industries. As one example of a specific modification needed in present law, the definition of "research" expenses eligible for the 25 percent incremental R&D tax credit should be changed to include specifically expenditures incurred in developing new "services" in order to eliminate the present discrimination against services. In these and other ways, there is a critical need to assure that the tax laws are revised to strengthen the services component in the economy.

3. <u>Procurement</u>.

Federal procurement is one of the most important ways that national policy affects the services economy. The government meets its needs directly through the use of government employees, indirectly through nonprofit organizations or by the acquisition of services by contracting with the taxpaying private sector. Those of us in the private sector familiar with the procurement process consider it to be seriously flawed and an example of Federal regulation at its worst. The thousands of procurement laws, rules and policies are out of control and produce major economic inefficiencies and dislocations.

To begin to reform this process, Congress should immediately act to mandate statutorily a national policy of reliance on the private sector for needed services. This mandated national policy should provide guidelines for the bold deregulation and simplification of the procurement system. Such action would --

- o stimulate the growth and enhance the capabilities of the private services sector and thereby make it a more formidable force in the world economy;
- o increase tax revenues;
- o reduce the cost of obtaining needed services by 15 to 60 percent;
- o improve the quality of services available to meet government needs;
- o enhance productivity in providing services.

In the new services economy, government must rethink what functions it should undertake and which can be more efficiently performed in the private sector. Lacking the discipline of either the market or the profit system, government efficiency and productivity is likely to remain low. As we are seeing with Congressional reaction to the recommendations of the Grace Commission, even where efficiencies and productivity gains are possible, politics constantly thwarts the effort. The entry of private professional and technical services firms into service areas formerly reserved for government offers major opportunities to achieve national goals effectively while building the new services economy.

4. Education and Training.

Ninety percent of all new jobs added to the economy from 1969 to 1976 were in the service occupations. As this trend has continued more and more of the labor force is being employed in service-producing industries. One of the greatest challenges for policymakers in government and the private sector is how to best

- assist and educate new workers for new kinds of jobs;
- assist experienced workers to deal with rapid employment changes and skill requirements;
- help employees adjust to a rapidly changing work force and the demands of international competitive forces.

It is my belief that the demands of the marketplace will force management and government to undertake this education and retraining task in order for U.S. business to remain competitive and economically viable.

Improvement in the educational preparation of the labor force is reflected in the higher skills required of workers.

Between 1959 and 1978 total employment increased by about 30 million. More than half of the increase -- 16 million new jobs -- was in the higher level professional, technical, managerial-administrative, sales and crafts occupations. The increasingly dominant role of human capital in the new services economy is clear. Tragically, there is evidence of growing skill shortages in some critical fields and a decline in the verbal and mathematical skills that are necessary to function in the new services economy. Education and training are central to meeting the changing employment needs of the 1980s and increasing the nation's productivity growth rate. It is my contention that the professional and technical services industry, given the competence of its management and the skills of its work force, has a crucial role in assisting both business and government in educating and retraining its work force to meet the demands of the new technologies.

5. Trade in Services.

For years, the United States has held a commanding position in the world of services. The United States in recent years has depended on substantial surpluses in the services account ($40 billion in 1981) to offset deficits in merchandise trade. Because of the strong dollar, world recession and new competition, the U.S. service surplus shrank in 1983 for the second year in a row. Increasing foreign barriers threaten U.S. suppliers of services both overseas and in the United States. U.S. efforts to address these services issues in the General Agreement on Tariffs and Trade are restricted to government procurement and are meeting resistance. More generally, there are few internationally-recognized rules governing the services trade and little consensus about what constitutes "fair trade" in services. If the United States is to maintain and build its position in international trade in services, it will require a far more comprehensive plan of action than has thus far been mounted.

6. Productivity Analyses.

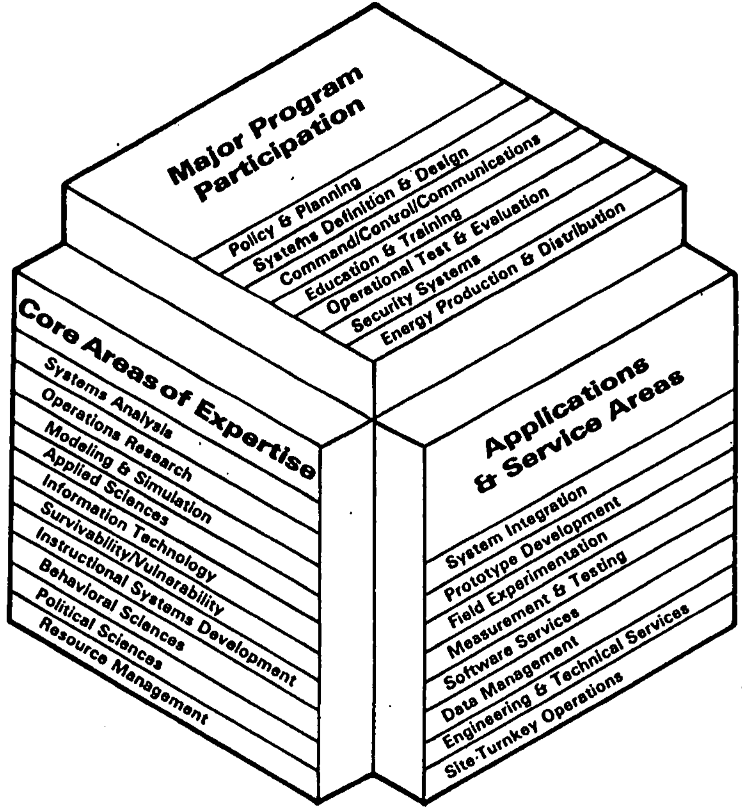
Experts have observed that methods of productivity measurement currently in use have little relevance to service firms and produce grossly distorted statistics. Inherent in this problem is the difficulty of obtaining meaningful measures of output per manhour. It is essential that improved methods for measuring the value of output and the quality of the service be developed. For example, how can one adequately measure the productivity enhancement of an electronic spreadsheet software program such as VisiCalc and its templates or an integrated software package such as Lotus 1-2-3? Only when new productivity measurements are developed will we be able to understand and evaluate the dramatic efficiencies and job-creating potential of this new economy. The complexity of this exercise and its lack of mathematical precision make generalizations in the short run risky. About all one can say is that standard methodologies no longer apply and radically new concepts are needed.

7. The Role of Government and Nonprofits in Providing Services in Competition with the Taxpaying Private Sector.

A fundamental and overriding policy issue is raised by the fact that much of the services activity required by the government is performed by the government itself or by non-profit, nongovernmental organizations it has fostered to provide these services. This is happening in spite of the tremendous growth in the capabilities of the private services sector since World War II. The emergence of a vast not-for-profit sector engaged in providing professional and technical services that are commercially available in the private sector creates special policy challenges. Several months ago the Chief Counsel for Advocacy at SBA, Frank Swain, issued a special report on Nonprofit Competition with Small Businesses: An Issue for the 1980s. He pointed out the explosive growth of "commercial" nonprofits which depend for revenues principally on selling their services as contrasted with "donative" nonprofits which depend on donations as their principal source of income. These commercial nonprofits are benefitting in their competition with private sector taxpaying firms by special treatment under a variety of Federal laws and policies. There is an acute need to develop reliable data to establish the nature and scope of services provided by the nonprofit sector, judge the effectiveness with which the nonprofit sector employs the large resources it commands and review existing laws and policies that provide special benefits and advantages to nonprofits in competing for opportunities to sell their services.

In summary, government and the public must reshape their thinking on the whole question of the services economy and national policies for the 1980s and beyond. In many ways the U.S. economy is stronger than we realize, but national policies relating to the services sector are so outdated and imperfect that we are failing to fully benefit as a nation from the unique strengths we have created or are within our ability to create. It is immensely frustrating to those of us who are part of this dynamic services economy to be ignored, misunderstood and forced to operate under hostile and damaging Federal incentives and policies. Your leadership in making our capabilities visible and our needs known is extremely welcome.

THE DIMENSIONS OF CAPABILITY AT BDM



BDM AREAS OF SYSTEMS ENGINEERING EXPERTISE

- ENGINEERING MANAGEMENT

- SYSTEM ARCHITECTURE

  SYSTEM DEFINITION
  CONCEPT DESIGN
  CANDIDATE SYSTEM DESIGN
  TRADEOFF ANALYSIS
  RISK ANALYSIS

- SYSTEM ECONOMIC ANALYSIS

  BASELINE COST ESTIMATE
  LIFE CYCLE COSTING
  FINANCIAL ANALYSIS
  MARKET ANALYSIS
  INVESTMENT STRATEGIES
  COST/BENEFIT ANALYSIS

- SYSTEM INTEGRATION

  INTEGRATION PLANNING
  SPECIFICATIONS
  CONTROL MECHANISMS/RESOURCES
  INTEGRATION TESTING

- CONFIGURATION MANAGEMENT

  DOCUMENTATION
  REVIEW AND CONTROLS
  INTERFACE DESCRIPTIONS
  ACCEPTANCE PROCEDURES

- QUALITY ASSURANCE

  DOCUMENT ANALYSIS
  INSPECTION
  PLANS

- SOFTWARE DEVELOPMENT

  ARCHITECTURE
  APPLICATIONS SOFTWARE
  MICROPROCESSOR EMULATION
  SYSTEM/ENVIRONMENT SIMULATION
  DOCUMENTATION

- TESTING AND PERFORMANCE EVALUATION

  TEST PLANNING AND DESIGN
  DATA MANAGEMENT AND REDUCTION
  PERFORMANCE EVALUATION

- INTEGRATED LOGISTICS SUPPORT

  LIFE CYCLE COSTING
  LOGISTICS MANAGEMENT PLANS
  LOGISTICS SUPPORT ANALYSIS
  PERSONNEL & TRAINING
  INTEGRATED TECHNICAL DOCUMENTATION AND TRAINING
  MAINTENANCE PROCEDURES AND SCHEDULES
  MAINTENANCE MANAGEMENT PLANS
  INVENTORY CONTROL
  SITE MANAGEMENT
  TECHNICAL DOCUMENTATION

- TECHNICAL SPECIALITIES

  HUMAN FACTORS
  RELIABILITY/MAINTAINABILITY/AVAILABILITY
  SAFETY/HAZARD ANALYSIS
  INSTRUMENTATION
  MODELING AND SIMULATION
  EMI/EMC/TEMPEST
  SURVIVABILITY/VULNERABILITY
  SECURITY

KEY FACTS ABOUT THE SERVICES SECTOR

The health and competitiveness of the services sector are vital to the U.S. economy.

Service industries dominate the U.S. economy.

- In 1982, services accounted for 69% of GNP.
- Even excluding government, the services sector is far larger than any other sector (57.2%). Manufacturing, for example is slightly under 21%.

Services are the fastest-growing segment in the U.S. economy and provide the greatest number of new jobs.

- Since 1920, the service-producing share of non-agricultural employment has risen from 53% to 72%.
- Since 1960, 86% of the job growth in this country has occurred in the service-producing sector. In 1982, services employment accounted for 74% of all jobs, up from 62% in 1960.

Basic changes in the structure of the U.S. economy and services growth are virtually synonomous. The link between services and high-tech is increasing with particular rapidity. Services drive demand for higher and higher tech, then buy, apply and sell it.

- Business and information services are the most rapidly growing elements of the sector. Between 1972 and 1980, jobs in business services grew by 1.2 million, to a total of 3 million, with the largest gains registered in personnel supply, computer and data processing, advertising, mailing, building maintenance, and stenographic services. An estimated 60% of the total U.S. workforce is now employed in information-related occupations, e.g. programmers, clerks, accountants, insurance brokers, teachers, government workers, and technicians. A high proportion of these jobs are technical, managerial, or professional.
- Business is increasingly shifting to the procurement of specialised services from the outside to increase productivity. This varies from "subcontractors of aggravation" handling operations and maintenance to specialized know-how involving the use of new technologies as well as traditional intermediaries (e.g., banking, finance, insurance, professional services and export management). Communications and and information management are at the heart of the growth of such diverse services as insurance, law, advertising, public relations, accounting, data processing, banking, equipment rental and management consulting.
- Rising family incomes (and two-income families) are another reason for services growth by causing an increase in demand for fast-food, day-care, travel and tourism, and financial management.

The U.S. services sector is the world's largest, most innovative, and productive. The outlook is for sustained healthy growth.

- Services firms have invested heavily in new technology. Expenditures (after inflation) increased by 145% between 1975 and 1982 to a level of $47 billion. This amounts to a 97% increase in investment per services worker and promises large gains in productivity.
- Demand for services should increase as technology advances. More sophisticated production will create more demand for more education, information and technical services of all kinds in fields ranging from hazardous waste management to genetic engineering, to computer-assisted design and telecommunciations.

A strong services sector is vital to U.S. international economic well-being. The international competitiveness of goods and services are inseparable.

- Services trade now accounts for 25% of world trade, reflecting services growth worldwide. The U.S. has the largest, but a declining share--about 15% in 1980, compared with 20% in 1972.
- The U.S. depends on substantial surpluses on the services account (ranging as high as $40 billion in 1981) to offset deficits in merchandise trade.
- International sales of U.S. services firms amount to about $140 billion annually through exports from the U.S. and sales of foreign affiliates.
- Employment generated by services exports totaled 1.8 million in 1982, or 37% of export-related employment.
- U.S. service businesses overseas generate heavy demand for U.S. merchandise exports. This amounted to an estimated $48 billion, or 25% of U.S. merchandise exports in 1982.
- Virtually nothing moves in international trade without being contracted for, financed, insured, transported, moved through ports and customs facilities, sold at wholesale and retail levels and accounted for several times over. Banks, insurance companies, airlines, shipping companies , etc., are essential to the movement of U.S. exports.
- There are few internationally accepted rules governing services trade, little international consensus about what constitutes "fair trade" in the sector, and practically no institutional dispute-settlement procedures.
- Increasing foreign barriers and intensified competition from both developed and developing countries threaten the position of U.S. suppliers, both at home and abroad.

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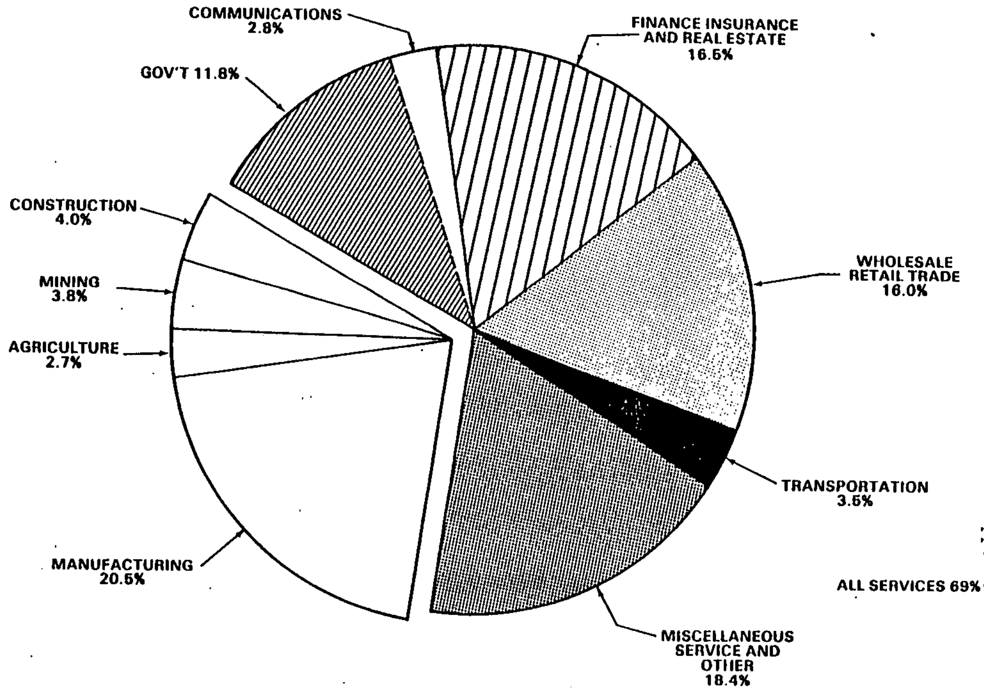
SERVICES IN THE GROSS NATIONAL PRODUCT 1982

(BILLIONS OF CURRENT DOLLARS)

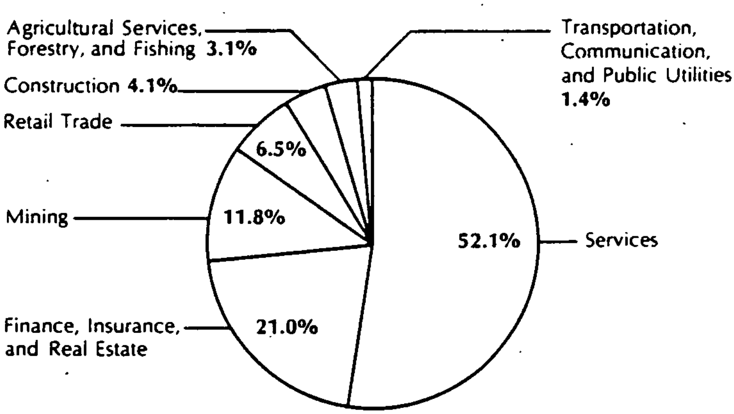


Survey of Current Business, July 1983, p 68
U.S. DEPARTMENT OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS

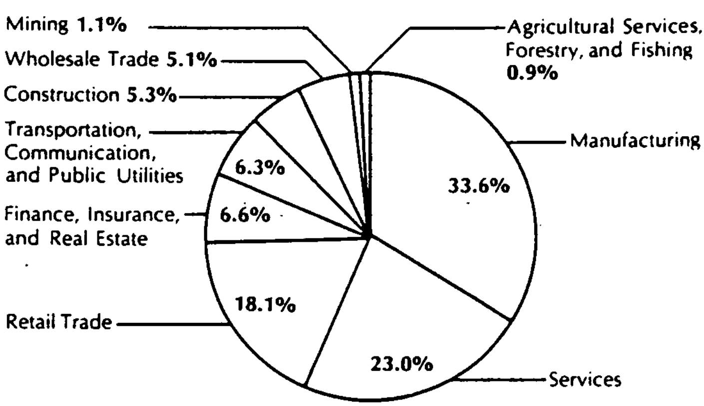
Appendix D

Appendix E

Distribution of Employment Growth, 1980–1982, versus Distribution of Employment, 1980, by Major Industry



(A) Distribution of Employment Growth, 1980-1982.



(B) Distribution of Employment, 1980.

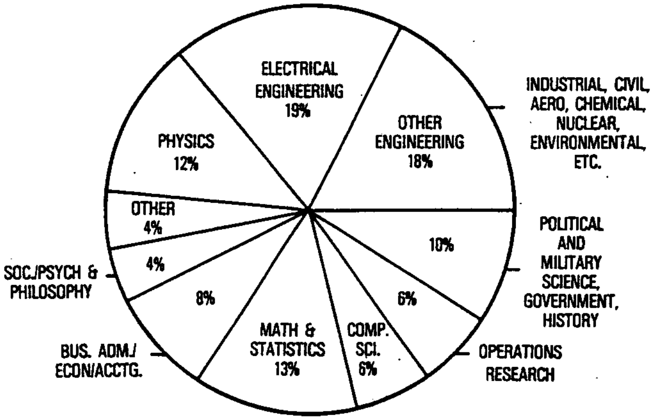
Source: U.S. Small Business Administration, Office of Advocacy, Small Business Data Base.

DEGREES HELD BY BDM STAFF	
ACCOUNTING	HEALTH, PHYSICAL EDUCATION, AND RECREATION
ADVERTISING AND ILLUSTRATION	HISTORY
AMERICAN HISTORY	HISTORY, AMERICAN
ART	HISTORY, RUSSIAN/EAST EUROPEAN
BIOLOGY	HUMAN FACTORS ENGINEERING
BUSINESS	INDUSTRIAL ARTS
BUSINESS ADMINSTRATION	INDUSTRIAL SECURITY
BUSINESS DATA PROCESSING	INFORMATION AND COMPUTER SCIENCE
CHEMISTRY	INFORMATION SYSTEMS MANAGEMENT
COMMERCE AND FINANCE	INTERNATIONAL RELATIONS
COMMUNICATION ARTS	INTERNATIONAL TRADE
COMPUTER PROGRAMMING	LANGUAGES
COMPUTER SCIENCE	LAW
CONTROL SYSTEMS	LIBERAL ARTS
ECONOMICS	LIBRARY SCIENCE
EDUCATION	MANAGEMENT
EDUCATION, SECONDARY	MATHEMATICS
EDUCATION, SECONDARY ADMINISTRATION, AND GUIDANCE	METEOROLOGY
EDUCATION RESEARCH, INSTRUCTIONAL SYSTEMS	MILITARY SCIENCE
EDUCATIONAL SYSTEMS ANALYSIS AND PLANNING	OCEANOGRAPHY
ENGINEERING, AERONAUTICAL	OPERATIONS RESEARCH
ENGINEERING AEROSPACE	PHILOSOPHY
ENGINEERING, CHEMICAL	PHYSICS
ENGINEERING, CIVIL	PHYSICS, APPLIED
ENGINEERING, ELECTRICAL	PHYSICS, NUCLEAR
ENGINEERING, INDUSTRIAL	PHYSICS, THEORETICAL
ENGINEERING, MECHANICAL	PSYCHOLOGY
ENGINEERING, NUCLEAR	PSYCHOLOGY, EDUCATIONAL
ENGLISH	PSYCHOLOGY, EXPERIMENTAL
ENGLISH LITERATURE	PSYCHOLOGY, INDUSTRIAL
FINANCE	PSYCHOLOGY, INDUSTRIAL AND ORGANIZATIONAL
FLUID MECHANICS	SCIENCE
FORESTRY	SCIENCE AND ENGINEERING
GAMING, COMPUTER SIMULATION, AND MODELING	SCIENCE, PHYSICAL AND SOCIAL
GEOGRAPHY	SCIENCE, POLITICAL
GEOLOGY	SECRETARIAL ADMINISTRATION
GEOPHYSICS	SOCIAL WORK
GOVERNMENT	STATISTICS
	TRANSPORTATION
	URBAN (REGIONAL) PLANNING

Appendix G

THE BDM CORPORATION

BDM CORPORATE OVERVIEW BY MAJOR FIELD



Senator JEPSEN. Thank you, Mr. Williams.

I think what our procedure will be is to hear the entire panel and then we will exchange both ideas and questions. At this time I would like to welcome Mr. Shelp and advise him that we will proceed with your testimony next and advise you that your prepared statement will be entered into the record as if read and you may proceed in any manner you so desire. Thank you for coming.

STATEMENT OF RONALD K. SHELP, VICE PRESIDENT AND DIRECTOR, AMERICAN INTERNATIONAL UNDERWRITERS CORP., NEW YORK, NY

Mr. SHELP. Thank you, Mr. Chairman. I apologize for being late. It is difficult to praise the service economy when you deal with the transportation problem between New York and Washington.

Senator JEPSEN. Especially when it is raining in Washington. I had the same experience myself.

Mr. SHELP. I view the transformation of our economy to a service economy as the most important development since the industrial revolution. But, frankly, I think the only reason we are now paying a small amount of attention to it is because of the problem of our manufacturing industries. Our concern about this has, unfortunately, caused us to miss the real issues that we must address. Instead, we tend to focus on the fears we have about being a service economy.

I would like to address these fears before turning to the real issues because if we can put the fears aside we can get down to business.

The first fear or myth is that the shift to a services-based economy represents a sudden structural change in the U.S. economy. Yet this shift has been going on for a long time, most of this century.

We first became a service economy in 1940 when for the first time more than half of American workers were employed in service industries than all other industry—agriculture, manufacturing, mining, and construction. But it started way before that. There were more workers in services than manufacturing at least as far back as 1925, and today, as you know, 73 percent of our work force is in services.

There has been tremendous job creation in services in the 1970's, about 87 percent. That makes us think the trend is accelerating unduly; yet 80 percent of all the new jobs created except in farming since 1925 were in services. Nevertheless, the trend has accelerated in recent years.

The second concern we have about becoming a service economy is that it means a decline of other sectors, especially the manufacturing sector. This concern is reinforced by the fact that the number of service jobs in our economy is growing, but 66 percent of our GNP comes from services. But to me, this makes no more sense than the notion that an industrial economy produces only goods and an agriculture economy produces only commodities.

I would draw an analogy with agriculture. In 1910, there were about 10 million Americans working in agriculture. Today there are 3 million. But, as you know, because of productivity, our agricultural output has increased 220 percent.

The same thing could happen in manufacturing but the interesting thing is—it is not happening. Instead of jobs going down and production going up, both are going up. So while we lost some 2 million industrial jobs during the recession we just went through, there are still more manufacturing workers today than there were in 1960 because we have added about 1 percent per year in the last 20 years. Production is up as well. The Industrial Production Index in January was 1.569, which is an all time high.

The third concern or myth we have about a service economy is that the jobs in it are low paying and menial. In the minds of many, the symbol of the service economy is a "Big Mac." Our national nightmare is that we are becoming a nation of fast food franchises and video arcade operators. It is true that there are jobs like that in a service economy as there were such jobs in an industrial economy. But the great majority of jobs are in the upper white collar occupations and over half of these jobs are highly professional jobs.

To me, the test of what kind of an economy a service economy is is where the job creation is occurring. Is it occurring in hamburger outlets or in the computer software industry? Between 1977 and 1982, the employment in the eating and drinking establishments rose 21 percent, but it rose 40 percent in professional and business services, with computer and data processing up 91 percent.

It demonstrates what a complex service economy is all about—high skill, knowledge-intensive work.

The fourth concern relates to the third. The belief is that service production is labor intensive, low in productivity and technology absent. Our conventional way of thinking about services gives credence to these assumptions. Service work is considered people work, so naturally it is labor intensive.

Second, how can you make it more productive? Can a doctor, for example, see 10 patients an hour instead of 2?

Finally, while we see the new technologies like robots being applied to the automobile industry to make it more efficient, can you really apply similar technologies to the advertising firm or to the Government office?

I think we are beginning to learn that all these assumptions are wrong.

A recent Bureau of Labor Statistics study compared a series of industries. Much to everybody's surprise the majority of the service industries it studied were among the 20 percent that were most capital intensive. It also found their productivity growth in the period studied higher than that of goods producing industries, and concluded that the reason that American productivity went down in this period was because of lack of productivity in the goods producing industries themselves.

As to whether the new technologies can make services more productive as well, there is not much empirical evidence. But one only has to look around the office and our environment today. You see word processors, personal computers, automated banking, and so forth.

The final concern or myth is that we have become a service economy because of the growth in government. Surprisingly, long before Ronald Reagan, growth in government was declining. By 1979, the United

States was a service economy without government. So by 1979 more than half of all American workers were working in private service industries.

To sum up, I think what this tells us about a service economy is that it is a diverse, rich, complex economy whose services do provide the majority of jobs and production, but where there are many other activities. It also tells us that services are not all we think they are. It is the traditional services like banking, finance, retailing, construction, engineering, and professional services. But it is also services associated with the new technologies—telecommunication services, computer services, and educational services.

I frankly think that our habit of talking about the economy and dividing it into services, manufacturing, and high tech is becoming more and more irrelevant. Let me give you some trends to illustrate why.

In the last 20 years we were magnetized by the big industrial conglomerates, the manufacturing firms like ITT that buy service firms like Hartford Insurance. Lately we have been mesmerized by the new service conglomerates such as American Express-Shearson and Prudential-Bache. Tomorrow I think we will be captivated by the opposite, with the large service firms acquiring industrial companies.

This is a logical development. Why should a securities firm like Merrill Lynch not own the financial printing firm that prints the stock certificates it deals in?

But more revolutionary is what is happening in manufacturing, mining, and agricultural firms themselves. They are becoming in many ways service firms or mixed firms. There are many reasons for this.

One is nationalism. Our oil companies abroad are forced to divest themselves and they start selling their technology and management expertise and become distributors and movers of petroleum. So they are service firms. A company like Honeywell now has approximately 30 percent, of their revenue from services, even though we think of it as a high tech computer company. Agribusiness giants like Cargill find that trading, marketing, and distribution of grain are as important as growing grain. And new trading companies like General Electric are a giant step ahead because they have a ready source of manufactured products.

This led last year to the creation of the Fortune 500 service companies, with 10 companies previously considered industrial moving over the Fortune 500 service list.

A second trend I will not go into, but is in my prepared statement, is the way manufacturing and service are becoming more and more alike. One reason we have had so many new jobs in manufacturing is that 80 percent of them are service functions in the manufacturing concern. Conversely, if you go in a modern office today, with word processors, computers, and modern supervision of processing various kinds of activities, it looks more and more like an assembly line with the mass production technique of a manufacturing firm.

What this all adds up to, is a series of important policy issues to address. I do not have time to address them all, but I would like to touch on a few.

It seems to me that our first priority must be to enhance our ability to understand and track a modern complex service economy. When we talk about industrial policy—a popular word today—do we know enough about the American economy to make intelligent decisions? I maintain we do not. Our central mechanism to track the American economy is the standard industrial classification manual which divides economy activities into 12 divisions and 84 industrial groups. The decisions as to what constitutes a major industry were made in the 1930's. Maybe that explains why leather and tobacco, which have about 4 percent of our output, are classified as major groups; yet digital computers are listed as part of the nonelectrical machinery group.

These problems arise elsewhere as well. The industrial outlook of the Bureau of Industrial Economics did not include any information on service industries until last year. Wage data suffer from the same shortcomings. Only 30 percent of the industries published in the wage data series are services, although 73 percent of the jobs are in services. Perhaps that is why we conclude that services are low paid—because we do not have enough information about them.

Our ability to track international trade trends fares no better. We have 10,000 categories of trade and goods, and 6 general categories in services.

This leads me to the recommendation that our first priority should be to update our data capability to reflect the late 1980's, not the 1930's. Only then can we begin to do what industrial policy presumably should do, which is anticipate change in the future. We are so worried about the smokestack industries, as we should be, we are not thinking about how international competition and technological change may affect services.

For example, Peter Drucker and Pat Choate have predicted that in the next 15 years, 7 to 15 million service jobs will be lost because of new technologies like word processors.

Has it occurred to us that the shifting of manufacturing production we saw from the Northeast to the Sun Belt or to developing countries can happen in services, too? The blending of computer and modern telecommunications techniques makes the processing of information something that can be moved around the world like manufacturing production has been. That means that Citibank cannot only move its credit cards to South Dakota, but that it can be moved to other countries such as Taiwan, Brazil, France, and Egypt.

The second thing we must do is reexamine our basic policies, be they fiscal, trade, regulatory, and consider how they impact a service economy. There are two that I will focus on because of limited time.

One is tax policy. Whether you call it Keynesian or supply side or something else, how does it affect the modern service economy? For example, most of our Presidents have seen tax cuts as a way to stimulate the economy. President Reagan has his three-phase supply-side tax cut. If you ask what we are trying to stimulate, the ultimate answer is purchase of durables. But if this is true, then in a service economy where individuals have higher and higher levels of income and spend more of their discretionary income on services than goods, is it not possible that these tax cuts could inadvertently spur the growth of services?

For example, at a certain income level do you use a $100 tax refund toward the purchase of a new refrigerator or a nice dinner in a French restaurant?

A second area of tax policy we have to rethink to see how it works in a service economy are business tax cuts. The President's tax cuts, like those proposed by President Carter, involved a liberalized investment tax credit and accelerated depreciation provisions. There provisions were meant to encourage investment in plant and equipment. A few months ago I would have argued what does that do for services since they do not invest much in plant and equipment. But the new studies I mentioned earlier indicate that many services are capital intensive. So the question is, Did the policy that seemed to be intended to reindustrialize America actually encourage people to invest in service industries?

The same thing goes for our hodgepodge of other tax incentives. They should be rethought through to see if they are relevant to today's economy. The best example is the R&D tax credit which gives benefits to goods producing firms but excludes service industries. Thereby, if you improve computer hardware, you get the tax credit; if you develop computer software, you do not.

The second area I want to touch on as an area where policy must be reevaluated in light of our service economy is the most difficult and that is trade policy.

For many years we depended on services to make up for our trade deficits. In fact, for 5 out of the 8 years up to 1981, even though we focused on our large merchandise trade deficit, the services surplus compensated for it. But that has changed. This year we are predicting a trade deficit in goods of over $100 billion. And the services surplus has dropped at least 25 percent in the past 2 years. So we are in a real dilemma. And how do we deal with it? We try to deal with our smokestack industries, our import sensitive industries, on a case-by-case basis with some form of limited protectionism. At the same time, we try to convince our trading partners that we should have rules to allow services and high technology to be more freely traded, rules that are not in GATT now.

The whole trouble with that is, that is what everybody else is doing, too. The Europeans and Japanese and others also are trying to deal with their smokestack industries. They too have seen the boon for high tech services. We are going to have to rethink our trade policy and come up with something more ingenious than a policy which seems to allow us the leader of the trading world, to protect our weak industries while forcing others to accept the domination of our strong industries, high technology and services.

As to services, other nations have caught on. Recently, there was a Japanese delegation of businessmen under the auspices of the Ministry of Foreign Affairs visiting the United States and Europe to learn about our service industries. They are ready to start competing too. The French have a commission studying it. The European Commission is studying it. There are lots of people catching on.

Yet look at the way we deal with it. Our Commerce Department spends 80 percent of its resources promoting 15 priority sectors—not one is a service. I am not ready to argue they should do that for services too. I think we should sit back and think about the best ways to promote American exports of services.

For example, with the Government promoting telecommunication satellites, could we not think of a way to link that to the sales of telecommunicator services? And we have to think about industries like my own, such as insurance, or banking and advertising. They cannot be promoted in the traditional way through trade fairs and trade missions. What we have to think of is the way they can be promoted.

A second example is export finance. The Eximbank spends about 95 percent of its resources financing goods for sale. Our competitors know this is shortsighted. The decision to finance the survey of a construction or engineering project might make the difference in winning the project, and that leads not only to service exports but to goods exports too, in building the project.

Finally, though, we should remember that just like goods are import sensitive, services can be too. Our laws to protect our industries from import competition that's unfair are the countervailing duty laws and the antidumping legislation which address subsidies and dumping, respectively. These laws exclude services, even though U.S. services are subject to foreign subsidies of exports to the United States and to dumping in this market.

Again, I am not ready to argue those laws should be changed to include services, but I think we should think about how we deal with unfair trade practices confronted by services.

A final element to think about is how to help service workers and firms adjust who lose out to foreign competition. The trade adjustment assistance law, which was meant to do that, to assist workers, firms, and communities adjust to competition, exclude services. This was driven home a few years ago when Pan American Airways workers were denied a petition from the Labor Department to help because they were a service industry. They were told you have to be a nonservice industry.

It seems to me that the challenge to policy of our transformation to a service economy is immense. But there is a clearcut objective to keep in mind: Our vibrant, diverse, and complex service economy must be strengthened and the same market forces that led the world from agricultural to industrial nations must be allowed to lead us to the next stage.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Shelp follows:]

Prepared Statement of Ronald K. Shelp

The dramatic shift of the U.S. economy to services is broadly recognized but little understood. More energy is spend on maligning then interpreting the most important economic transition since the Industrial Revolution.

This passage to a new economy would probably have continued largely unnoticed except for an equally dramatic but much more recent development: the deterioration of America's manufacturing industries. In the public mind the two developments have become inextricably linked. While no one has explicitly blamed the troubles of smokestack America on the rise of services, almost everyone is uncomfortable with the result.

This stark contrast between the boom of our service industries and the bust of our traditional industries has forced us to evaluate where the nation is headed. At long last, we are beginning to examine the consequences of this revolution in the American economy.

But the fundamental issues we must address are blurred by our apprehensions about what we think a shift to a service economy means. We have let our fears about a service economy define the issues - and delayed coming to grips with the more central questions. Instead, most of the attention given to services has centered on five basic worries.

The first is that the shift to a services-based economy marks a sudden structural change in the U.S. economy. The shift to services is not recent: it has been underway for most of this century.

The United States first became a service economy in 1940. In that year for the first time one-half of the American labor force was employed in service industries, more than worked in manufacturing, agriculture, mining and construction combined. But 1940 did not mark the first time more American workers were employed in services than in manufacturing. That was true as early as 1925.

Since the U.S. first crossed the magic 50 percent threshold and became a service economy, the trend has continued. Today about 73 percent of the working population gains their livelihood in services. About 87 percent of all new jobs created in the 1970's were in service industries which suggests this shift is accelerating. Yet since 1925, eighty percent of the growth in non-farm employment has been in services.

What is striking is the shift in percentage terms in the past decade. In 1980, the Bureau of Labor Statistics predicted that in 10 more years, 71 percent of the work force would be in services. Yet we passed the 70 percent mark in less than three years.

The second concern is that the development of a service economy means the decline of other sectors, especially manufacturing. This view is reinforced by the fact that the growth of employment in services is accompanied by substantial increases in services production as well. Since 66 percent of our GNP derives from services activities, it is reasoned, we are producing less and less of everything else.

This makes no more sense than the notion that an industrial society produces mainly goods or an agricultural economy produces mainly commodities. Just because services have persistently increased their share of employment and GNP does not support the conclusion that everything else is in decline. Our evolution from an agricultural to an industrial economy offers a parallel for the shift to a service dominated economy. While farm employment declined from 10 million to 3.6 million workers between 1910 and 1981, real agricultural output rose 219 percent during the same period.

But this is not what is happening in manufacturing. The number of jobs is not going down while production is going up. Both are going up. While we lost an estimated two million industrial jobs during the recession, there are still more manufacturing workers today than there were in 1960. One reason is because increases in manufacturing employment have averaged about 1 percent a year during the past two decades. And the upturn in many manufacturing industries as we emerge from the recession has strengthened this trend.

Industrial production has surged as well. Productivity increases and the introduction of new technologies have spurred the industrial sector so that by January of this year our industrial production index was 156.9, an all time high.

The third concern is that service jobs are low paying and menial. In the minds of many, the symbol of the service economy is Big Mac. Our national nightmare is that we are fast becoming a nation of fast food franchisers and video arcade operators. There are, without question, many jobs like this in a service economy just as there are many such jobs in an industrial economy.

But the facts do not support this snap judgment. Only about 2 percent of service employment is in the personal service category. The great majority of service jobs are white collar and half of these are found in upper white collar occupations such as professional, technical, administrative and sales functions.

The best test of the kind of work that dominates a service economy is where job creation is occurring. Is it in hamburger outlets or in computer software? Between 1977 and 1982, employment in eating and drinking establishments rose 21 percent. During the same period, business services employment increased 40 percent - with computer and data processing up 91 percent. Job gains of 34 to 44 percent were recorded in legal, engineering and architectural services and in accounting, auditing and bookkeeping.

These kinds of jobs demonstrate what a complex service economy is all about: high skill, knowledge-intensive work.

<u>The fourth concern relates to the third: service production is primarily labor-intensive, low in productivity and technology-absent</u>. The conventional way of thinking about services lends credence to these assumptions. First, service work is mainly "people" work, so naturally it is labor intensive. Secondly, how do you make a doctor more productive - have him see 10 patients an hour instead of two? Finally, while the application of new technologies, like robots, may make the automobile industry more efficient, what can they do for the advertising firm? Or the government office?

We are only beginning to rethink the conventional wisdom. A recent Bureau of Labor Statistics study is a first step down the road to reshaping our prejudices. The study ranked 145 industries and reached a startling conclusion about services: the majority were among the 20 percent that were most capital-intensive; not one service industry was among the 20 percent that were lowest in capital-intensiveness. The same study compared 16 service industries that provide about one-third of total service employment with goods producing industries. Its findings: a) the productivity growth of these services exceeded that of goods producing industries; b) the productivity slowdown of recent years was not due to the employment shift to service industries.

While empirical evidence on the capacity of service industries to utilize new technologies is scant, the world around us is awash with suggestions it can. Witness the word processor, automated banking, interactive computer shopping.

The final concern is that the growth of government is the main reason we have become a service economy. In 1976, the Bureau of Labor Statistics estimate that approximately 5 out of the 6 million new jobs expected to be created by 1985 would be government jobs. For reasons we are all familiar with that has not happened. In fact, the contrary has occurred. Even before President Reagan, government employment was declining. In 1979, the United States became a service economy without government. As of that year, more than half of all American workers were employed in private service industries.

The Real Nature of the U.S. Service Economy

This suggests that a service economy is much different than we think. It is a diverse, rich, complex economy, one where services provide the majority of jobs and production but where manufacturing and agriculture are strong and viable as well. The service businesses we find therein are, like the economy, varied and diverse. They include the so-called traditional services - banking, insurance, securities, transportation, retailing, advertising, consulting, tourism, construction/engineering and professional services - medical, legal, accounting. But there are also an exploding range of new services associated with the new technologies: telecommunications services, computer services, educational services. This is an economy where the different sectors complement, not compete with each other. For example, the computer spawned the computer services industry. The latter has grown much faster than its progenitor and is fast approaching one percent of GNP.

Today's service economy is but a continuation of a trend that started at the beginning of this century. It is not a step backward but has consistently provided us with an increasingly higher standard of living. It is the most advanced state of economic development.

I would argue that our habit of segmenting discussion of the economy into services or manufacturing or high technology is fast becoming an exercise in irrelevance. It clouds the discussion and diverts us from focusing on what is really happening. Two trends illustrate this.

<u>One is the melting pot of industries in our economy. With each passing day, distinguishing between a service firm and a goods producing firm becomes more difficult and less important</u>.

In the 1960's and 70's we were magnetized by the giant manufacturing companies acquiring services companies: example - ITT buys the Hartford Insurance Company. Today we are mesmerized by the service firm buying the service firm, resulting in the cration of the service/financial conglomerate: Amex-Shearson, Pru-Bache. Tomorrow we will see the converse of the first: service firms will acquire industrial companies.

This is a logical development. Why shouldn't the securities firm, like Merrill Lynch, or the issuer of travelers checks, like Citibank, own the financial printing firms that print the stock certificates and prepare the travelers checks? An acquisition that would have seemed even more farfetched a few years back almost happened. In the first round of American Express' purchase of IDS, Amex acquired a small steel company in the process. It was not part of the final acquisition but it makes a point. Whether a service firm buys a manufacturing firm as a complement to its existing business or as a good investment or as a requisite for another acquisition, it can and will happen.

More revolutionary yet is the transformation of manufacturing, mining and agricultural firms into service firms or into firms dealing in both goods and services. It happens for a variety of reasons. One is nationalism. Many companies that were formerly extractive industry firms become service firms out of necessity. Oil companies forced to divest overseas, such as Aramco in Saudi Arabia, become instead suppliers of technology and management expertise, distributors and movers of petroleum.

Another is the natural linkage between tangible production and intangible activities. Consider Honeywell: it is estimated that some 30 percent of the revenue of this company, perceived as a high tech computer manufacturer, actually comes from services. Yet considering the hardware it produces, the service component is not surprising. Or General Telephone and Telegraph which has earned more than half of its revenues from services since 1974. Or the agri-business giants, like Cargill, who find the trading, marketing and distribution of grain no small part of their business. Or the new trading companies like General Electric who are off to a giant leap in this new service activity because they have a ready source of manufactured products to trade.

This trend led Fortune magazine to the inevitable: the creation of its much vaunted Fortune 500 list of Service Companies. And in 1982, ten companies previously included among the Fortune 500 Industrials were moved to the Service 500 list.

A second dramatic trend is the nature of work itself in both manufacturing and service firms.

Work on the plant floor had changed long before the current drive to modernize the industrial work place through the introduction of robots and other sophisticated, computerized production and quality control techniques. Eighty percent of those millions of new jobs added in the manufacturing firms in the past twenty years were in service functions. So the shift to services is not just a broad macro-economic trend - it is occurring within the manufacturing firm itself.

But work in in the office has changed as well. New production techniques in service firms are strikingly similar to those we have long associated with the factory. Organization of the data processing function - in banks, insurance companies, credit card firms and others - takes on many aspects of traditional industrial production. Word processors and computer monitored supervision of activities like processing of insurance claims allows massive productivity increases. In essence, assembly line and mass production techniques have been transplanted to the office. They permit standardization of quality and measurable productivity, something previously viewed as impossible in service activities.

But the technological revolution that is transforming service firms is not just limited to the routine such as processing bank transactions. Only last week the New York Times described experiments underway in major property and casualty insurance companies to codify the subjective knowledge of insurance underwriters into a computer capability.

The Policy Consequences

This upheaval in the American economy has staggering implications for public policy. They require us to step back and reassess the way we think about our economy. Our prejudices, the baggage we carry because of our intuitive fears of a service economy, must not keep us from facing this new reality objectively and dispassionately. No longer will it suffice to carry a brief for our prized kind of economic activity - be it steel production, wheat growing, or satellite communications. We must understand where we are instead of where we think we are or wish we were.

The first necessity is to enhance our ability to understand and track a modern complex service economy. Our capability to trace the American economy is hopelessly out of date. The rapid rate of technological change, with new businesses and even new industries emerging overnight, makes the task formidable enough. But the limitation inherent in the traditional indices we use to track our economy makes it impossible.

The central tracking mechanism is the Standard Industrial Classification Manual which divides all economic activities into 12 divisions and 84 "major industry groups". Decisions as to what constitutes a major industry were made in the 1930's. Perhaps this explains why the leather and tobacco industries, which between them account for only 4 percent of total output, are both classed as major groups. Yet digital computers, which did not exist when the classification system was established, is part of the non-electrical machinery group. And microprocessors do not have a code of their own but are lumped with semiconductors and related devices.

These failings open a Pandora's Box of misleading data. For example, the Federal Reserve industrial production and capacity utilization findings are based on a composite index of the relative importance to total production of 215 industries in 1967. Naturally, the growth industries of the last 16 years, like electronics, are understated and the declining industries, like steel, are overstated. Similarly, the Industrial Outlook of the Bureau of Industrial Economics did not include any information on servies until 1983.

Wage data suffers from similar shortcomings. Labor Department data was developed to measure manufacturing wages and only tangentially touches on our major employer - services. Only 30 percent of the industries published in the wage data series are service industries, although 73 percent of the nations; jobs are found in this sector.

Or ability to track international trade trends fares no better. While there are some 10,000 specific product categories for goods trade, there are only six aggregate categories for services trade. Likewise, the surveys used to gather data on U.S. international investment is skewed mainly towards manufacturing investments.

Little wonder that the widely followed indicators we look to as the bellweathers of our economy - the index of leading and lagging indicators - do not really reflect a modern service economy. While indicators such as the average manufacturing workweek, new orders for plant and equipment, inventory levels, commodity prices, might have been sufficient for the old economy, do they accurately gauge a nation where the majority of production and employment comes from service industries?

The time is long overdue to commit the resources to bringing our data collecting capability to the mid 1980's. This should be joined by a determination to utilize this information to interpret international competitive trends and monitor technological change. Only by anticipating the future is there a likelihood of avoiding the mistakes of the past.

For example, even as we anguish over the job displacement in our smokestack industries, have we begun to anticipate how international competition and technological change is likely to impact our booming service industries? If Peter Drucker an Pat Choate are correct, between 7 and 15 million service jobs will be lost in the next 15 years because of the technologies found in advances such as word processors and automated electronic banking.

Have we foreseen that the shifting of manufacturing production from the Northeast to the Sun Belt or to other nations may be repeated in service industries because of new technology. The blending of the computer and modern telecommunications techniques makes the processing of information, a central activity to many services firms, as moveable as was manufacturing production. Citibank illustrated this by shifting its credit card operations to South Dakota. This process will be repeated often - only it will not be limited to a move to other U.S. states. It could as well be Taiwan, Brazil, France, Egypt.

The second necessity is to reexamine how our policies - fiscal, productivity, trade regulatory - impact a service economy.

Tax policy is an excellent case in point. We must rethink our standard assumptions to see if they are as relevant for the kind of economy we have today. How, for example, do tax cuts, whether called Keynesian or supply-side, effect a modern service economy.

The individual tax cut, a favorite tool of recent Presidents to stimulate growth or recovery, should be submitted to this test. Under President Reagan we have the three-phase supply side tax cut. President Carter has his infamous $50 tax rebate. The idea in both instances was to stimulate demand. But demand for what? The policymakers answer: demand for durables. But if it is true that in service economies, individuals spend more of their discretionary income on service than on goods, is it not possible these tax cuts could inadvertently spur the growth of services? Is a $100 tax refund more likely to be applied towards a refrigerator or a dinner in a a French restaurant?

Similarly, did the Reagan business tax cuts (a variation of the original Carter proposals) intended to reindustrialize America, achieve their goal? The centerpiece of these proposals - the liberalized investment tax credit and accelerated depreciation provisions - were meant to hasten investment in plant and equipment. But if services are indeed more capital intensive than we thought, do they steer investment away from manufacturing and towards services?

In the same vein, the hodgepodge of individual tax incentives in our legislation should be looked at from a fresh perspective to see if they are relevant to today's economy. Does a Research and Development Tax Credit provision which grants benefits to goods producing firms but excludes all but two service industries, really make sense in an economy where so much innovation and growth occurs in the service sector? Why grant and R&D credit for improvements in computer hardware but deny the credit to the designer of new software?

<u>Productivity Policy</u>

A universal them shared by at least our last four Presidents is that U.S. productivity is deplorable. Suggestions for improving it range from imitating the innovative workplace methods pioneered in Scandinavia, such as working in teams and rotating assignments, to adapting targeted tax incentives to encourage industry to modernize.

It is fair to say that this industrial orientation pervades most of the solutions that have been suggested. The proposal to import the successful factory techniques tried overseas is just that - work experimentation in an industrial setting. A paragon of labor relations to be tried in the non-manufacturing workplace it is not.

It is remarkable that attempts at improving productivity ignore the service workplace, especially since the problem of productivity there has not gone unnoticed. Many economists cite laggard service productivity as the villain for declining U.S. productivity. They argue that the spectacular job creation in services is more a factor of inefficiency than real growth. Only the Nixon Administration focused on service productivity to any extent. Yet the findings on services of his National Commission on Productivity were never translated into policy.

Admittedly, improving productivity in services is difficult since there is little understanding on how to measure it. But the difficulties of the subject provide a lame excuse for failing to grapple with it, especially if there is any truth to the allegation that improving this dominant activity in our economy could turn around our low productivity. It is time to dedicate the kind of attention and resources to this challeng that we have given to our other national problems.

Trade Policy

The one are we would expect to be subject to the kind of broad scrutiny that our changing economy demands is trade policy. This is because it was the huge service trade surpluses - contrasted to the giant trade deficits - that first drew policymaker attention to services. But appreciating the benefits of service exports and understanding the policy needs of industries in a service economy are two different things.

Our failure to shape a trade policy fully in tune with the new American economy is finally taking its toll. Not only has the merchandise trade deficit soared to a new high predicted to be in excess of $100 billion this year, but the services surplus has plummeted 25 percent in the past two years. No longer can we count on the services surplus to offset the goods deficit. It will not even come close. But surprisingly, this development has not hardened our determination to reshape trade strategy. Instead, it has reaffirmed to many it was foolish to count on services exports to begin with.

Shaping a trade policy reflective of a changed U.S. economy and responsive to a new international economy is a colossal challenge. It requires understanding our present and future competitive strengths and weaknesses and reconciling these with the interests of other nations.

Lately, we have acted on a case by case basis to respond to the problems of import-sensitive industries. This has involved some form of relief for steel, textiles, motorcycles, and other industries. At the same time, we seek to enhance international opportunities for the most competitive industries - high technology and services, by seeking to negotiate new international trading rules covering them.

But this strategy is unlikely to persuade the rest of the world since in essence this is what it is doing as well. The smokestack industries of our major trading partners are encountering the same difficulties. And virtually every nation has concluded that its economic future lies in the development of high technology industries. More recently, many have reached the same conclusion about services. So they are following the U.S. lead by protecting their most troubled manufacturing sectors while launching major efforts to develop the high technology and service industries.

Every nation cannot rebuild and protect its traditional industries and foster the high technology and service industries. The United States, as it has throughout the post-war period, must provide the leadership out of this mire. This will require something more ingenious than a program that appears to the rest of the world to allow it to protect its weak industries while forcing others to accept its continue domination of high technology and services.

While struggling with this dilemma, we must begin to rethink our domestic trade policies. They are captive to the same bias that permeates our other economic policies: a predisposition to thinking exclusively in terms of manufacturing. This sharply contrasts with the attitude of our competitors.

Recently, a Japanese delegation of businessmen, under the auspices of their Ministry of Foreign Affairs, visited the United States and Europe to study service industries. Both MITI, the Ministry of International Trade and Investment, and the Japanese Planning Agency, are studying the service sector. They clearly perceive it as an important area in which Japan must compete. The French Commissariat du Plan is focusing on the future of financial services and intermediaries. And recently, the European Community reversed its opposition to the U.S. proposal for a GATT trade negotiation on services by announcing its studies showed it the world's largest service exporter.

Yet the Department of Commerce, our principal export promotion agency, still devotes about 80 percent of its resources to promoting 15 priority sectors - and not one is a service. That does not lead time to conclude we should give equal support to services. Instead we should first reexamine how best to encourage the export of American goods and services. Is there a relationship between the sale of a good and a service? Astute marketing of our telecommunication satellites, for example, might link the sales of telecommunicator services. Clearly, many services, such as insurance, banking or advertising, will not benefit from the traditional governmental export promotion techniques such as trade missions and trade fairs. But what, if any, are the government aids that could make a difference in exporting these services?

A parallel analysis is necessary for export finance. The Export Import Bank spends at least 95 percent of its resources on financing only goods sales. Yet our competitors know this is shortsighted. A decision to finance the survey of a pending construction or engineering project might make the difference in winning the project. If a U.S. firm wins, it will utilize a bundle of American goods and services. In short, traditional ways of considering export finance must be updated.

If we are to modernize our trade promotion policies, we must do the same with mechanisms for responding to unfair competition and assisting industries ailing from import competition. The principal tool for responding to foreign export subsidies to the United States is the countervailing duty legislation which allows the assessing of a duty to offset the subsidy. The principal tool for responding to foreign practice of selling products in our market below home market price is the anti-dumping provision in our trade law.

While foreign service exporters both subsidize and dump their services in the U.S., our countervailing duty and anti-dumping laws are not applicable to services. The trade experts argue they should not be. How, they ask, can you duty a service or determine the home market price of a service? My response to this is to remind the skeptics that a few years ago they said: "How can we subject services to international trading rules designed for goods trade? They are so different." Again, this is not intended to be an argument for extending these laws to cover services, but and exhortation to examine the best means to shape responses that will give our thriving services industries the benefit of equal protection under the laws.

Finally, we must remember that service industries are no different than other industries in that they too are subject to international competition.

Yet the mechanism specifically tailored to assist workers, firms and communities in adjusting to competition - Trade Adjustment Assistance - excludes services. This was driven home a few years back when the Labor Department was forced to deny a petition from Pan American Airways workers for assistance because services are denied such benefits.

The challenge a shift to a service economy presents is immense. But the objective we should bear in mind in responding to that challenge is straightforward. Our vibrant, diverse complex service economy must be strengthened. And the same market forces that led the world from agricultural to industrial nations must be allowed to lead us to the next stage.

Senator JEPSEN. Thank you.
Mr. Wolff, please proceed.

STATEMENT OF EDWARD N. WOLFF, PROFESSOR OF ECONOMICS, NEW YORK UNIVERSITY, NEW YORK, NY

Mr. WOLFF. Thank you, Mr. Chairman. It is a pleasure to be here this morning.

What I would like to talk about mainly is the macroeconomic performance of the service sector in the postwar period in the United States. In particular, I will focus on productivity, employment, wage, price, and output trends. Because of data limitations, I will focus on the period from 1947 to 1976.

The major point I want to make is that, at least in regard to macroeconomic performance, the service sector is very heterogeneous. That is to say, the usual dichotomy of the economy into a goods producing and a service sector is really inadequate to capture important differences in performance and behavior. Indeed there is more diversity of economic characteristics within the service sector than between the service and commodity producing sector.

It is perhaps helpful to review an important argument put forward by my colleague, Prof. William Baumol, in a 1967 article. At that time, he argued that there were really two relatively distinct sectors in the economy, which he labeled the "progressive" and the "stagnant" sector. The former was characterized by a relatively constant and high rate of productivity growth over time. The latter was generally characterized by little or no labor productivity growth over time. It was shown that relative prices and costs in the stagnant sector would tend to increase over time, and that if the output proportions of the two sectors remained constant over time, then the share of labor used by the stagnant sector must rise to 100 percent. Finally, it was shown that the economy's overall productivity growth rate would decline over time as a result of this unbalanced growth.

Now in the original piece, the progressive sector was identified as the goods producing industries and the stagnant sector as services. In recent work, however, by my colleague and myself, we have found that the simple identification of services as the stagnant sector was not correct. Indeed, there are many services which are among the most progressive in the economy.

I have made some calculations of the annual rate of labor productivity growth for 15 different industries in the U.S. economy over the 1947–76 period. The data came from the National Income and Product Accounts of the U.S. Government. The average annual rate of overall productivity growth was 2.16 percent over the period. However, sectoral rates of productivity growth ranged from a high of 5.4 percent in communications and broadcasting, a service sector, to a low of −0.51 percent in Government enterprises. Agriculture had an annual productivity growth rate of 3.6 percent; construction 1.7 percent; durable manufacturing 2.5 percent; nondurable manufacturing 3.2 percent; transportation 1.7 percent; and utilities 5 percent. Though there is a fairly wide spread in sectoral rates of productivity growth, there also appears to be a sharp break between the construction sector at 1.7 percent and the so-called general services sector at 0.93 percent. By this criterion, there are really four stagnant sectors in the economy—so-called general services, finance, and insurance which has an annual productivity growth rate of 0.5 percent; the Government industry at 0.3 percent, and government enterprises.

Productivity growth in the remaining sectors was fairly rapid, putting them in the progressive group. Note that this group includes four service sectors—communications, 5.4 percent; wholesale trade at 2.4 percent; retail trade at 2 percent; real estate at 2.7 percent. I call these the progressive services group.

I then made some calculations for the aggregated progressive and stagnant sectors. For the whole progressive sector, labor productivity growth averaged 3 percent per year and for stagnant services it was 0.8 percent per year. For progressive services, it was 2.8 percent per year.

The progressive sector's share of real output remained virtually unchanged over this period at 79 percent of final output. Likewise, the stagnant sector's share of real output was also constant over this period, at 21 percent. So as predicted by our model, the stagnant sector's share of total employment rose from 22 percent in 1947 to 41 percent in 1976. Also, as predicted by our model, the price of the output of the stagnant sector relative to that of the progressive sector also rose over the 1947–76 period. This is evidenced by the almost 10 percentage point increase in the stagnant sector's share of output in current dollars.

Progressive services seem to lie somewhere in between the progressive sector and stagnant sector in regard to performance. They have had high productivity growth, though lower than that of goods producers. Their output share in real terms expanded over the period from 25 percent in 1947 to 32 percent in 1976. The relative price of the output of progressive services fell over the period. As a result, their share of output in current dollars was constant over the period. Finally, their share of employment over this period was also almost constant at 22 percent.

Another interesting finding is that the average wage and salary per full-time equivalent employee was almost the same in the stagnant service sector in 1976, about $11,500, as in the progressive sector, at $11,700. The average wage and salary in the progressive services was slightly lower, at $10,200, and this is due to a large segment of retail trade workers. Among service sectors in general, there was a wide dispersion in average wage and salary levels, the highest being among civilian Federal Government employees at $16,300; the next highest was in communication and broadcasting at $15,300; wholesale trade $13,700; legal services $13,400; $12,200 for the whole government sector; $11,400 in finance, insurance and real estate; $9,700 in the whole general service sector; $8,400 in retail trade, which is by the way sometimes construed to the representative of the whole service sector; and $6,500 among domestic workers.

In conclusion, then, the service sector is very heterogeneous with respect to economic performance. It includes some of the highest productivity growth sectors and some of the lowest. Its total share of employment increased from 43 percent in 1947 to 64 percent in 1976, and today it is 73 percent. But this increase, unfortunately, by my calculations, comes mainly from the increase of employment in stagnant services. Its share of final output rose from 47 percent in 1947 to 53 percent in 1976 in constant dollars and from 44 percent to 56 percent in current dollars. In 1976, its average wage and salary was $11,000 compared to $11,600 for all workers. As far as public policy goes, there is very little sense in designing measures for the "service sector" as a whole, since the sector is so diverse in performance. However, in regard to stagnant services in particular, as they absorb an increasing share of total employment, overall productivity growth will necessarily fall, unless ways can be found to stimulate productivity growth in such areas as medicine, law, education, other professions, repair work, and the Government itself.

Thank you.

[The prepared statement of Mr. Wolff follows:]

Prepared Statement of Edward N. Wolff

I would like to make some remarks about the macroeconomic performance of the service sector in the post-war period in the U.S.. In particular, I will focus on productivity, employment, wage, price, and output trends. Because of data limitations, my analysis will comprise the period from 1947 to 1976.

The major point I want to make is that, at least in regard to macroeconomic performance in the post-war period, the service sector is very heterogeneous. That is to say, the usual dichotomy of the economy into a goods-producing and a service sector is really inadequate to capture important differences in performance and behavior. Indeed there is more diversity of economic characteristics within the service sector than between the service and commodity-producing sector.

It is perhaps helpful to review an important argument put forward by Professor William Baumol in a 1967 article entitled "Macroeconomics of Unbalanced Growth: The Anatomy of Urban Crisis". At that time, he argued that there were two relatively distinct sectors in the economy, which he labeled the "progressive" and the "stagnant sector". The former was characterized by a relatively constant and high rate of labor productivity growth over time. The latter was generally characterized by little or no labor productivity growth over time. It was shown that relative prices and costs in the stagnant sector would tend to increase over time, and that if the output proportions of the two sectors remained constant over time, then the share of labor used by the stagnant sector must rise to 100 percent. Finally, it was shown that the economy's overall productivity growth rate would decline over time as a result of this unbalanced growth.

In the original piece, the progressive sector was identified as the goods producing industries and the stagnant sector as services. In recent work by my colleague William Baumol and myself, we have found that the simple identification of services as the stagnant sector was not correct Indeed, there are many services which are among the most progressive in the economy.

I have made some calculations of the annual rate of labor productivity growth for 15 different industries in the U.S. economy over the 1947-76 period. The output concept I have used is "gross product originating," or GPO, in constant dollars, which is the value added by each industry deflated by a price index. The employment concept I have used is "persons employed", which is defined as the sum of the number of full-time equivalent employees and self-employed workers. The data came from the National Income and Product Accounts of the U.S. government. (See Table 1) The average annual rate of aggregate productivity growth was 2.16 percent over the period using GDP as the measure of output, 2.18 using GNP and 1.99 using NNP. Sectoral rates of productivity growth ranged from a high of 5.42 percent in communications and broadcasting, a service sector, to a low of - 0.51 percent in government enterprises. Though there is a fairly wide spread in sectoral rates of productivity growth, there also appears to be a sharp break between the construction sector at 1.66 percent and the narrowly-defined "general services" sector, at 0.93 percent. By this criterion and these data, four sectors are stagnant: services (0.93 percent), finance and insurance (0.50 percent), government industry (0.31 percent), and government enterprises (- 0.51 percent). Productivity growth in the remaining sectors was fairly rapid, putting them in the progressive group. Note that this group includes four service sectors--communications, wholesale trade, retail trade, and real estate.[1]

Table 1:

Average Annual Rate of Labor Productivity Growth by Sector, 1947-76[a]

INDUSTRY	MEASURE
1) Agriculture	3.59%
2) Mining	2.70
3) Construction	1.66
4) Manufacturing-Durables	2.52
5) Manufacturing-Non-durables	3.21
6) Transportation and Warehousing	1.74
7) Communication and Broadcasting	5.42
8) Utilities	4.96
9) Trade	
a) Wholesale Trade	2.37
b) Retail Trade	1.99
10) Finance and Insurance	0.50
11) Real Estate	2.72
12) General Services	0.93
a) Hotels, Personal and Repair (except auto)	
b) Business and Professional Services	
c) Auto Repair and Services	
d) Movies and Amusements	
e) Medical, Educational and Non-Profit	
f) Household Workers	
13) Government Enterprises	-0.51
14) Government Industry	0.31
OVERALL: GDP	2.16
GNP	2.18
NNP	1.99

[a] Productivity is measured as the ratio of GPO in constant dollars to persons employed. The source is:

Bureau of Economic Analysis, The National Income and Product Accounts of the United States, 1929-76 Statistical Tables, September 1981, Tables 6.2 and 6.11.

I also made some calculations for the aggregated progressive and stagnant sectors (see Table 2). Over the 1947-76 period, labor productivity growth averaged 2.2 percent per year for the whole economy. For the whole progressive sector, labor productivity growth averaged about 3.0 percent per year and for stagnant service it was about 0.8 percent per year. For progressive services, it was 2.8 percent per year. Total factor productivity (TFP) growth, where TFP is defined as the ratio of output to a weighted average of both labor and capital stock, averaged 1.3 percent for the full economy, 1.4 percent for the progressive sector, 1.0 percent for progressive services and 0.6 percent for stagnant services.

The progressive sector's share of real output remained virtually unchanged over the 1947-76 period at 79 percent of final output (in 1958 dollars) and 83 percent of gross output (in 1958 dollars). Likewise, the stagnant sector's share of real output was also constant over the period, at 21 percent of final output and 17 percent of gross output. As predicted by our model, the stagnant sector's share of total employment rose from 22 percent in 1947 to 41 percent in 1976. Also, as predicted by our model, the price of the output of the stagnant sector relative to that of the progressive sector rose over the 1947-76 period. This is evidenced by the almost 10 percentage point increase in the stagnant sector's share of output in current dollars.

Also of interest is that the share of the total capital stock owned by the progressive sector increased over the 1947-76 period from 46 percent to 55 percent, and the share owned by the stagnant sector declined correspondingly. This helps to explain, in part, the higher rate of labor productivity growth in the progressive sector than in the stagnant sector and also the fact that the rate of TFP growth in the progressive sector was considerably lower than its rate of labor productivity growth. It also indicates that the progressive sector is much more amenable to technological change than the stagnant sector.

Table 2

The Rate of Annual Productivity Growth and the Share of Employment, Capital Stock, and Output in Progressive and Stagnant Sectors, 1947-76.

	Progressive Sector (all)[a]	Progressive Services[b]	Stagnant Services[c]	Overall
1. Rate of Productivity Growth, 1947-76[d]				
a) GPO/N	2.94%	2.71%	0.64%	2.16%
b) GDO/N	3.00	2.85	0.87	2.16
c) TFP	1.38	0.97	0.50	1.27
2. Employment Share				
a) 1947	72.4	21.3	21.6	100.0
b) 1976	58.8	22.5	41.2	100.0
3. Capital Stock Share (1958 $)				
a) 1947	46.2	7.2	53.8	100.0
b) 1976	54.8	13.2	45.2	100.0
4. Final Output Share (1958 $)				
a) 1947	78.6	25.3	21.4	100.0
b) 1976	78.8	32.2	21.2	100.0
5. Gross Output (GDO) Share (1958 $)				
a) 1947	83.2	21.7	16.8	100.0
b) 1976	83.2	28.5	16.8	100.0
6. Final Output Share (Current $)				
a) 1947	82.1	26.3	17.9	100.0
b) 1976	70.1	26.5	29.9	100.0

Table 2 (continued)

7. Gross Output (GDO) Share (Current $)	Progressive Sector (all)[a]	Progressive Services[b]	Stagnant Services[c]	Overall
a) 1947	86.3	22.4	13.7	100.0
b) 1976	77.1	23.9	22.9	100.0
8. Average Wages and Salaries per Full-Time Equivalent Employee in 1976	$11,706	$10,183	$11,468	$11,608

a) The progressive sector consists of (1) agriculture, (2) mining, (3) construction, (4) manufacturing, (5) transportation and warehousing, (6) communications and broadcasting, (7) utilities, (8) trade, and (9) real estate. It should be noted that the output of the real estate sector includes rent imputed to owner-occupied housing. Since imputed rent enters the official GNP statistics, the reported rate of productivity growth in real estate is the appropriate figure to use.

b) Progressive services consist of (1) communications and broadcasting, (2) wholesale trade, (3) retail trade, and (4) real estate.

c) The stagnant sector consists of (1) finance and insurance, (2) hotels, personal, and repair services, (3) business and professional services, (4) auto repair and related services, (5) movies and amusements, (6) medical and educational services and non-profit institutions, (7) household workers, (8) government enterprises, and (9) government industry.

d) GPO refers to gross product originating in 1958 dollars. GDO refers to gross output or sales in 1958 dollars. The symbol N refers to total persons employed, which is defined as the sum of the number of full-time equivalent employees and self-employed workers. TFP refers to total factor productivity and is defined for sector i as:

$$TFP_i = \frac{GPO_i}{N_i^{\alpha_i} K_i^{(1-\alpha_i)}}$$

where N_i is employment in sector i, K_i is the capital stock employed in sector i, and α_i is the average share of labor compensation in GPO for sector i over the period. The overall rate of productivity growth is based on GNP in 1958 dollars.

Progressive services seem to lie somewhere in between the progressive sector and stagnant sector in regard to performance. They have had high productivity growth, though lower than that of goods producers. The share of the total capital stock owned by progressive sectors almost doubled from 7 percent in 1947 to 13 percent in 1976. This rapid rate of capital accumulation helps to explain, in part, its high rate of labor productivity growth. Their output share in real terms expanded over the period from 25 percent of final output in 1947 to 32 percent in 1976 (and from 22 percent of gross output to 29 percent). The relative price of the output of progressive services fell over the period. As a result, their share of output in current dollars was constant over the period. Finally, their share of employment of the period was almost constant at 22 percent.

Another interesting finding is that the average wage and salary per full-time equivalent employee was almost the same in the stagnant service sector in 1976 ($11,468) as in the progressive sector ($11,706). The average wage and salary in progressive services was slightly lower, at $10,183. Among service sectors in general, there was a wide dispersion in average wage and salary levels, from $16,269 among civilian federal government employees to $15,292 in communications and broadcasting, $13,683 in wholesale trade, $13,390 in legal services, $12,213 for the whole government sector, $11,388 in finance, insurance and real estate, $9,715 in the whole general service sector, $8,442 in retail trade, and $6,474 among domestic workers.

In conclusion, then, the service sector is very heterogeneous with respect to economic performance. It includes some of the highest productivity growth sectors and the lowest. Its total share of employment increased from 43 percent in 1947 to 64 percent in 1976, mainly from the increase of employment in the stagnant services. Its share of final output rose from 47 percent in 1947 to 53 percent in 1976 in constant dollars and from 44 percent to 56 percent in current dollars. In 1976, its average wage and salary was $11,014, compared to $11,608 for all workers. As far as public policy goes, there is very little sense in designing measures for the "service sector" as a whole, since the sector is so diverse in performance. However, in regard to stagnant services in particular, as they absorb an increasing share of total employment, overall productivity growth will fall, unless ways can be found to stimulate productivity growth in such areas as medicine, law, education, other professions, repair work, and the government itself.

FOOTNOTE

1 The real estate data must be interpreted cautiously, since part of the "output" is the rent imputed to owner-occupied housing. However, where imputed rent enters official GNP and GDP statistics, the reported rate of productivity growth in real estate is the appropriate datum.

Senator JEPSEN. Thank you.
Mr. Faulhaber, you may proceed.

STATEMENT OF GERALD R. FAULHABER, DIRECTOR, FISHMAN-DAVIDSON CENTER FOR THE STUDY OF THE SERVICE SECTOR, AND ASSOCIATE PROFESSOR, DEPARTMENT OF PUBLIC POLICY AND MANAGEMENT, WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA

Mr. FAULHABER. Thank you, Senator. I appreciate the opportunity to be here today and I think it might be helpful if I identified myself just a bit further.

I am associate professor of public policy and management at the Wharton School at the University of Pennsylvania, and director of the Fishman-Davidson Center for the Study of the Service Sector. The center was recently established at Wharton to encourage and support the highest quality research on the problems unique to the service economy and to disseminate the results of that research through publication in scholarly journals, professional conferences and the university curriculum.

But before assuming this position at the first of this year, I was director of strategic and financial management at the American Telephone & Telegraph Co., where I served in a variety of positions for the last 21 years.

So today I bring to these hearings not only the perspective of my current academic responsibility for research in the service sector, but also the perspective of extensive practical experience in what was the Nation's largest service enterprise. My testimony, therefore, is my research interest as director of the center and by my hands-on experience in the private sector as well.

Now my fellow panel members have addressed themselves to what I would call some of the traditional issues of the service sector—productivity, employment outlook, trade in services, data, and measurement problems—and for the most part I share their concerns.

However, I would like to bring to your attention three specific problem areas which may not be as familiar to you at least in the context of services and which fall under the general heading of market structure. In contrast with Professor Wolff who dealt with the macroeconomic issues, these are more microeconomic issues.

Those problems are innovation and R&D in the services sector; services as reputation goods—and I will explain in a moment—and regulation and deregulation in the service sector. I would like to deal with each of those in turn, leading off with innovation and R&D services.

Now you do not need an economist to tell you that innovation is the primary engine of economic growth and that that engine is fueled by substantial investments in R&D by firms and individuals. Nor do you really need an economist to tell you that firms will only make those investments in innovative activities if the superior products and services that result are protected against copycat firms who would duplicate the service, quickly enter the market and compete away the returns from innovation.

In fact, our patent system is designed to help innovators capture the competitive rewards for innovation by protecting the inventor from unauthorized duplication.

But patent protection was designed for physical goods, for devices and for gadgets, and it provides little or no protection for innovations which are applicable to the service sector where the product is less tangible. There is no protection, for example, for innovations designed to reduce operating costs such as improving the utilization of hotel-motel capacity or automating citation review in law firms. There is no protection for innovation in new customer delivery systems, such as discount self-service shoe stores or H&R Block's mass merchandising of tax return preparation. There is no protection for innovative packaging of new services, such as designing and development of new financial markets or financial instruments or innovative insurance policies. And there is little or no protection for software in which I include not only computer programs and video games, but more broadly, management services and new management techniques.

With virtually no protection for services, we can expect less innovation unless at least some patentlike protection, which now covers the manufacturing sector, could be extended to cover these innovations most important to the service sector as well.

Now some innovations in service have occurred and will no doubt continue to occur in the future. Nevertheless, increased protection of the investment in innovative activities needed to create innovation in the service sector can be expected to increase the productivity of this sector. I think consideration should be given to the appropriate extension of that kind of system.

Now I earlier characterized services as reputation goods and I suspect that may be a term that is new to you because the area of economics of reputation has been the subject of research only for the past few years. However, the implications of this work in the service sector are worthy of your attention.

There are many products for which we as consumers can quickly and easily determine the quality of the product we are about to purchase simply by inspecting it before we buy it—does it have all the features I want, is it metal or plastic, how does it feel and how does it sound? But for intangible services, we know very little about a service before we must put our money down and buy it—will the doctor cure me, will my lawyer write a good contract, will I have a good restaurant meal, will the consultant deliver first-rate relevant analysis of my problem?

For many services, we consumers tend to rely heavily on the seller reputation as a means to accurately assess quality. We view our own past experiences as well as that of others as the best predictor of how pleased I will be by this doctor, lawyer, restaurant, or consultant.

Sellers build reputations by inducing customers to buy their products and services using a variety of strategems—introductory offers, free samples, two tickets for the price of one, heavy promotion, and attempting to create a brand's identity. But building reputations is an expensive investment for sellers; firms who are selling reputation goods must price so as to recover their investment in reputation.

Prices in markets in reputation goods generally not only cover the direct cost of providing the quality, but include a price premium that represents returns to the seller's investment in reputation.

Now will that investment in reputation be large? Will the price premium be large? In other words, is this an important problem? The answer is yes, in those service markets where (1) purchases are infrequent, (2) reputation disseminates slowly, or (3) detection of quality is difficult. If any of those conditions occur, generally speaking, returns to reputation investments will be a large part of the price of those services.

Furthermore, investment in reputation becomes a sunk cost. If I have a reputation as a restauranteur, I cannot translate that or transfer that into being a lawyer. So it is unique to the business I am in. It is a sunk cost and it tends to make markets less competitive than they would be if reputations were not demanded by consumers.

Now what can be done to help? I think two areas are worthy of consideration.

The first is to remove any legal or regulatory impediments to timely and full information flow by private information sources. For example, we are all used to the fact that the media and other sources provide fairly good information on the reputations of restaurants, movies, and plays. Reputations therefore disseminate quickly and reputation costs are low.

But why do we not see reviews in the media by doctors, lawyers, auto mechanics, and other services? Is it possible that liability laws or libel laws are discouraging the media from taking on the role of reputation disseminators for these services? I raise the question without an answer because I think, if so, legislative action could be directed to do something about it.

Second, the cost to firms of building reputations could be reduced by highly selective tax incentives for reputation building activities in service markets both domestically and overseas. While such tax incentives obviously must be carefully crafted, I would expect the longrun result to be lower prices to consumers and more competitive service markets.

The last topic I shall mention is regulation. So much has been said by economists about the pernicious effects of price-entry regulation over the past several decades that I need not repeat the analysis for this committee. Further, Congress has been pursuing deregulation rather vigorously since before 1978 with members of this committee conspicuously associated with that effort.

Today, I need only remind you that the dead hand of regulation falls most heavily in the service sector. Very few commodities or goods are subject to price-entry regulation. Oil, gas, and milk are the only ones that come to my mind. The preponderance of our service sector is or quite recently was subject to very pervasive regulation—banking, insurance, transportation, telecommunications, and a host of smaller industries.

In my view, if you are looking for things to do to increase the vitality and competitiveness of the service economy, I have three suggestions. The first is deregulate. The second is deregulate. The third is deregulate.

Now I know there is a limit to laissez-faire economics even for the most relentless free market advocate. A significant market failure such as associated with, for example, product safety, may appropriately call for very specific and highly focused public intervention.

A good example comes to mind—the FAA in regulating airline safety. Now what makes such intervention a success is that it is focused on the problem—in the FAA case, regulating airline safety—and does not try to regulate price and entry for the industry as a whole.

A second and more serious problem is the political one. Deregulation is like any other economic change. Some people will be worse off as a result, even if most people are better off and the industry as a whole is more vital and more productive. Often this translates into a political demand to protect the affected parties from this change.

Some examples of this are the service to small communities debate which occurred during airline deregulation as well as the current debate about the telephone access charges.

It is easy to adopt the posture of defending the little guy against the forces of change. I think that copout simply ensures that the inefficiency built into the regulated service sector will continue and possibly compound.

What is needed, in my view, is the leadership and the legislative vision to attempt both. On one hand, to achieve the greater efficiency and vitality of competitive markets in the service sector through deregulation; and on the other hand, to help the adversely affected groups accommodate to deregulation. In a nutshell, not to block change, but to help people accommodate to change. Good public policy must seek to ease the transition for the negatively impacted, but must seek to make that transition to deregulation happen.

Thank you.

[The prepared statement of Mr. Faulhaber follows:]

PREPARED STATEMENT OF GERALD R. FAULHABER

My name is Gerald R. Faulhaber; I am Director of the Fishman-Davidson Center for the Study of the Service Sector, and Associate Professor in the Department of Public Policy and Management at the Wharton School, University of Pennsylvania. I have held this position since January 1, 1984; previously, I was Director of Strategic Planning and Financial Management at the American Telephone and Telegraph, Inc. in New York, where I was engaged in financial and strategic analysis of information markets, as well as regulatory and public policy analysis.

The Fishman-Davidson Center for the Study of the Service Sector was founded to support and encourage high-quality research on the problems unique to the service sector from the disciplines of economics, finance, marketing, accounting, and management. Its mission is to increase our understanding of services and their unique problems through scholarly research, and to disseminate the results of that research through publication, conferences, and the university curriculum.

Understanding the service sector and its recent phenomenal growth is the common purpose of these hearings and of the research undertaken by our Center at Wharton. To help in identifying problems unique to the service sector, I would like to focus on three specific problem areas that may be new to you, at least in the context of services. They are:

1) R&D and innovation in services

2) The role (and cost) of reputation in the service industry

3) regulation and deregulation in the service sector.

I also share many of the concerns traditionally voiced about the service sector, viz. productivity, trade in services, differential tax treatment of services vs. goods, etc. Rather than repeat these concerns, I wish to raise issues* not as familiar to you, but perhaps more fundamental to the long-run growth of an economy increasingly dominated by services.

R&D and Innovation in Services

The primary engine of economic growth is innovation. In today's complex economy, innovation occurs as a result of substantial investment by firms and individuals in research and product development. The payoff to R&D investment can be better and cheaper products, enabling firms to outperform their domestic and overseas competitors. Clearly, these investments in R&D will only be made by firms who can realize the returns from the superior performance in the market that can flow from innovation. If competitors can quickly and cheaply duplicate the innovations which are the fruits of that R&D, the advantage to the innovator and, thus, the incentive to perform R&D are gone.

*but not to espouse specific and detailed policy recommendations. The purpose of this testimony is to help structure the problems of the service economy, and perhaps suggest the directions in which solutions might be found, not to champion specific programs or policies.

Our patent system is designed to help innovators capture the competitive rewards for investment in innovation by protecting the inventor from unauthorized duplication. That protection is often necessary to insure that investment in R&D, if successful, will be rewarded by the market and not stolen by a copy-cat innovator.

But patent protection was designed in an era when invention was associated exclusively with devices, or "gadgets", physical products (or processes) that embody the inventor's bright idea. Unfortunately, much of the innovation needed in the service sector takes other forms, generally not patentable:

-Improved operations; e.g., more efficient utilization of a truck fleet, or automation of the paper-flow in the back office of a brokerage house.

-New delivery systems; e.g., McDonald's fast food format, or H&R Block's mass merchandising of tax return preparation.

-Packaging of new services; e.g., banks and financial institutions offering cash management accounts.

-Software; e.g. computer programs, management guidelines, instruction manuals, or videogames.

Generally, the protection of investment in such innovations is minimal (as with computer software)* to non-existent. When such innovations are implemented, they can easily be observed and duplicated by competitors; copy-cat firms come easily to mind for some of the above examples. An innovator may have

*The 1976 Copyright Act affords some protection against the most blatant forms of software piracy, but recent case law in videogames (e.g., Atari, Inc. vs. Amusement World, Inc., 547 F. Suppl. 222, 226 (D. Md., 1981)) suggests that protection is weak indeed.

a few months, at best, during which he or she has the competitive advantage and returns that reward innovation, rather than the seventeen year protection that patents afford.

As a result, we can expect less innovation in the service sector than would occur if patent-like protection, similar to that in the goods sector, were available for R&D investment. This is not to say no innovation will take place without such protection; it obviously has taken place in the past, and will continue to do so in the future. Firms are often driven to innovate to keep up with competitors, or will innovate through the deployment of a physical product or device, like automatic teller machines in banking, that enhance a service. But we can certainly expect a lower rate of innovation and therefore a lower rate of productivity increases, than would be the case with more patent-like protection.

Consideration should therefore be given to increasing the scope of patent protection to include process and product innovations most prevalent in the service industries.

Services as Reputation Goods

For many everyday products, consumers can quickly and easily determine by inspection prior to purchase what the product is, and the quality of the product (e.g., fresh fruit, ballpoint pens, sweaters, etc.) For other products, some significant product attributes, such as durability or safety, may not be easily determined prior to purchase.* Consumers may be unwilling to purchase what they perceive as a "pig in a poke", even though the product may actually be of high (though unobservable) quality.

In the case of services, however, almost nothing can be determined about the services prior to purchase (other than from advertising and supplier-provided "information") by consumers, since a service is intangible. Only after the service is bought, paid for, and consumed does the buyer know exactly what the product was, and sometimes not even then. Such goods are called "experience goods", and include restaurant meals, consultant services, educational programs, and movies. Since virtually all services are experience goods, seller reputation becomes a key component in service sector transactions. The quality and positioning of a service are conveyed by reputation.

Reputations are built with substantial investments by firms in introductory offers, "twofers" (two tickets for the price of one), heavy promotion, and/or brand-name creation, all designed to induce "pioneer" customers to risk consumption of an unknown product. As the quality of the new product becomes known, by word-of-mouth or media review (TV, newspapers, and buyers guides), the firm's business builds and prices will increase from the "introductory" level to a level that reflects not only the cost to provide the quality that conforms to the firm's reputation,

*Although the seller may have better information as to durability, quality, etc., it may be difficult to convey this information credibly to wary consumers. If the attribute can be observed after purchase (e.g., product failure), warranties may be offered to consumers pre-purchase as a means (rather imperfect) of credibly conveying information to consumers about, say, durability. Warranties have not been used extensively in the service sector, probably because "product failure" for an intangible becomes highly subjective.

but returns to the investment the firm has made* in its reputation (see, for example Shapiro, C. "Premiums for High Quality Products as Returns to Reputation", QJE, Nov., 1983, pp.659-679).

But reputation-building is a costly investment, and this cost is reflected in the prices consumers pay for quality services, even in markets characterized by free competitive entry. Further, such reputations become a "sunk cost" (see Baumol, Panzar & Willig, Contestable Markets and the Theory of Industry Structure, Harcourt, Brace, Jovanovich, 1982) and constitute a barrier to entry, reducing the likelihood of competitive behavior. Recent research in the economics of reputation suggest that reputation costs increase as (i) time between consumer purchases increases, (ii) information disseminates more slowly, or (iii) detecting quality is more difficult.

The result: prices for quality are higher (since firms must recover their investment in reputation), quality is undersupplied, and competitiveness, or contestability of markets decreases.

What can be done to help reduce these costs, thereby reducing prices and entry barriers in the long run? I do not believe that government should become generally involved in evaluating service firms and disseminating the results to its citizens, but I do believe consideration should be given to encouraging and supporting

*Firms may buy into reputations built by other firms:
- -a good-quality appliance repair service without a consumer reputation may associate with a major distributor with an established reputation (e.g., "Bill's Appliance Repair" may become "Sears Roebuck Service").
- -a local entrepreneur without a consumer reputation purchases a nationally known franchise operation (e.g., fast food outlet, shoe store, or drug store), thereby buying an instant reputation for product quality and product positioning.
- -a young physician may buy into the established practice of an older, "reputable" physician.

private provision of information. For example, newspapers and local entertainment guides provide reasonably reliable means of disseminating reputations for restaurants, movies, and plays. We do not see similar "reviews" of doctors, lawyers, auto mechanics, or other services in these media; do liability laws or libel laws discourage the media from producing such reviews? Do these laws unduly restrict Better Business Bureaus or other private reference sources? If so, these laws have the undesirable side effect of raising reputation cost, and thus prices, in these services. Further analyses are needed, but we should insure that unintended legal and regulatory impediments to timely and full information flow regarding service firm reputations are removed.

But even if such information flows are unconstrained, reputation-building will still be a costly activity for firms and individuals. Consideration should be given to tax incentives for reputation-building (but not reputation-maintaining) activities in service markets which can be expected to be competitive or contestable, both domestic and overseas.* By reducing a

* Since a key reputation-building device is establishing a brand name, this suggestion is diametrically opposed to certain theories and practices of the 1970's which held price premiums associated with brand identification as evidence of monopoly (e.g., the ReaLemon case), and sought forced licensing of the brand name. In view of the recent literature, these price premiums may represent legitimate returns to reputation investment, which reputations have value to consumers. Pursuing an aggressive forced licensing policy could make both consumers and the branded firm worse off.

competitive firm's cost to build a reputation, long-run prices will tend downward and the market's competitiveness will tend to increase (ceteris paribus).

Regulation in the Service Sector

So much has been written by economists over the past two decades on the pernicious effects of price-entry regulation that there is no need to repeat it here. Suffice it to say that there is broad agreement within the profession that pervasive regulation can cause cost inefficiencies, overinvestment in some markets together with underinvestment in other markets, too slow a deployment of technical innovation, and subsidies to customer groups politically well-positioned with regulatory authorities at the expense of others.* This broad agreement has been translated into vigorous policy action to deregulate key industries such as airlines, telecommunications, banking, and surface freight. Much remains to be done.

Unfortunately, the dead hand of regulation rests most heavily on the service sector. As we make our first steps to deregulate, we continue price and/or entry regulation of taxicabs, real estate agents, household movers, hairdressers, ocean shipping, insurance, and a host of other industries, small and large. Protected from competitive pressures, service industries can lose their vitality, and some are set up to be knocked over by aggressive foreign competition.

*For some services, regulation has been justified at least in part on income or regional redistribution grounds. It has been noted often that regulating rate structures is a particularly ineffective way of redistributing income when compared with other instruments for redistribution at the command of Congress.

But not all regulation is pernicious, even to the most relentless free-market advocate. I still need the local Boards of Health to insure that my hot dog at the ballpark won't kill me, and I still need the FAA to insure that the airplane I fly in is reasonably safe. But to achieve those objectives, we don't need to regulate price-entry in the food business, nor regulate price-entry in the airline business (as recent experience has taught us).

Some general thoughts, then, on intelligent deregulation in the service sector, for consideration:

- If "market failure" suggests competition/deregulation will not work well in a particular market, pinpoint the problem precisely, and tailor the solution to fix the specific problem while minimizing price-entry intervention, e.g.,
  - If the problem is safety, try certification or producer liability laws rather than direct regulation. If regulation is needed, regulate safety, not price or entry.
  - If the problem is "sunk cost" non-contestable markets, regulate (or publicly own) <u>only</u> the sunk cost portion of the market; deregulate the rest (e.g., airline terminal gate space (sunk and publicly owned) vs. airline operations (contestable)).

- If certain groups of consumers may be worse off as a result of deregulation (as will happen with almost any economic change or growth), public policy should be directed at helping that group adjust to change, not attempting to block change in the name of "protecting the consumer".

Within these broad guidelines, however, a key strategy for growth, improved productivity, and increased competitiveness of our service sector both here and overseas is deregulation. This Congress has shown a willingness to step up to the problem of deregulation and I can only encourage you (to borrow a phrase) to stay the course.

Conclusions

The analysis of these problems in the market structure of services suggests that:

- It may be too easy to enter markets for innovative services by copy-cat firms seeking to appropriate the fruits of R&D investment by leading-edge firms. Appropriate extensions of patent protection may help this problem, and lead to a more innovative, more productive service economy.

- It may be too hard (i.e., too costly) to enter service markets in which reputation for quality is important; viz., services with infrequent purchases, difficulty in detecting quality, or slow dissemination of reputation. These costs may be reduced by removing public policy impediments to timely and full information flow and providing incentives to firms for reputation-building activities. In competitive service markets, such cost reductions are likely to result in lower prices to consumers.
- It may be that prices of and entry into services markets are over-regulated. Continued policy emphasis on deregulating price and entry should help improve efficiency and long-term growth prospects for the service economy. Residual regulation should be tightly focussed on significant and clearly identified "market failures".

Senator JEPSEN. I thank you, Mr. Faulhaber.

Mr. Williams, you point out a number of policy issues which need to be addressed and others have touched on that. I will start with Mr. Williams.

If you were to give some order of priority, what would you recommend we do by way of policy issue, either creation or change?

Mr. WILLIAMS. Senator, it is tempting to say that what I would like to have first would be to have the system simply accept my assertions about what the problems are and move from there. My observation is that the system does not work that way. They are not likely to take my word for what the real problems are. I think pragmatically, the first priority is to gather the information and the data about the service industry. Then those people responsible for making policy will have a common base of knowledge and understanding which will lead them to the conclusions I have expressed here today. The SIC codes are an example of a major starting point; simply the gathering of data, understanding that there is a problem, and then turning the resources of the various departments of government loose on gathering information in a way that you can work with it.

My second priority is narrowly focused on those organizations in the R&D business primarily but applies to other service industries which work for the Federal Government. As an aside, let me say that the Government itself has recognized that much of the innovative R&D work being financed today is being done by the U.S. Government. The successful entry by small businesses into an economy based on the application of technology is largely dependent on support by Federal Government operations. In that arena, we need very clearly to mandate a Federal Government policy of reliance on the private sector to encourage innovative activities, particularly by small business, in areas of interest.

Today, the executive branch has a number of bulletins and procedures in place which say it is the policy of the executive branch to depend on the private sector to the maximum extent possible to obtain goods and services needed by the Government. Congress regularly tries and succeeds in overcoming that executive branch policy and insisting that in fact the Government do many things in-house that could be better done and less expensively done by the private sector.

Senator JEPSEN. Why is that, do you think?

Mr. WILLIAMS. I think it is primarily politics, Senator. When you have a situation in which a large number of people believe that you would be better served by increasing the size of the Federal Government, increasing the number of employees; when people's promotion opportunities are felt to be threatened, when districts back home are dependent on people in a particular part of the operation, government services, legislators are going to vote in a manner which supports those people. Consequently, you get a lot of pressure from the Government employee labor unions to keep work in-house rather than contracting it out. At the high level work of R&D, you have people who really believe that the work is best controlled by doing it in-house and in some cases that may be true. It is certainly not true to the extent that they would have you believe. And there are those who feel that as a simple matter of national policy the private sector should not be allowed to do certain things.

I noticed someone the other day, some Senator, had proposed that we solve the problem of excess profits in the defense industry by simply having the Government own all production facilities for weapons systems and pay people only to operate the facilities—pay them a salary and essentially there should be no profit. That is a philosophical point of view, one which I do not agree with, but one which was made quite clear.

Senator JEPSEN. Now, the Grace Commission points out that the reporting of their activities now is being printed and sold by a government agency for $14. McMillan sells the same report for $9.95 and when they asked McMillan why they were doing that, they said, "We are in the business to make a profit."

Mr. WILLIAMS. Precisely.

Senator JEPSEN. That can tell a very dramatic story about the efficiency of Government bureaucracy.

Well, some of you gentlemen's arguments present a thorny problem for service sector firms. As chairman of a subcommittee on the Senate Armed Services Committee, I can attest to this. If you want to fill up the corridors, just talk about contracting out and you will jam the stairwells and the meeting rooms with organized labor, especially Federal employees.

Why is this so? What can be done to alleviate this? Do any of you want to respond? Mr. Shelp, do you have any experience with this in your American International Underwriters Corp.?

Mr. SHELP. You are talking about selling to the Government?

Senator JEPSEN. Yes.

Mr. SHELP. Well, let me turn it around a little and take trade as an example. The Government has many programs where they are trying to promote the sale of American goods and services abroad. Only it tends to be limited to promoting the sale of goods.

Let me use insurance as an example, since you asked about my company.

In the Defense Department military assistance programs or outright aid programs, whether F–14's to Egypt or whatever, one of the things ignored is the insurance on those sales.

Let me give you an anecdote to illustrate this. A few years ago in a sale approaching $1 billion to Egypt with preferential financing, the insurance ended up being insured in Egypt, reinsured in London, and finally a small portion came back to U.S. insurers.

We studied the Government's procurement policy in this instance and traced down a second lieutenant in Dayton, Ohio, who handled it. We asked him how did you determine who handles the insurance on this transaction. He said, "Well, I opened the phone book and alphabetically the first one I came to was Alexander & Alexander." We said, "That's not an insurance company. That's a broker." He said, "Well, let me go back to it." So he goes back, he says, "Oh, well, it's okay. Alexander & Alexander insured it with an American insurance company, Commercial Union Insurance Co.," which happens to be a British company.

The point is there is not a government procurement policy for insurance or often other services relating to its international activities. I could relate a similar story for the Agriculture Department in shipping wheat or other commodities at subsidized or on preferential terms. I could tell you a similar story for the Eximbank or the Agency for International Development.

I do not think it is malicious. There is just a tendency to not think of services when you think of promoting the export of American goods and services.

Senator JEPSEN. You are talking about the insurance for all the companies in all these various transactions?

Mr. SHELP. Exactly, but I would view them as a symbol for other U.S. services that could accompany these transactions.

Senator JEPSEN. Well, it is reflective of what we have had over the years. The somewhat adversarial relationship is starting to disappear between government and the private sector; maybe it is a change of perception. Would that be a charitable way to put it?

Mr. SHELP. That is a good way to put it.

Senator JEPSEN. The United States currently has a much larger proportion of jobs in the service industries and does lead many of the industrialized nations of the world. The question is why is this so and what significance is it to our public policy?

And I think you, Mr. Williams, were the one that said that it takes $3 here to get the same that $1 moved in Japan.

Mr. WILLIAMS. It was the cost of capital is what I was referring to.

Senator JEPSEN. And yet we still have a much larger proportion of our jobs in the service industries than does Japan. How come? Or is that an inaccurate statement?

Mr. WILLIAMS. I do not know that I can comment on that, Senator. I really do not know the answer.

Senator JEPSEN. Does anyone want to comment?

Mr. SHELP. I would, Senator. Japan is now a service economy too and they are moving faster in the same direction. I understand both MITI, the Ministry for International Trade and Investment, and the Japanese Planning Agency already have task forces in place to study how to accelerate the trend. When Prime Minister Nakasone was here after the Williamsburg Summit, he made a speech in New York where he talked about the greatest problem facing Japan today is to make the transition to a postindustrial economy. So I think Japan has seen the future and their view of the future is where we already are.

Mr. WOLFF. May I say something on that point?

Senator JEPSEN. Yes.

Mr. WOLFF. There is a very important international study that was done by Robert Summers of the University of Pennsylvania which indicated that the percentage of employment in services was highly related to per capita income. In other words, countries with higher per capita income tended to have a higher percentage of their labor force employed in services. Also, the percentage of GNP in current dollars provided by the service sector was also higher in countries with higher per capita income than in countries with lower.

Now Japan has a lower per capita income than we do and so by this analysis they also have a lower percentage of people employed in services. As their per capita grows, as it reaches the level of the United States, I am sure they will experience the same thing with the percentage of their labor force employed in services coming close to ours.

Senator JEPSEN. In your opinion, Mr. Wolff, are the service sectors more or less adversely affected by high interest rates and the strong dollar? Are they more adversely affected than the goods producing sectors?

Mr. WOLFF. Well, I do not really feel qualified to comment on that.

Senator JEPSEN. Does anybody want to tackle that?

Mr. FAULHABER. I think to the extent that we see certain portions of the service sector as being highly capital intensive, electric utilities and communications, they will not be particularly affected by high interest rates. In those areas of the service sector where it is much more person intensive—consulting operations, for example—it would be I think relatively immune. So the service sector with respect to interest rates and capital intensity in investment is so diverse that it is difficult to make a blanket statement for the service sector as a whole.

Senator JEPSEN. You mentioned the need for change in patent and copyright laws to encourage R&D investment in the service sector. Would you mind going into a little more detail on that recommendation?

Mr. FAULHABER. I should say, if I could respond a bit more generally here about the ordering of my concerns, I would seek deregulation as first and the protection of innovation second.

As I think the issue stands now, the source of innovations, excepting software that I have discussed that have been in the service sector that have driven whatever productivity gains we have had in the service sector, are essentially easily duplicable. The innovations that we need in the service sector, with the exception of the software issue that I mentioned, tend to be not patentable. They tend to be easy to copy and the investment that firms must undertake to develop those innovations—in essence, it is difficult to recover the returns from those innovations because they are so easily duplicable.

There are a number of examples of services in my prepared statement that are very easy to duplicate. In the area of software, software narrowly defined, computer programs, video games and what have you, the 1976 Copyright Act attempted to address those issues. There has been some recent case law on that in terms of protection of video games and I think even that 1976 Copyright Act has been less than successful in providing the kind of protection for intellectual property that is needed.

So I have some real concerns here, I think we know what needs to be done to ensure that the returns from innovations go to the innovator and they are not copied and taken away by others. Exactly how such legislation or patent system extension might be made, I am not prepared to comment on today. But we know where we need to go. How we need to get there I think is worthy of attention, but I cannot comment on it today.

Mr. WILLIAMS. Senator, may I address a related issue? I made the same point early on in my testimony, that this concept of intellectual property as an asset with a dollar value goes to the heart of what Mr. Faulhaber was saying when he discussed how you might protect it.

There is a related problem, too, which I think can only be solved finally by having additional information and a better understanding of what the professional services industry is about. The fact is that there is something in the operations of the professional services industry which is diffierent from the purchase of goods, and the procurement people do not understand it. They do not know how to buy professional services.

If they are going to buy an automobile for the Government or for a company, as an example, and there is an automobile that will do the basic things that need to be done at $15,000 but there is also an automobile available for $30,000, most everyone in the procurement office, and indeed in the management structure, knows that after you solve the ego problem of the fancier car, that $30,000 car really will not do much more for you by way of transportation than the $15,000 car. So there is a strong tendency to buy the $15,000 car.

When you are talking about physicists, as an example, a $60,000 a year physicist can in fact provide you with much more intellectual capacity than can two $30,000 a year physicists in the same market place. That seems to fly in the face of conventional procurement wisdom, and procurement officials take a look at a bid or quotation and they say, "You bid $60,000 to do this job but you only proposed to provide us with 2,000 man-hours. This other company has bid $60,000 but they are going to give us 4,000 man-hours and, therefore, that is a better deal." Well, it normally is not a better deal. But the problem of specifying quality in services turns out to be fairly difficult. It ends up getting specified, certainly often by the Government and to a large extent by some companies, in terms of cost per man-hour to do a job, and that's simply the wrong way of looking at it.

Intellectual property does not move in the same dimensions that quality of goods does, and this can cause you a real problem in procurement. It goes back to the question of what is it that we try to protect and what is it worth to protect it. What we are talking about in many cases is intellectual output. It is a very difficult problem to deal with.

Senator JEPSEN. We seem to have lost quality in many areas, in fact, across the board. I do not know whether you agree with that or not, but whether it be in the area of finished product in a building, or carpentry for a kitchen, or the parts of an automobile, or how long something lasts or works, quality is lacking. It seems to be that this desire to demand for something instantly, as we came from the 1940's through the roaring 1970's into the 1980's, has brought us an acceptance, with a lot of griping with it I might add, about low quality in all kinds of things.

In the service area it is quite a comforting situation if one has a mechanic that he can rely upon and feel like maybe it is going to be all right. I do not mean to single out mechanics, but I think it is part of an across-the-board concern where we have gone ahead and instantly bought a half-baked cake or product or whatever because it shines when we bought it and it works for a day or two. That attitude carries over into the area of services, too.

Along those lines, in what way does the intangible nature of services create special regulatory problems for government? Does anyone want to comment? What do you recommend is the best way to relieve the regulatory burden of government? Mr. Faulhaber, I think you said there were three things you would list they ought to do. The first was deregulate; the second one was deregulate; and the third was deregulate. Since I have been in the Senate, we have done pretty good with deregulation. I was quoted in 1978 as saying that the Government ought to deliver my mail on time and defend my country and then leave me alone. But when we deregulated the trucking industry we went in there and jerked the rug right out from under them. I have friends in the business who went broke. They had just bought a three-quarter million dollar franchise that became worthless overnight. A lot of small rural communities lost their service.

We did not learn too much from that. We went in and jerked the rug out from under the airlines and some small communities. Now they are coming back but in my State suddenly there were no airplanes to fly out of there any more.

Without the Government doing it, we sat and watched a judge named Green listen to the ranting and raving of the 1970's when anything that was big was bad and anything that was profitable was bad and everything was bad in the establishment. Finally with the litigation and a number of other things, they suddenly said, "Ma Bell Telephone, you are the biggest and the best and the most profitable, so let us just break you up."

I have yet to talk to one person in the United States of America who thinks that is a good idea now when they start trying to figure out which phone bill they should pay, who owns the phone, whether they need service on it, and how long they are going to be able to keep it. I have ceased using the WATS line I had in my office because the air, whistle and crackling has got so bad I cannot use them any more. A lot of things have happened. I am not sure that they are all for the good.

I guess when we start talking about deregulation, we had better make sure that when we have had something that is regulated for an awful long time on a national basis, we had better do it very carefully. Otherwise, an awful lot of people get hurt very painfully and financially in the crunch. I think supply-demand applies to services too and should let the market rule the marketplace, but when you have over a quarter of a century, or in some instances 35 to 40 years of regulation, and then suddenly jerk it out, you best be careful.

Now in the area of service, are there any special regulatory problems that the Government has in that area?

Mr. SHELP. Senator, I would make one comment. Your point is well taken. The problem with deregulation from my perspective is we often overlook the fact that we are linked to an international environment—a cliche that is true. Take the trucking industry as an example. We deregulated trucking, but our neighbors to the north and south, Canada and Mexico, did not. So suddenly American truckers face a great deal of competition from the trucking industry in those two countries. That is fine except we do not yet have access to do the same thing—our trucking industry cannot go into Canada and Mexico because they have not deregulated.

The same argument can be made about Ma Bell. I realize that one justification for deregulating it was to help AT&T be more competitive internationally. Virtually every country is trying to develop the new telecommunications technology and sees the future in this. But it could be argued that by breaking it up, and ultimately deregulating, one also affected its ability to compete internationally because it is weaker in some ways. This is especially true because Ma Bell's competitors protect, and and often own their telephone and telecommunications industries.

When you think of deregulation, although we all have sort of a visceral instinct that tells us it is good, one should also realize that for many industries that deal in the international economy there are some consequences there that need to be thought through.

Senator JEPSEN. Don't fix it if it isn't broken.

Mr. FAULHABER. I would like to address some of the real concerns that you mentioned about deregulation. Some of your examples cut pretty close to home, Senator, and I am sympathetic with them. The concerns, of course, of those industries which have entered markets that have been subject to regulatory protection where niches have been created by the process of regulation—and this could be the case of interstate truckers, for example—may indeed get hurt by the process of moving to a more efficient structure.

I see, for example, that the current state of resellers in telecommunications is a fairly temporary phenomenon—as the market moves in telecommunications to something which is more competitive. I think it is reasonably clear that the resellers who are currently taking a large fraction of the market—life will be much tougher for them.

The notion of the rural communities that may lose service of the airlines, that may have difficulty in the future receiving low-cost telephone service—your concerns about them I think are right on. I think that is part of what I perhaps too glibly mentioned as the folks who may end up being hurt, even though we end up with a more efficient industry structure.

From a public policy perspective, I think the concern here is to identify those groups who may be adversely affected and to attempt to structure public policy alternatives that will bridge the gap while the industry structure is being sorted out, while the new airlines third tier carriers have not yet arrived in the small towns, while the radio carriers that may eventually provide local access to the networks that is now done by the somewhat inefficient means of twisted pair loops to distant farm houses, while all that is being put in place, some of our rural communities and some groups will be adversely affected.

It seems to me that that is the focus of where public policy ought to be, helping to design public policies to assist those negatively impacted in one way or the other, and I think it is difficult to determine in each case as to what the appropriate recommendation is. But it seems to me, rather than saying no we do not want deregulation, I think what we need is public policy that helps us get to deregulation with the least social dislocation, and that is a much different mind-set, Senator.

Senator JEPSEN. Do it very carefully?

Mr. FAULHABER. Indeed.

Senator JEPSEN. I have a couple of questions that are general and there is some overlapping of what we have been talking about, but I would like to have an expression from each of you for the record to the following question: In your opinion, what are the major barriers to continued domestic expansion of the service sector and what public policies would you recommend to remove these barriers? I know that you probably could elaborate for an hour and a half, each one of you, but if you could just in a minute or two give a couple of one-liners on that. In your opinion, what are the major barriers to continued domestic expansion of the service sector and what public policies would you recommend to remove these barriers? And I might add that my next and final question will be: What are the barriers to trade in services and what public policies should government follow when we look at both the domestic and the international aspect of this? Start first with the domestic, Mr. Shelp.

Mr. SHELP. Well, I think the major problem is to step back and be able to make the public policy. I agree with Mr. Williams that we do not have the facts, but I would extend it a step beyond the facts on services, that the facts on the service economy and the facts on our economy include not only services but everything from microprocesses to digital computers.

Senator JEPSEN. Excuse me for interrupting there. I heard Mr. Williams say that and I heard you. Whose responsibility is it to get the facts and who should do it?

Mr. SHELP. The Government. I think the most conservative businessman would agree that one thing the Government should do is gather facts on the American economy. There has been a lot of effort to get more spending and a rethinking of some of these systems of gathering data. There is considerable opposition to it, especially from the OMB. Although there has been some progress made.

Senator JEPSEN. Would you recommend that the Government make that a project and then farm it out to some service consulting organization to gather the facts?

Mr. SHELP. I think you can do it both ways.

Mr. WILLIAMS. I would.

Mr. SHELP. There is already in place a mechanism. It just does not include services in the data. I do not have a strong view on who should do it, but the main thing is if you are gathering data on census, on wages, on trade, on anything else, you ought to factor in questions about service industries and these new industries that are not service industries but are dynamic new industries in our economy.

However, I know that takes years, so I would hate to leave policymakers with an excuse saying they cannot do anything about our changing economy until they get the facts.

The biggest area domestically that I would start dealing with is tax policy.

It seems to me tax policy is skewed all over the place. Some of it favors manufacturing, some favors services and it interferes with the marketplace in many ways from making the right choices.

But let us assume that you want a vibrant economy that fosters all elements. I would certainly do away with what I would call the biases in the tax policy against services. I named one, the R&D tax credit. One that is debatable is the investment tax provisions and the liberalized depreciation. Instead of doing away with them, you could factor in services to encourage investments to be made in human resources. Domestically, that would be my major priority.

Senator JEPSEN. Mr. Wolff, in your opinion, what are the major barriers to continued domestic expansion of the service sector and what public policies would you recommend to remove these barriers?

Mr. WOLFF. Well, my major concern would be in regard to productivity growth. You mentioned before what I think is a very crucial concern is what appears to be deteriorating quality in our goods and services. Well, in particular, services—again I will emphasize my original point—that we really cannot talk about the service sector as a whole because it is too diverse and there are too many segments, and in regard to characteristics and performance different service industries are very different.

But there is a group which I would call the stagnant group services which deserve special attention. These are industries which are basically labor industries, labor intensive—education, for example, or law, or medicine. And the problem there is that because they are labor intensive, it is very difficult to innovate technologically. That is, how can you—if education requires a teacher teaching 30 students, how do you change that service without affecting the quality of the goods? You can certainly expand class size which would lower the cost, but as a result the quality of the service will deteriorate.

The same is true in medicine. In medicine, there is a lot of new technology but it is still basically a labor intensive process. You can cut down on the number of tests. You can cut down on the number of visits and so on. That will reduce the cost of the service, but the quality is going to deteriorate.

The example you mentioned about the mechanic is another case in point. Repair work is very labor intensive. It is very difficult to innovate technologically. It is very difficult to replace a good mechanic with a machine. Of course, you have diagnostic machines now, but still if you want to get your car repaired you need a mechanic who knows his stuff and knows his way around a car, and that is a person.

So this is where in a sense—from a productivity point of view—this is really the problem area. These services are basically labor intensive and they are very difficult to substitute capital for labor.

Now, though it is difficult, I am still optimistic that there are ways in introducing new technologies, of even changing the nature of the service, and I think this is the area where the Government should play a role.

I did a study of the allocation of government research and development. The Government contributes about one-third of all the research and development moneys in the United States. The great majority, perhaps 90 percent of that, goes to goods producers and, of course, there is a heavy bias toward defense manufacturers. But I think that the Government can facilitate and improve productivity performance and the problem with the service industries by providing R&D funds to improve their efficiency.

Now, they do provide a lot of funds in medicine but most of the money is geared toward a very important goal, namely, finding cures for various diseases like cancer and so on, but very little money goes to the actual process of providing medical services. And this is the sort of place where we need new R&D and where we need new innovation.

Senator JEPSEN. I would like to ask this for the record. You used the term "stagnant sectors" to describe some service industries that are providing service society wants and are creating jobs in the process, some of them with high employment growth. Was that an economic term or a term of yours or what does it mean—stagnant?

Mr. WOLFF. Well, it is a term I will take responsibility for. The way I use it is to refer to a sector with a very low or zero rate of productivity growth. When I said stagnant, I referred to its productivity growth. I did not refer to whether it provides useful services or not. Education is supposed to provide a useful service but the rate of productivity growth in education itself has been extremely low over the last 50 years. So that is the sense in which I use that term.

Senator JEPSEN. Thank you.

Mr. Faulhaber.

Mr. FAULHABER. As I indicated before, in terms of policy recommendations, carefully deregulate with an eye toward foreign competitive activity, and the second would be explore alternatives for extending the form of patent protection to cover innovations applicable to services.

Senator JEPSEN. Thank you.

Mr. Williams.

Mr. WILLIAMS. I share Mr. Shelp's concern that if I say information is the first priority, this will give people a way to get off the hook. I would say information and tax policy. I really think that the information has to be gathered. I do not believe that we are going to get anywhere until we can agree on where we are, where we are going, and what exists out there. So I still think that really does have to be first.

But the thing we perhaps could get started on first, where we could get the quickest payoff, is on the tax policies. I think that export policy also has to be looked at very hard. We vacillate a bit on one item which is of particular importance in export policy. I thought this issue was pretty much solved because Congress some years ago helped us with the income tax on individuals overseas. The problem of income tax on overseas income hurts the services industry much harder than it does the firm who has just one plant manager overseas. If I have 40 people on a service contract in the Middle East, that is a big problem. The European countries that compete with us have people that are somewhat more amenable to going into overseas regions where living is less comfortable than it is at home without the kind of income incentive that our people require. This country vacillated a couple of times on this issue but I thought we had come up with a policy which had become law. On Monday, I was watching a national TV program and here was a Senator and a Congressman advocating on a national TV program what they called their new fair tax bill that they wanted everybody to write in about. One of the provisions of that bill is to go back to full taxation of overseas income.

So apparently somebody has not received the word. It is going to be devastating to the services economy if we go back to that sort of thing. When trade policy and export policy are being considered we have to look at what we can do to make it more reasonable and more cost effective to export services.

I think there should be more congressional emphasis on the Government using the private sector to the maximum extent possible by establishing a national policy that the private sector ought to be responsible for doing the things it does best.

I guess I would like to pick up—and I realize the debate we got into here about deregulation and the pros and cons of that—the point that Mr. Faulhaber made about the protection of intellectual properties. That sort of thing is a real concern, particularly about how you sell and protect reputations which is very important. You made that point when you remarked about finding a mechanic who can really do the job right; it is a real treasure when you have found one.

The problem today is that the mechanic is not making any more money than the guy down the street who butchers your car when you take it in. Furthermore, word of mouth is about the only way that the word gets around about the good mechanic. In your neighborhood you tell your friend to take his car down there and that sort of thing.

In the Government procurement process, if I owned the filling station or garage where that fine mechanic works and somebody else has the butcher down the street and we both bid on a job to service government automobiles, reputation is practically statutorily prohibited from being considered by the Government when it makes a decision as to which service to buy. That is a specific example I think of where the procurement policies work in a way which harms both the client and the business.

Senator JEPSEN. I agree. Well, does anyone want to comment on the barriers to trade? You have touched on that. Are there any additional remarks before we close or any closing remarks you would like to make?

Mr. SHELP. Well, I think a trade policy has two parts—what you do overseas and what you do at home. We have given most attention to the first and we have done a good job. The administration's goal for 3 or 4 years has been to move our trading partners to be prepared for a trade negotiation to include services in GATT. As you know, Senator, it is rather amazing that services constitute about $400 billion in world trade and yet they are not covered by the international trading rules. So you can deal with them with impunity. Now the rest of the world has discovered services. The European Community originally opposed the U.S. initiative. Then it did its own internal study and now says that it not only supports it but that it is the biggest service exporter in the world. Nevertheless, that was our objective.

I think where we have fallen short, as I indicated in my testimony and my prepared statement, is in what we do at home. Our export promotion policies do not factor in services. Our export finance policies do not factor in services. One other example that I did not include in my prepared statement is export tax incentives. We are having a debate in Congress now, as you know, over what we are going to replace the DISC with, the Domestic International Sales Corp. It is being challenged by our trading partners and it is very simply a tax incentive for exports. Presently it covers only two services—architectural and construction services.

The new proposal, the FSC—I think it is the Foreign Service Corp.—would again exclude services. The reasoning is that there would be a revenue loss if we covered services. I understand that reasoning, but it sort of bothers me if you take one of the most dynamic parts of the American export scene and deny them the benefits that can help them export more since I suspect the ultimate benefits and the ultimate tax revenue in the American economy would many times make up the small revenue loss that is going to occur if you include services.

So once again getting back to tax policy but making it export tax policy, I think this bias of excluding the services of basic incentives is a serious mistake.

Senator JEPSEN. Anybody else?

Mr. WOLFF. I just want to make a somewhat marginal point but perhaps of some importance, namely, when you think of the export of services or the export of anything for that matter, technically that also includes the purchase by foreigners of goods or services at home. So, for example, tourism, though technically there is no physical movement of goods or services abroad, in fact purchases made by foreign tourists is an export.

One area where I think there is some great potential for this kind of export is in education, particularly higher education. Here we have a problem with the declining college age student body and as a result a declining domestic enrollment, but here is an opportunity for us to export educational services by trying to attract foreign students, and I think it could serve to be a major source of export revenue.

Senator JEPSEN. Mr. Faulhaber.

Mr. FAULHABER. The obvious trade problems associated with both the deregulation issue, which I mentioned before, as well as the protection of R&D, I think cut two ways. As we deregulate I think we see two things. One is the potential for foreign incursion into our markets without reciprocity and yet in certain areas—I am thinking of aviation and telecommunications—the United States has been a leader in deregulation, with British Telecom following, for example, in communications; and the bonds of regulation and public ownership of PTT's in Europe are beginning to loosen. So we have a leadership position there. But nevertheless, as we deregulate at home, we must ensure that we do not give away the farm to our foreign competitors.

In terms of protection of innovation, I think we not only have to worry about that domestically but as our service firms export their innovations and financial services, insurance or what have you, that we understand that we need that protection overseas as well through mutual agreements with foreign governments, and that means we have to keep an eye on that, as well.

Senator JEPSEN. Do you have any closing remarks, Mr. Williams?

Mr. WILLIAMS. No, sir.

Senator JEPSEN. I thank all of you for coming. Among other things, today I have heard a thread woven through the fabric of the conversation that we need to have a greater awareness and perspective of the role the service economy plays in this country, as in the impact of public policy in all sectors, not only tax and trade areas. There is room for great improvement with a better perspective and appreciation for the service sector. Certainly how the services tie in to our dealing with our customers overseas has been dramatically brought out here. There is a need for greater awareness, and certainly greater sensitivity, to the role of services in trade.

I thought the example of the insurance was interesting and good, Mr. Shelp. I think letting contracts where a project tries to identify the borders of what the project is going to be, and all the services that go with that, if we were involved in it, it would enhance the possibility of American companies getting the contract for the job. These are good points and we have a great need for education and better perception of the role the service industry plays. The bookmaker trends do not catch it all and I think hearings like this are going to help tremendously.

Please do not hesitate to send for the record anything else that you would like to have entered in the record with regard to these things, and I thank you all for coming.

This committee is adjourned.

[Whereupon, at 11:50 a.m., the committee adjourned, subject to the call of the Chair.]

THE SERVICE ECONOMY AND INDUSTRIAL CHANGE

WEDNESDAY, APRIL 11, 1984

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 10:08 a.m., in room SR-385, Russell Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senator Jepsen.

Also present: Charles H. Bradford, acting executive director; and Robert Premus, professional staff member.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. The Joint Economic Committee will come to order.

This is the second of two Joint Economic Committee hearings on the importance of the service industries to the national economy. We learned last week that the service industries provide most of the jobs, contribute to our balance of payments, and are a major source of technological innovation.

Unfortunately, despite these impressive achievements, we also learned that the service industries are often thought of as nonprogressive, dead-end industries. This has led to biases in our trade, tax, and procurement policies against these service industries. Employment and trade opportunities may be lost as a result.

Today's hearing will investigate the public policy biases confronting the service industries. Our objective is to expose the biases so that we can design public policies to be more neutral across industry lines and, I might add to that, hopefully helpful.

We are fortunate to have with us today Mr. Gilbert Simonetti, Jr., chairman of the Committee on Services, National Foreign Trade Council. He will discuss important barriers to services trade and what needs to be done to eliminate these barriers.

We are equally pleased to have with us Mr. James Hostetler, partner in Chapman, Duff, and Paul, and Mr. Dwight Ink, chairman of the Special Panel on Revitalizing Federal Management, National Academy of Public Administration, to discuss U.S. procurement policies and how they affect the service industries.

Our last witness, Mr. Donald Rappaport, national director of Smaller Business Services, Price Waterhouse, will present his expert views on U.S. tax policies as they affect service-oriented firms.

Gentlemen, I appreciate having such a highly qualified panel to discuss the trade, procurement, and tax issues confronting the service industries. I would like to welcome each of you and thank you for taking the time out of your busy schedules to appear before the Joint Economic Committee on these important matters. We look forward to hearing your testimony and then to the question-and-answer session that will follow.

We will start going from right to left. We will start with Mr. Simonetti.

STATEMENT OF GILBERT SIMONETTI, JR., CHAIRMAN, COMMITTEE ON SERVICES, NATIONAL FOREIGN TRADE COUNCIL, WASHINGTON, DC, AND PARTNER, PRICE WATERHOUSE, ACCOMPANIED BY PAUL T. MURPHY, NFTC VICE PRESIDENT FOR GOVERNMENT RELATIONS

Mr. SIMONETTI. Thank you, Mr. Chairman. It is good to be here on a spring day. Washington has needed to have the springtime finally arrive.

I am pleased to have the opportunity to appear today to discuss the subject of international trade in services.

The purpose of my testimony is to highlight the results of a survey Price Waterhouse conducted in 1983 to assist the National Foreign Trade Council in developing the information necessary to build an understanding of the service sector's relationship to international trade.

Since 1981 our merchandise deficit has skyrocketed, and our services surplus, which had been on the rise, began to decline from $36 billion to $28.4 billion in 1983. One begins to wonder why this decline in services trade.

Even as the importance of services trade to our economy grows, barriers to trade in services are on the rise around the world. In attempting to expand services exports, U.S. companies are encountering more and more nontariff barriers created by countries attempting to protect their domestic service industries from foreign competition.

Such barriers are indeed having a chilling effect on our services exports and may be contributing to the continuing decline that we are beginning to experience in the services surplus.

As an organization devoted to providing timely review of developments affecting international business, the NFTC wanted more information about the perceptions of services companies on the trade environment and policies. How do they view the international competitive position of U.S. service organizations, and is there any kind of consensus as to what should be done to enhance that position?

In August 1983 we undertook a survey of companies in the newly created Fortune 500 Services Directory who had some foreign operations. We received a rather high response to the survey, something like 35 percent of those surveyed responding. I believe that high level is significant in terms of the interest of the services sector with these issues.

Rather than review all the results of the survey, we respectfully request, Mr. Chairman, that the report of the survey "Business Views on International Trade in Services" be made part of the record of the hearing.

Senator JEPSEN. It is so ordered. And I would advise all of the witnesses that your written statement will be entered into the record as if read, and that you may proceed in any manner you so desire.

Mr. Simonetti. Thank you.

[The report referred to follows:]

BUSINESS VIEWS ON
INTERNATIONAL TRADE IN SERVICES

THE RESULTS OF A
SURVEY OF
FORTUNE'S DIRECTORY OF SERVICE COMPANIES

December 1983

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SURVEY OF
BUSINESS VIEWS ON
INTERNATIONAL TRADE IN SERVICES

EXECUTIVE SUMMARY

In August and September of 1983 Price Waterhouse conducted a survey of selected companies in the Fortune Services 500 Directory identified as having some foreign operations. As defined by Fortune, service companies are those companies which derive over 50 percent of revenues from sales of services, as opposed to manufactured goods.

The purpose of the survey was to help develop the information necessary to build an understanding of the service sector's relationship to international trade. We sought answers to such questions as:

- How widespread are non-tariff barriers to trade in services, what form do they take, and which are most serious?
- Are such barriers truly an increasing problem for our service companies trading abroad?
- How do service companies view the role and effectiveness of the U.S. government in promoting international trade in services?

Price Waterhouse

- o How do service companies rate the potential impact of various trade-related proposals on their international competitiveness, and what other proposals would they like to see implemented?
- o Is more data on domestic service industries and international services trade needed, and who should collect it?

Confidential questionnaires were sent to the Chief Executive Officers of 220 companies on the Fortune list. These companies fell into the following categories, as defined by Fortune:

Commercial Banks
Diversified Services
Diversified Financial Services
Life Insurance
Retail
Transportation
Utilities

We received 76 replies for a response rate of 34.5 percent. By far the largest response was from banks. Fifty-eight percent of the banks that received questionnaires responded, representing almost 49 percent of the total response. For that reason, banks are analyzed as a separate group where meaningful, and instances where their opinions and activities differ significantly from other service companies and the group of respondents as a whole are pointed out.

Our respondents ranged from less than $25 million to over $5 billion in terms of foreign source revenue. The percentage of total service revenues represented by foreign trade ranged from less than one percent to over 90 percent, with concentration in the less than 20 percent range.

Highlights

In terms of overall impressions, the following results were of particular interest:

- 72 percent believe other countries are taking unfair advantage of this country's open services trade policies.
- 82 percent believe the U.S. should not become more restrictive in its services trade policies.
- 86 percent believe other countries will retaliate if the U.S. institutes new restrictions on services trade.
- 73 percent believe the needs and problems of service organizations trading abroad are not adequately recognized by the U.S. government.
- 64 percent indicate that foreign barriers to trade in services are an increasing problem.
- 68 percent believe use of trade as a foreign policy mechanism (Soviet pipeline sanctions, grain embargo, etc.) is counterproductive.
- There was significant opposition (about two-thirds of respondents) to mandatory government collection of services data.
- About 85 percent of respondents are only guardedly optimistic about future services trade. They expect it to increase only moderately, remain essentially flat, or decline. This is significant in view of the fact that over half the respondents experienced more than 20 percent growth in export trade between fiscal 1980 and fiscal 1982.

- Banks are far more positive in their responses about export trading companies (ETCs) than other types of service companies. Five banks have formed ETCs, and over 80 percent of banks responding believe ETCs have advantages for them.

- Support for a GATT for services was lukewarm, as was support for the Administration's proposed Trade Department.

In terms of foreign barriers to trade in services encountered by respondents, restrictions on right of establishment was cited as by far the most troublesome. About 70 percent of the respondents called such restrictions a significant interference.

Narrative Analysis

Following is a narrative analysis of the survey in these areas:

- Profile of Companies and Their Export Activities
- Views on Export Trading Companies
- Foreign Barriers to Trade in Services
- U.S. Services Trade Policies
- Data on Services Trade

Not every question is discussed in each section. A detailed analysis of the responses is included in Appendix A, and Appendix B contains the questionnaire. In all cases, percentages are based on the actual number of responses received to a given question since not all respondents answered every question. The order of the questions in the analysis does not correspond exactly to the order in the questionnaire.

Profiles of Companies and Their Export Activities

The most interesting result in this section of the survey is the finding that respondents are not overly optimistic about the potential for increasing services exports over the next five years, despite good export performance by a majority of the companies in the recent past. Eighty-five percent expect their export trade to expand only moderately, be essentially flat, or decline moderately. This lack of optimism may be related to the fact that two-thirds of the respondents see barriers to trade in services as an increasing problem, and a large percentage feel government support of export trade is inadequate. Nonbank service companies are more optimistic about their services trade than are banks. Eighteen percent expect such trade to expand greatly, as opposed to 11 percent for banks.

The great majority of companies do business overseas through subsidiaries or branches:

- 90.3 percent of banks
- 87.2 percent of nonbank companies
- 88.6 percent of all respondents

Joint ventures are the second preference of nonbank service companies (56.4 percent of respondents), while the second choice of banks is foreign affiliates (41.9 percent of respondents). About one-fourth of all respondents use at least two organizational approaches to marketing their services overseas.

In terms of size, bank respondents range from revenues of under $50 million annually (6.7 percent) to over $10 billion annually (3.3 percent), with the highest concentration in the $200-$500 million range (approximately one-third). Figures were requested for fiscal years 1980, 1981, and 1982. These percentages represent the average for the three-year period.

Other types of service companies responding are generally larger in terms of annual revenues, ranging from $100-$200 million (2.7 percent) to over $10 billion (11.7 percent). The heaviest concentration appears in the $500 million to $2 billion range.

In terms of foreign services business as a percentage of all services business, companies range from less than one percent in services exports to a very few companies (2 or 3, depending on the year) with foreign services business accounting for over 60 percent of their total services business. The largest number of companies (an average of 16 for banks, and an average of 23 for other companies) did 20 percent or less of their services business overseas. All but 4 companies responding experienced a net increase in foreign services trade over the three-year period.

Views on Export Trading Companies (ETCs)

This is the area where the activities and viewpoints of banks differ most markedly from other service companies. On the whole, their attitude is far more positive than may have been anticipated when the ETC Act was passed. Of those responding to the questions:

- Banks are the only category in which any ETCs have been formed;
- 81.5 percent of banks responding believe ETCs have business advantages, as opposed to only 6.9 percent of the companies in all other categories;
- 72 percent of banks responding believe ETCs can significantly increase U.S. exports, as opposed to 45.2 percent for all other categories;
- Positive comments on ETCs were received from 20 banks, as opposed to 3 from other categories;
- 28 negative comments on ETCs were received from other categories, as opposed to 4 from banks.

It is interesting to note that many of the negative comments on ETCs indicate a lack of complete understanding of the functions and purpose of an Export Trading Company. Respondents appeared to believe that ETCs are formed primarily to export their own goods and services rather than provide export-related services to other companies. For example, insurance companies commenting generally responded that an ETC was not an appropriate vehicle for insurance sales. They did not view ETCs as an opportunity to diversify into other lines of service business. It may be that much more education regarding the potential of ETCs is required.

Foreign Barriers to Trade in Services

About 64 percent of all those responding indicated that foreign barriers to trade in services are an increasing problem, with a significant difference between the viewpoints of banks (54.3 percent of respondents) and other types of service companies (72.9 percent of respondents). Thus about one-half to two-thirds of the companies responding are encountering increased difficulty in trading abroad because of practices in other countries, depending on the type of business. And, as one respondent pointed out, this does not take into account those companies for whom barriers represent a constant, although not necessarily increasing problem.

Two-thirds of all respondents see foreign barriers exclusively as the result of intentional protectionism. Only 6.2 percent believe the barriers result from policies which apply equally to all services companies but in fact discriminate against foreign firms.

Both banks and other service companies indicated that restrictions on right of establishment or foreign ownership represented by far the most significant barrier to trade (67.6 percent of banks, and 74.3 percent of others). Moreover, such restrictions were cited as a significant interference in the greatest number of countries (29) and also accounted for the greatest number of repeated citings of specific countries (17). Australia, Mexico, Brazil and Canada were all mentioned more than 10 times each.

Restrictions on repatriation of royalties, fees and profits constituted the second most serious barrier--a distant second. They were rated a significant interference by 41.4 percent of banks, 55.6 percent of other service companies, and 49.2 percent of all respondents. Twenty-six countries were cited for imposing remittance restrictions serious enough to be considered a significant interference. Six countries were mentioned more than once: Brazil (9), Mexico (6), Greece (4), Venezuela (4), Argentina (4), and Colombia (3).

Discriminatory tax policies was the third most significant barrier for nonbank service companies. Banks regard restrictions on transborder data flow as the third most significant barrier, but only narrowly over unfair competition from government-owned operations in other countries.

In terms of all types of barriers representing a "significant interference," Brazil was the country mentioned most often (29 times, for seven different barriers), while Latin America was the region cited most frequently (16 times for five barriers).

U.S. Services Trade Policies

Answers in this section also revealed some significant differences between banks and nonbank service companies, both in terms of views on specific questions and in the pattern of support for various trade policy proposals. For example, 77.1 percent of banks responding felt other countries are taking unfair advantage of U.S. open services trade policies, as opposed to only 55.6 percent of respondents in other categories. This may indicate sensitivity to the particular problem of prohibition on interstate branching, which applies to domestic banks but not to foreign-owned banks. Also, 91.7 percent of banks responding believe the U.S. should not become more restrictive in its services trade policies, as opposed to 71.4 percent of respondents in all other categories.

On the other hand, banks and other respondents are in close agreement on three questions:

- 86.1 percent of banks and 86.5 percent of other respondents say other countries will retaliate if the U.S. institutes new restrictions on services trade.

- 74.3 percent of banks and 72.7 percent of other respondents feel the interests and problems of service companies trading abroad are not adequately understood by the U.S. government.

- 69.0 percent of banks and 70.6 percent of other respondents believe there is insufficient support and understanding of U.S. service companies by officials in U.S. embassies overseas.

In addition to differences in attitudes of banks and other service companies toward specific trade policy proposals, the survey also revealed a surprising lack of enthusiasm for two proposals that have received broad media attention:

- Only 26.8 percent of all respondents felt creation of a new Department of Trade would have a "significant positive effect." However, there was noticeably greater support for the proposal among banks (31.4 percent versus 19.4 percent of all other categories).

- Only 30.4 percent of all respondents felt creation of a GATT for services would have a "significant positive effect." On this question banks and other types of service companies were in close agreement.

The most popular proposal for banks was reciprocity legislation requiring that U.S. regulators take into account a foreign country's treatment of U.S. service suppliers in licensing or regulating businesses from that country. Other service companies chose export subsidies and incentives as their highest priority. Bilateral agreements with trading partners ranked second and amendment of the Foreign Corrupt Practices Act was third for both banks and other types of service companies.

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APPENDIX A

BUSINESS VIEWS ON INTERNATIONAL TRADE IN SERVICES

DETAILED SURVEY RESULTS

I. BACKGROUND DATA

1. Total number of respondents 76
   Percentage of recipients (220) 34.5%

2. Response according to *Fortune* categories

	Number	% of Total
Commercial Banks	37	48.7%
Diversified Services	19	25.0%
Diversified Financial Services	7	9.2%
Life Insurance	5	6.6%
Retail	4	5.3%
Transportation	2	2.6%
Utilities	2	2.6%

3. Percent response by category for companies sent questionnaire:

Commercial Banks	57.8%
Utilities	33.3%
Diversified Services	29.2%
Insurance	27.8%
Diversified Financial Services	21.2%
Retail	16.7%
Transportation	10.5%

NOTE: Throughout analysis, percentages may not total 100% because of rounding.

II. PROFILE OF COMPANIES AND THEIR EXPORT ACTIVITIES

1. Expectations for trade in services over the next five years.

	Banks	Others	All
Expand Greatly	11.4%	18.4%	15.1%
Expand Moderately	77.1%	78.9%	78.1%
Be Essentially Flat	8.6%	2.6%	5.5%
Decrease Moderately	2.9%	0	1.4%
Decrease Greatly	0	0	0

2. Organizational structure or marketing method used for international services business. (Percentages will not total 100% since most respondents checked more than one method).

	Banks	Others	All
Foreign Affiliate	41.9%	41.0%	41.4%
Subsidiary or Branch	90.3%	87.2%	88.6%
Joint Venture	29.0%	56.4%	44.3%
Franchise	0	10.3%	5.7%
Licensing	0	15.4%	8.6%
Export from Domestic Base	19.4%	30.8%	25.7%
Other	12.9%	0	5.7%
More than one method			
2	25.8%	23.1%	24.3%
3	16.1%	20.5%	18.6%
4	9.9%	10.3%	10.0%
5	0	2.6%	1.4%
6	0	5.1%	2.9%

3. Aggregate revenues from services business (by percentage of respondents).

	Banks		
	FY 1980	FY 1981	FY 1982
0-50 million	6.7%	6.7%	6.7%
Over 50-100 million	3.3%	0	0
Over 100-200 million	6.7%	10.0%	6.7%
Over 200-500 million	33.3%	30.0%	30.0%
Over 500-800 million	16.7%	13.3%	13.3%
Over 800 million - 1 billion	0	3.3%	6.7%

	Banks		
	FY 1980	FY 1981	FY 1982
Over 1 - 2 billion	16.7%	6.7%	6.7%
Over 2 - 5 billion	10.0%	23.3%	23.3%
Over 5 - 10 billion	3.3%	3.3%	3.3%
Over 10 billion	3.3%	3.3%	3.3%

	Others		
	FY 1980	FY 1981	FY 1982
0-50 Million	0	0	0
Over 50-100 Million	0	0	0
Over 100-200 million	2.7%	2.7%	2.7%
Over 200-500 million	27.0%	18.9%	13.5%
Over 500-800 million	16.2%	18.9%	16.2%
Over 800 million - 1 billion	10.8%	5.4%	8.1%
Over 1-2 billion	18.9%	18.9%	27.0%
Over 2-5 billion	8.1%	16.2%	10.8%
Over 5-10 billion	5.4%	8.1%	8.1%
10 billion	10.8%	10.8%	13.5%

4. Foreign revenues from services business (by percentage of respondents).

	Banks		
	FY 1980	FY 1981	FY 1982
0-25 Million	20.0%	16.7%	16.7%
Over 25-50 million	16.7%	10.0%	10.0%
Over 50-100 million	3.3%	10.0%	10.0%
Over 100-200 million	20.0%	16.7%	13.3%
Over 200-500 million	16.7%	16.7%	20.0%
Over 500-800 million	6.7%	6.7%	3.3%
Over 800 million - 1 billion	6.7%	0	3.3%
Over 1-2 billion	3.3%	13.3%	16.7%
Over 2-5 billion	3.3%	6.7%	3.3%
Over 5 billion	3.3%	3.3%	3.3%

	Others		
	FY 1980	FY 1981	FY 1982
0-25 million	16.2%	8.1%	8.1%
Over 25-50 million	8.1%	10.8%	10.8%
Over 50-100 million	2.7%	5.4%	2.7%
Over 100-200 million	35.1%	29.7%	27.0%
Over 200-500 million	18.9%	27.0%	24.3%
Over 500-800 million	8.1%	8.1%	10.8%
Over 800 million - 1 billion	0	0	2.7%
Over 1-2 billion	5.4%	5.4%	5.4%
Over 2-5 billion	5.4%	5.4%	8.1%

5. Foreign services business as percentage of all services business (by number of respondents).

	Banks		
	FY 1980	FY 1981	FY 1982
Less than 1% - 10%	6	5	5
Over 10% - 20%	11	11	10
Over 20% - 30%	5	4	5
Over 30% - 40%	2	3	4
Over 40% - 50%	3	4	3
Over 50% - 60%	3	3	3

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	Others		
	FY 1980	FY 1981	FY 1982
Less than 1% - 10%	14	15	15
Over 10% - 20%	9	9	6
Over 20% - 30%	4	4	5
Over 30% - 40%	2	0	1
Over 40% - 50%	4	6	3
Over 50% - 60%	0	0	4
Over 60% - 70%	2	1	1
Over 70% - 90%	0	0	0
Over 90%	1	1	1

6. Declines and increases in foreign trade (by number of respondents).

Declines	Fiscal 1980-82
10% or less	1
Over 10%	3
Increases	
Up to 1%	0
Over 1% - 5%	3
over 5% - 10%	4
Over 10% - 20%	6
Over 20% - 50%	22
Over 50% - 100%	15
Over 100%	12

7. Top 15 trading partners (in order)

Canada	Taiwan	France
United Kingdom	Venezuela	Italy
Mexico	Australia	Argentina
Japan	Korea	Spain
Brazil	Germany	Colombia

III. VIEWS ON ETCs

1. Has your company formed an ETC?

	Banks	Others	All
Yes	15.1%	0.0%	7.4%
No	84.9%	100.0%	92.6%

2. If you have not formed an ETC, do you believe it would have an advantage for your business?

	Banks	Others	All
Yes	81.5%	6.9%	41.9%
No	18.5%	93.1%	58.1%

3. Would you consider using the services of an ETC formed by another business?

	Banks	Others	All
Yes	47.1%	41.9%	42.6%
No	52.9%	58.1%	57.4%

4. Can formation of ETCs significantly increase U.S. exports?

	Banks	Others	All
Yes	72.2%	45.2%	59.7%
No	37.8%	54.8%	40.3%

5. Comments on forming/not forming an ETC.

<u>Positive Comments</u>. (Expansion of client base, expansion of services, take advantage of international network, better serve current customers, greater profits, assist smaller manufacturers not currently exporting).

Banks	Others
20	3

<u>Negative Comments</u>. (Not applicable to business, no benefit to business, don't believe ETC can be effective, already providing export services).

Banks	Others
4	28

<u>Studying possibility of forming ETC</u>.

Banks	Others
3	2

IV. FOREIGN BARRIERS TO TRADE IN SERVICES

1. Are foreign barriers to trade in services an increasing problem for your company?

	Banks	Others	All
Yes	54.3%	72.9%	63.9%
No	45.7%	27.1%	36.1%

2. Do foreign barriers encountered represent:

   a. The direct result of efforts by the foreign country to protect its domestic services industry from foreign competition;

   b. Policies which apply equally to all services companies but which have a more negative impact on foreign companies;

   c. Any other cause

	Banks	Others	All
"a" only	71.9%	59.4%	65.6%
"b" only	6.2%	6.2%	6.2%
"c" only	3.1%	12.5%	7.8%
"a" and "b"	15.6%	9.4%	12.5%
"a" and "c"	3.1%	9.4%	6.2%
all	0	3.1%	1.6%

Other Specified Causes (with number of respondents)

Foreign exchange and remittance controls caused by economic conditions in the country	(5)
Efforts to develop own industry and technical expertise	(2)
Efforts to increase employment of nationals	(3)
Protection of confidentiality of information and restrictions on transborder data flows	(2)
Government monopolies and regulation of air transporation and communications/postal system	(1)
Many European countries legislate that hospitals must be nonprofit	(1)

3. Evaluation of specific foreign barriers to trade in service.

	No Interference	Slight Interference	Significant Interference
a. Restrictions on right of establishment or foreign ownership			
Banks	20.6%	11.8%	67.6%
Others	11.4%	14.3%	74.3%
All	15.9%	13.1%	71.0%
b. Restrictions on repatriation of royalties, fees & profits			
Banks	27.6%	31.0%	41.4%
Others	19.4%	25.0%	55.6%
All	23.1%	27.7%	49.2%
c. Discriminatory licensing or certification standards			
Banks	61.5%	26.9%	11.5%
Others	50.0%	26.5%	23.5%
All	55.0%	26.7%	18.3%
d. Restrictions on employment of U.S. nationals			
Banks	41.9%	45.2%	12.9%
Others	33.3%	36.1%	30.6%
All	37.3%	40.3%	22.4%

	No Interference	Slight Interference	Significant Interference
e. Discriminatory tax policies, (for example, taxation of foreign service companies at higher rate than domestic companies).			
Banks	64.3%	17.9%	17.9%
Others	44.4%	19.4%	36.1%
All	53.1%	18.8%	28.1%
f. Restriction on use of company name			
Banks	92.9%	7.1%	0
Others	76.5%	20.6%	2.9%
All	83.9%	14.5%	1.6%
g. Prohibition on association with local service companies			
Banks	85.7%	7.1%	7.1%
Others	91.2%	5.9%	2.9%
All	88.7%	6.5%	4.8%

	No Interference	Slight Interference	Significant Interference
h. Government contracting policies which favor local service companies			
Banks	67.9%	21.4%	10.7%
Others	44.1%	26.5%	29.4%
All	54.8%	24.2%	21.0%
i. Restrictions on use of facilities (e.g. airports and port facilities), or user fees applicable only to foreign service companies.			
Banks	92.6%	3.7%	3.7%
Others	83.3%	10.0%	6.7%
All	87.7%	7.0%	5.3%
j. Unfair competition from government-owned operations			
Banks	56.7%	16.7%	26.6%
Others	43.7%	31.3%	25.0%
All	50.0%	24.2%	25.8%
k. Barriers to trans-border data flow			
Banks	48.3%	24.1%	27.6%
Others	64.5%	16.1%	19.4%
All	56.7%	20.0%	23.3%

Examples of restrictions on transborder data flow. (With number of respondents)

Requirement that all data processing be carried out locally.	(4)
General restrictions on transmitting data into and out of country.	(4)
Current or proposed taxation of data transmitted across borders.	(3)
Confidentiality and privacy rules preventing financial information from leaving country, primarily in countries maintaining confidential banking relationships.	(3)
Lack of access to leased lines.	(1)
In Singapore and U.K., proposed restrictions could result in severe interference.	(1)
In Canada, inability to integrate accounting and management information system into U.S. mainframe is significant problem.	(1)
Inability to transmit facsimile to French location for future "door to door" delivery.	(1)
Taiwan - Bank not permitted to institute electronic fund transfer services which would be beneficial to our customers.	(1)
In South Korea and Canada, nationalistic laws could shut down data flows--e.g. for credit decisions.	(1)
Particularly difficult to plan data processing operations.	(1)

4. Countries Where Barriers Encountered

Because of the broad array of answers given, analysis is confined to those countries mentioned most frequently as having barriers which represent "significant interference" to U.S. services export trade. In addition, many respondents named no countries or only named countries for certain barriers. Therefore the number of countries cited may not necessarily reflect the seriousness of the barrier.

a. Barriers to ownership and establishment

Number of countries named:	29
Countries mentioned more than once:	17
Regions named:	6

Countries

Australia	15	Taiwan	2
Mexico	12	Colombia	2
Brazil	10	Argentina	
Canada	10	Barbados	
Japan	6	Republic of China	
Indonesia	6	Egypt	
Venezuela	4	Finland	
Malaysia	4	Germany	
Norway	3	Greece	
France	2	Jamaica	
Spain	2	Kuwait	
Korea	2	Saudi Arabia	
Nigeria	2	Singapore	
Philippines	2	Thailand	
Sweden	2		

Regions

Andean Pact	3	Asia	2
Latin America	3	Middle East	2
Middle East	2	Far East	
		North Africa	

b. Repatriation and remittance restrictions

Number of countries named	26
Countries mentioned more than once	6
Regions named	4

Countries

Brazil	9	India
Mexico	6	Jamaica
Greece	4	Nigeria
Venezuela	4	Peru
Argentina	4	Philippines
Colombia	3	Portugal
Bolivia		Paraguay
Bahamas		Poland
Canada		Sweden
Chile		Spain
Dominican Republic		Taiwan
Egypt		Trinidad
France		Zimbabwe

Regions

Latin America	5	Andean Pact
Asia	2	Far East

c. Discriminatory licensing

Number of countries named	11
Countries mentioned more than once	3
Regions named	2

Countries

Indonesia	3	Korea
Malaysia	2	Kuwait
Japan	2	Norway
Austrailia		Taiwan
Brazil		Thailand
Germany		

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Regions

Far East
Middle East

d. Employment restrictions

Number of countries named	14
Countries mentioned more than once	3
Regions named	3

Countries

Canada	3	Chile
Mexico	3	Colombia
Brazil	2	Egypt
Abu Dhabi		Nigeria
Austrailia		Panama
Bahamas		Singapore
Bermuda		United Kingdom

Regions

Middle East
Latin America
Asia

e. Discriminatory taxes

Number of countries named	11
Countries mentioned more than once	3
Regions named	4

Countries

Mexico	3	Greece
Chile	3	Germany
Canada	2	Korea
Barbados		Saudi Arabia
Colombia		Venezuela
France		

Regions

Latin America	3
Asia	
Europe	
Far East	

f. Restrictions on use of company name.

No countries mentioned as having barriers posing "significant interference"

g. Prohibition on association with local service companies.

No countries mentioned as having barriers posing "significant interference"

h. Discriminatory government contracting.

Number of countries named 13

Countries mentioned more than once 4

Regions named 1

Countries

Brazil	4	France
Indonesia	2	Japan
Korea	2	Nigeria
Malaysia	2	Saudi Arabia
Abu Dhabi		Taiwan
Argentina		Venezuela
Canada		

Regions

Latin America

i. Restriction on use of facilities

Number of countries named 4

No country mentioned more than once

No regions mentioned

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Country List

Brazil	Kuwait
France	Norway

j. Unfair competition from government operations

Number of countries named 13

Countries mentioned more than once 2

Regions named 2

Countries

Argentina	2	Kuwait
Brazil	2	Mexico
Costa Rica		Nigeria
England		Peru
France		Switzerland
India		Taiwan
Italy		

k. Barriers to transborder data flow

Number of countries named 3

Countries mentioned more than once 1

No regions named

Countries

Canada	3
Japan	
Taiwan	

5. Examples of other barriers companies have encountered (with number of responses).

In the case of banks, numerous regulations discriminating against foreign banks, such as credit ceilings, access to local deposits, access to discount facilities, restrictions on branching, discriminatory deposit/capital requirements, and restrictions on leverage. (6)

Implicit or explicit foreign exchange controls	(3)
Withholding taxes on repatriation of interest, dividends, management fees	(3)
Export subsidies and subsidized insurance for domestic firms	(3)
Preemption of insurance markets by national or regional companies	(3)
Lack of transparency	(1)
Quotas on imports of certain products	(1)
Inconsistency of customs laws and regulations, documentation requirements	(1)

6. What steps have companies take in reaction to barriers to foreign services trade? (With number of responses.)

Work to reduce barriers in the countries where they exist, either directly with government authorities, through local representatives, or through international associations	(14)
Work in the U.S. for liberalization of trade-in services, through participation in trade and industry associations, government contacts, testimony before Congress, etc.	(12)
Where restrictions on ownership exist, enter into alternative business alliances, such as joint ventures, minority ownership, licensing, etc.	(9)
Compliance, in some cases requiring changes in normal business practices	(8)
Withdraw from, or refuse to do business in, countries where certain barriers exist	(5)
Support utilization of existing mechanisms providing relief from unfair trade practices (e.g., Section 301)	(1)

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V. U.S. SERVICES TRADE POLICIES

1. Are other countries taking unfair advantage of this country's open services trade policies?

	Banks	Others	All
Yes	77.1%	55.6%	71.8%
No	22.9%	44.4%	28.2%

2. Should the U.S. become more restrictive in its services trade policies?

	Banks	Others	All
Yes	8.3%	28.6%	18,3%
No	91.7%	71.4%	81.7%

3. Will other countries retaliate if the U.S. institutes new restrictions on services trade?

	Banks	Others	All
Yes	86.1%	86.5%	86.3%
No	13.9%	13.5%	13.7%

4. Are the interests and problems of service companies trading abroad adequately understood by the U.S. government?

	Banks	Others	All
Yes	25.7%	27.3%	26.5%
No	74.3%	72.7%	73.5%

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5. Is there sufficient support and understanding of U.S. service companies by officials in U.S. embassies overseas?

	Banks	Others	All
Yes	31.0%	29.4%	30.2%
No	69.0%	70.6%	69.8%

6. Evaluation of the impact of specific trade policies and proposals.

	No Effect	Slight Positive Effect	Significant Positive Effect	Counter-Productive
a. Create a cabinet-level Department of Trade, as proposed by the Administration.				
Banks	20.0%	42.9%	31.4%	5.7%
Others	27.8%	44.4%	19.4%	8.3%
All	23.9%	43.7%	26.8%	7.6%
b. Negotiate bilateral agreements on services with trading partners.				
Banks	2.9%	54.3%	37.1%	5.7%
Others	7.1%	39.3%	43.9%	10.7%
All	4.8%	47.6%	39.7%	7.9%

	No Effect	Slight Positive Effect	Significant Positive Effect	Counter-Productive
c. Legislation to sharpen application of existing U.S. trade remedies (e.g. Section 301 of 1974 Trade Act) to services.				
Banks	21.2%	48.5%	12.1%	18.2%
Others	36.4%	30.3%	27.3%	6.1%
All	28.8%	39.4%	19.7%	12.1%
d. Reciprocity legislation requiring that U.S. regulators take into account a foreign country's treatment of U.S. service suppliers in licensing or regulating businesses from that country.				
Banks	8.6%	31.4%	40.0%	20.0%
Others	21.0%	28.9%	28.9%	21.1%
All	15.1%	30.2%	34.3%	20.5%

	No Effect	Slight Positive Effect	Significant Positive Effect	Counter-Productive
e. "Local content" legislation or services trade restrictions with similar intent.				
Banks	27.3%	9.1%	0	63.6%
Others	44.4%	16.7%	5.6%	33.3%
All	36.2%	13.0%	2.9%	47.8%
f. Creation of a multilateral framework for trade in services under GATT.				
Banks	24.2%	45.5%	30.3%	0
Others	25.0%	38.9%	30.6%	5.6%
All	24.6%	42.0%	30.4%	2.9%
g. Creation of a multilateral framework for trade in services under OECD.				
Banks	38.2%	44.1%	17.7%	0
Others	31.4%	45.7%	20.0%	2.9%
All	34.8%	44.9%	18.8%	1.5%

	No Effect	Slight Positive Effect	Significant Positive Effect	Counter-Productive
h. Modification of DISC to meet objectives of GATT signatories.				
Banks	58.1%	29.0%	6.5%	6.5%
Others	51.6%	41.9%	3.2%	3.2%
All	54.8%	35.5%	4.8%	4.8%
i. Preservation and strengthening of DISC (e.g. broader services coverage) regardless of objections of GATT signatories.				
Banks	32.3%	29.0%	19.4%	19.3%
Others	29.4%	32.4%	23.5%	14.7%
All	30.8%	30.8%	21.5%	16.9%

	No Effect	Slight Positive Effect	Significant Positive Effect	Counter-Productive
j. Authorization for the President to establish terms and conditions under which foreign service firms may engage in interstate commerce in the U.S., upon a determination that a foreign country discriminates against U.S. service companies.				
Banks	32.4%	23.5%	26.5%	17.6%
Others	18.9%	35.1%	27.0%	18.9%
All	25.4%	29.6%	26.7%	18.3%
k. Utilize subsidies and incentives to encourage services exports.				
Banks	17.1%	28.6%	34.3%	20.0%
Others	30.6%	13.9%	44.4%	11.1%
All	23.9%	21.1%	39.4%	15.5%

	No Effect	Slight Positive Effect	Significant Positive Effect	Counter-Productive
l. Simplification of export licensing requirements.				
Banks	23.5%	44.1%	32.4%	0
Others	40.6%	31.2%	28.1%	0
All	31.8%	37.9%	30.3%	0
m. Use of trade as a foreign policy mechanism, e.g. Soviet pipeline sanctions, grain embargo, etc.				
Banks	14.3%	5.7%	0	80.0%
Others	30.6%	5.6%	8.3%	55.6%
All	22.5%	5.6%	4.2%	67.6%
n. Amendment of Foreign Corrupt Practices Act to clarify accounting and antibribery provisions.				
Banks	16.7%	44.4%	36.1%	2.8%
Others	24.3%	35.1%	32.4%	8.1%
All	20.6%	39.7%	34.3%	5.5%

7. Examples of other proposals respondents would like to see implemented.

Note: So that diversity of responses can be seen, individual comments are presented, except where very similar. (For multiple responses, number is indicated in parentheses).

Export Incentives and Assistance (Non-tax)

Expand Eximbank lending authority at more competitive terms. (7)

Greater general government support of foreign trade. (2)

Require Eximbank, AID, Department of Agriculture and multilateral lending agencies to have procurement policies for services, especially insurance.

Transform OPIC into reinsurer of private insurance companies providing political risk insurance.

Support from state or federal agencies in the form of interest rate subsidies or credit insurance readily available for smaller to medium-sized firms.

Tax Proposals

Elimination of discriminatory taxation of companies earning foreign source income. (3)

New tax incentives for increased investment in foreign countries and increased exports. (2)

Access to government export credits.

More bilateral tax treaties.

Tax free status for foreign resident U.S. personnel.

Clarification of services definition in DISC (or DISC alternative) to clearly include all home offices of engineering and construction firms.

DISC alternative with arm's-length/foreign presence rules that are administratively workable for engineering and construction firms.

Removal of Trade Barriers

Guarantees that work permits are obtainable for a reasonable number of Americans at all times.

International agreements indicating policy of deregulation of transportation and allowing competition with national air carriers and postal authorities.

Removal of restrictive import quotas which only, and for a limited time, assist non-competitive domestic industry, while resulting in higher product costs and thus causing inflation.

Seek reciprocity wherever and whenever possible with foreign governments.

U.S. Regulatory Policy

Federal legislation on the interstate banking issue is a critical first step toward implementation of any effort to negotiate reciprocity.

Changes in antitrust laws.

Develop formal consultative mechanism between federal and state regulatory agencies to deal with services trade matters.

Reconciliation of Department of Commerce and IRS anti-boycott regulations.

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VI. DATA ON SERVICES TRADE

1. Could your company use more data on the domestic services sector?

	Banks	Others	All
Yes	54.3%	47.2%	50.7%
No	45.7%	52.8%	49.3%

2. Could your company use more data on international trade in services?

	Banks	Others	All
Yes	71.4%	86.1%	78.3%
No	28.6%	13.9%	21.7%

3. Examples of types of data most useful to respondents. (For multiple responses, number is indicated in parentheses.)

Trade flows and marketing (e.g., volume and dollar value of services exports, on country-by-country and industry basis).	(9)
Detailed country-by-country data on trade barriers, by industry, updated frequently.	(7)
Information on U.S. trade assistance programs.	(7)
General economic and employment data (e.g., compensation, productivity)	(6)
Financial information (e.g., foreign debt figures)	(4)

4. Should the data be collected by the government?

	Banks	Others	All
Yes	50.0%	51.5%	50.8%
No	50.0%	48.5%	49.2%

5. Should data collection be a private sector initiative?

	Banks	Others	All
Yes	67.7%	65.6%	66.7%
No	32.3%	34.4%	33.3%

6. Respondents saying both government and private sector should collect data.

Banks	Others	All
10.6%	10.6%	21.2%

7. Comments on questions 4 and 5 (For multiple responses, number indicated in parentheses).

A cooperative public/private sector effort is best (10)

<u>Public Sector Effort</u>

Government can make collection mandatory (4)

Government has better access to information (3)

Government collection would be more efficient

Data collection is a natural extension of broader government involvement

The government probably already has the data, but it is difficult to locate

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VII. ADDITIONAL ISSUES

Five respondents had additional comments.

Three respondents argued for greater U.S. government support of U.S. export trade, specifically citing competitive financing packages, a greater financing role for Eximbank, and more support and development work by the Commerce and State Departments.

One respondent made the point that the U.S. should not subsidize exports or restrict imports in either the services or merchandise areas. Even though such a free trade environment does not currently exist, it is the objective for which the U.S. should strive. Protectionism can only produce misallocation of resources, fewer rewards for the more productive, and a lower standard of living everywhere.

One respondent advised care in analyzing services trade data and in defining what industries are classified as services.

APPENDIX B

INTERNATIONAL TRADE IN SERVICES
CONFIDENTIAL QUESTIONNAIRE

NAME AND ADDRESS OF RESPONDING COMPANY ______________________________

____

____

COMPANY CONTACT FOR CLARIFICATION OF RESPONSES Name______________________________

Title ______________________________

Address______________________________

Phone ______________________________

PLEASE RESPOND BY AUGUST 25, 1983
to
Gilbert Simonetti, Jr.
Price Waterhouse
1801 K Street, N.W., #700
Washington, D.C. 20006

Price Waterhouse

GENERAL INSTRUCTIONS

1. We estimate that the survey should take no more than two hours to complete.

2. Some of the questions may not be applicable to all respondents. If this is the case, please specify "N/A" as the answer.

3. If you have comments on any question or require additional space, please use addendum sheets specifying number of question which is being answered.

4. Responses should cover all foreign services business regardless of methods and forms of organization used to conduct such business.

5. The "revenues" considered in questions I.1 - I.3 should cover all foreign source services revenue represented in the company's financial statements for the specified fiscal years, including income from services investment abroad accounted for by the equity method.

6. We would appreciate a response by **August 25, 1983.** For your convenience, please use the enclosed, self-addressed stamped envelope to return the questionnaire.

7. If you have any questions about the survey, contact: Andrea R. Andrews or Gilbert Simonetti, Jr., at (202) 296-0800.

DEFINITIONS

For the purposes of this questionnaire, the following definitions apply:

1. **Company**—An individual proprietorship, partnership, joint venture, franchised or licensed operation, association, corporation, including any subsidiary corporation, business trust, cooperative, trustees in bankruptcy or receivers under decree of any court, owning or controlling one or more establishments.

2. **Services**—The term "services" encompasses economic activities in which the principal outputs are not the products of manufacturing, mining or agricultural activities.

3. **Section 301 of the 1974 Trade Act,** as amended by the 1979 Trade Agreements Act, permits companies to seek relief from unfair trade practices or violations of international trade agreements by foreign governments by filing a petition with the U.S. Trade Representative's Office, which can then undertake an investigation and make recommendations for action, including retaliatory measures, to the President.

4. **Export Trading Company (ETC)**—A company that provides a range of export services which effectively connect U.S. exporters with overseas markets.

I. PROFILE OF YOUR INTERNATIONAL SERVICES BUSINESS

1. Over the next five years, what do you expect of your company's international trade in services?

   Expand greatly ____________
   Expand moderately ________
   Be essentially flat __________
   Decrease moderately ______
   Decrease greatly __________

2. a. What were the approximate aggregate revenues generated by your company's services business, domestic and foreign? (U.S. $1,000)

	FY 1980	FY 1981	FY 1982
a.	$ ____________	$ ____________	$ ____________
b.	$ ____________	$ ____________	$ ____________

   b. What were the approximate aggregate revenues generated by the foreign portion of your company's services business? (U.S. $1,000)

3. Principal lines of services business (Domestic and Foreign) (Describe in terms generally used by your company.)

	Approximate Percent of Total Revenues			Approximate Percent of Foreign Revenues for Each Service Line to Total Revenues		
	FY 1980	FY 1981	FY 1982	FY 1980	FY 1981	FY 1982
____________	___ %	___ %	___ %	___ %	___ %	___ %
____________	___ %	___ %	___ %	___ %	___ %	___ %
____________	___ %	___ %	___ %	___ %	___ %	___ %
____________	___ %	___ %	___ %	___ %	___ %	___ %
Total	___ %	___ %	___ %	___ %	___ %	___ %

4. Principal countries served. (Other than U.S.)

   ____
   ____
   ____

II. ORGANIZING FOR INTERNATIONAL SERVICES TRADE

1. What organizational structure or marketing method do you use to further your international services business?
   - Foreign affiliate ____________
   - Subsidiary or branch ________
   - Joint venture______________
   - Franchising ______________
   - Licensing ________________
   - Export from domestic base_____

2. Have you formed an export trading company? If so, is the purpose to: _____ Yes _____ No
   - Market your company's services? _____ Yes _____ No
   - Perform export services for others? _____ Yes _____ No

3. If you have not formed an export trading company, do you believe such a company would provide an advantage for your business? _____ Yes _____ No

4. Please provide the basis for your answer to No. 3. ____
   ____
   ____
   ____

5. Would you consider using the services provided by an export trading company formed by another business? _____ Yes _____ No

6. Do you believe formation of export trading companies can significantly increase U.S. services exports? _____ Yes _____ No

III. FOREIGN BARRIERS TO TRADE IN SERVICES

1. Are foreign barriers to trade in services an increasing problem for your company? _____ Yes _____ No

2. Do you believe that the foreign barrier or barriers, if any, that your company encounters represent:

   _____ the direct result of efforts by the foreign country to protect its domestic service industry from foreign competition.

   _____ policies which apply equally to all service companies, but which have a more negative impact on foreign companies.

   _____ Any other cause (specify).

   ____

   ____

3. Below is a list of policies which a foreign government may establish. Please evaluate them according to the impact on your company's trade in services. PLEASE CHECK APPROPRIATE LINE. Also, please list countries representative of your response.

	No Interference	Slight Interference	Significant Interference	Country or Countries
a. Restrictions on right of establishment or foreign ownership.	_____	_____	_____	__________
b. Restrictions on repatriation of fees, royalties, and profits.	_____	_____	_____	__________
c. Discriminatory licensing or certification standards.	_____	_____	_____	__________
d. Restrictions on employment of U.S. nationals.	_____	_____	_____	__________
e. Discriminatory tax policies, (for example, taxation of foreign service companies at higher rate than domestic companies).	_____	_____	_____	__________

	No Interference	Slight Interference	Significant Interference	Country or Countries
f. Restrictions on the use of a company's name.				
g. Prohibition on association with local service companies.				
h. Government contracting policies which favor local service companies.				
i. Restrictions on use of facilities (for example, airports and port facilities), or user fees applicable only to foreign service companies.				
j. Unfair competition from government-owned operations.				
k. Barriers to transborder data flow.				

Since transborder data flow is an especially significant issue, could you describe what specific barriers you have encountered?

6. Are there any other barriers which your company has encountered? In what countries?

7. What steps has your company taken in reaction to foreign barriers to services trade?

IV. ATTITUDE TOWARD U.S. SERVICES TRADE POLICIES

1. Do you believe other countries are taking unfair advantage of this country's open services trade policies? _____ Yes _____ No

2. Should the U.S. become more restrictive in its services trade policies? _____ Yes _____ No

3. Do you believe that other countries will retaliate if the U.S. institutes new restrictions on services trade? _____ Yes _____ No

4. Are the interests and problems of service companies trading abroad adequately recognized by the U.S. government? _____ Yes _____ No

5. Is there sufficient support and understanding of U.S. service companies by officials in U.S. embassies overseas? _____ Yes _____ No

6. Listed below are commonly cited actions that might be taken by the U.S. government related to international trade in services. Please evaluate them according to what effect they would have on your company. PLEASE CHECK APPROPRIATE LINE.

	No Effect	Slight Positive Effect	Significant Positive Effect	Counter-Productive
a. Create a cabinet-level Department of Trade, as proposed by the Administration	_____	_____	_____	_____
b. Negotiate bilateral agreements on services with trading partners.	_____	_____	_____	_____
c. Legislation to sharpen application of existing U.S. trade remedies (e.g. Section 301 of 1974 Trade Act) to services.	_____	_____	_____	_____
d. Reciprocity legislation requiring that U.S. regulators take into account a foreign country's treatment of U.S. service suppliers in licensing or regulating businesses from that country.	_____	_____	_____	_____

	No Effect	Slight Positive Effect	Significant Positive Effect	Counter-Productive
e. "Local content" legislation or services trade restrictions with similar intent.				
f. Creation of a multilateral framework for trade in services under GATT.				
g. Creation of a multilateral framework for trade in services under OECD.				
h. Modification of DISC to meet objections of GATT signatories.				
i. Preservation and strengthening of DISC (e.g. broader services coverage) regardless of objections of GATT signatories.				
j. Authorization for the President to establish terms and conditions under which foreign service firms may engage in interstate commerce in the U.S., upon a determination that a foreign country discriminates against U.S. service companies.				
k. Utilize subsidies and incentives to encourage services exports.				
l. Simplification of export licensing requirements.				

	No Effect	Slight Positive Effect	Significant Positive Effect	Counter-Productive
m. Use of trade as a foreign policy mechanism, e.g. Soviet pipeline sanctions, grain embargo, etc.	______	______	______	______
n. Amendment of Foreign Corrupt Practices Act to clarify accounting and antibribery provisions.	______	______	______	______

7. What other proposals would you like to see implemented, either to remove disincentives or to enhance your company's competitiveness in international services trade. ______________________________

____

____

Mr. SIMONETTI. At this point, then, let me summarize the findings.

Senator JEPSEN. Excuse me. I need to take 5 minutes now. It is a good point. You are just going to summarize the findings, and we will start from there.

So as we say in the service, at ease.

[Whereupon, a short recess was taken.]

Senator JEPSEN. The meeting will come to order.

I thank you for your understanding, and you were about to summarize.

Mr. SIMONETTI. Yes; thank you, Mr. Chairman.

Senator JEPSEN. You may proceed.

Mr. SIMONETTI. The respondents were very emphatic on several significant issues. For example:

Seventy-two percent believe other countries are taking unfair advantage of this country's open services trade policies.

Eighty-two percent of the respondents believe the United States should not, however, become more restrictive in its services trade policies.

Eighty-six percent believe other countries will retaliate if the United States institutes new restrictions on services trade.

Seventy-three percent believe the needs and problems of service organizations trading abroad are not adequately recognized by the U.S. Government.

Senator JEPSEN. May I interrupt? I want to make sure of this point. You say 86 percent of countries will reciprocate?

Mr. SIMONETTI. Yes; the view of the respondents was that in the event the United States would increase their restrictions on trade, that action would trigger retaliatory responses by foreign nations.

Senator JEPSEN. And 86 percent——

Mr. SIMONETTI. And 86 percent of the respondents believe that that would occur, that other countries would in fact retaliate against the United States if we became more restrictive with our services trade policies.

And a key indicator of concern by the service industries responding was that 85 percent are only guardedly optimistic about future international trade in services.

This lack of optimism for future services trade is significant in view of the fact that one-half of the respondents experienced more than 20-percent growth in export trade between fiscal 1980 and 1982. It may also be related to the fact that two-thirds of the respondents see barriers to trade in services as an increasing problem and a large percentage feel U.S. Government support of export trade is inadequate.

In general, 64 percent of all those responding indicated that foreign barriers to trade in services are clearly an increasing problem. Thus, about two-thirds of the companies responding are encountering increased difficulty in trading abroad because of these practices in other countries.

Two-thirds of all respondents see foreign barriers exclusively as the result of intentional protectionism as opposed to merely those barriers that relate to policies that would apply both to foreign companies as well as domestic.

Turning to the barriers seen to be the most restrictive, the three principal barriers cited by respondents were restrictions on right of establishment or foreign ownership; restrictions on repatriations of fees, royalties, and profits; and discriminatory tax policies.

This response seems logical, since service companies would find the particular barrier of right of establishment as a particular problem since most services often require a sales or support or distribution system in the host country.

Restrictions on repatriation of royalties, fees, and profits constituted the second most serious barrier.

And I think it is interesting to note where the barriers were seen to be most egregious. In terms of all types of barriers representing a significant interference, Brazil was cited 29 separate times for 7 different type barriers. Latin America as a region was cited most frequently with 16 references for 5 barriers.

This trend of increased barriers in the services sector coincides with a general increase in foreign government interference in trade and investment matters documented by the general membership of the National Foreign Trade Council.

Let me now turn briefly to the respondents' attitudes on various existing and proposed U.S. governmental actions related to trade in services.

Despite considerable concern that other countries are taking unfair advantage of this country's open services trade policies, respondents believe that the United States should not become more restrictive. And this, we believe, is primarily for fear of retaliation in world markets.

The survey also revealed only marginal enthusiasm for two proposals which have received considerable attention in this country, the creation of a new Cabinet-level Department of Trade and Industry, and the creation of a General Agreement on Tariffs and Trade for services.

Only 27 percent of all respondents felt creation of a new Department of Trade would have a significant positive effect, although I should add that 44 percent additionally thought it would have a slight positive beneficial effect in their ability to compete abroad.

The most popular proposal for banks was reciprocity legislation requiring that U.S. regulators take into account a foreign country's treatment of U.S. service suppliers in licensing or regulating businesses from that country. Other service companies chose export incentives as their highest priority. Bilateral agreements with trading partners ranked second, and amendment of the Foreign Corrupt Practices Act was third for both banks and other types of service companies.

Local content legislation and use of trade as a foreign policy mechanism, as in the Soviet pipeline situation, for example, were seen as the most unpopular policies with both the bank respondents and other respondents.

Mr. Chairman, the National Foreign Trade Council believes that expansion of our services trade should be recognized as a key factor to increasing our country's international competitiveness.

The similarities between the impressions conveyed by the respondents to the survey and the views expressed in the 1984 National Foreign Trade Council policy declaration, "Sell American"—and I have a copy of that booklet here—provide strong evidence of the need to redirect our services trade policies.

Let me briefly outline the similarities between the survey results and the NFTC policy declaration:

Both urge the careful reduction of barriers to trade through greater utilization of multilateral and bilateral negotiations.

Both urge increased support of U.S. exports by providing coordinated government assistance.

Both urge the reduction of disincentives to exports in the form of unnecessary export controls and ambiguous interpretations of the Foreign Corrupt Practices Act.

Both urge the avoidance of protectionist tendencies, but at the same time taking full advantage of U.S. trade remedy laws to combat unfair competition.

The similarities drawn from the opinions of the service firms in this survey and other sector participants in international trade provide a guiding focus for the formulation of trade policy.

When discussing trade issues, it is not a question of either goods or services. It is a question of equitable treatment for each. The same attention that has been given to reducing barriers to trade in goods should now be given to reducing barriers that are beginning to expand to trade in services. Trade in goods and trade in services support and contribute to each other. They are not mutually exclusive.

Particularly interesting to me was the marginal support for the creation of a multilateral framework for trade in services under GATT, which I personally view as a very important long-term goal. Only 30 percent of the respondents felt a GATT framework for services would have a significant positive effect. An additional 42 percent felt it would have a slight positive effect.

This may be a reaction to the manner in which the GATT for goods has been administered. One does not have the information on that. That is merely an impression that I would have without regard to the survey.

Without a multilateral mechanism to work toward the progressive reduction and elimination of barriers, quotas will increase, and licensing requirements and customs regulations will be used with greater regularity against foreign participation in domestic markets. As a result, the United States as well as service firms from other countries will face increasing difficulties in doing business abroad.

In short, NFTC believes we need a GATT for services. We already know from recent experience at the November 1982 GATT Ministerial Conference that it will not be easy to convince our trading partners to extend GATT to services. But this must be our long-term goal. And while we work toward it, and as we work toward it, we must leave no stone unturned in developing other positive approaches to enhancing our international competitiveness in services trade. As we do so, however, we must tread a fine line between fairly protecting our trade rights and ill-considered retaliatory actions that may increase barriers rather than eliminate them.

That, Mr. Chairman, is a summary of my remarks, and I would be pleased to respond to questions when the time comes.

Thank you.

[The prepared statement of Mr. Simonetti, together with the booklet referred to, follows:]

PREPARED STATEMENT OF GILBERT SIMONETTI, JR.

Thank you, Mr. Chairman, I am pleased to have the opportunity to appear today to discuss the subject of international trade in services.

My name is Gilbert Simonetti, Jr. I am a partner with the international accounting firm of Price Waterhouse and currently serve as chairman of the National Foreign Trade Council's Services Committee. I am accompanied by Paul T. Murphy, NFTC Vice President for Government Relations.

The National Foreign Trade Council established in 1914, is the oldest and largest private, non-profit organization exclusively concerned with the expansion of American foreign trade and investment. Council membership of over 600 firms engaged in all aspects of international trade and investment account for over 70 percent of all U.S. exports and foreign direct private investment.

The purpose of my testimony today is to highlight the results of a survey my firm undertook in 1983 to assist the NFTC in developing the information necessary to build an understanding of the service sector's relationship to international trade.

Let's look at the recent data.

The Commerce Department's trade statistics for 1983 have just been released. The current account was in deficit by a record \$40.8 billion compared with a deficit of \$11.2 billion in 1982.

The relatively good news is that the net service balance was in surplus by \$28.4 billion. This news is only relatively good because prior to 1982 the surplus in services had historically balanced the deficit in merchandise trade. Since 1981 our merchandise deficit has skyrocketed and our services surplus has declined from \$36 billion to \$28.4 billion in 1983.

Why this decline in services trade?

Even as the importance of services trade to our economy grows, barriers to trade in services are on the rise around the world. In attempting to expand services exports, U.S. companies are encountering more and more non-tariff barriers created by countries attempting to protect their domestic service industries from foreign competition.

Such barriers are having a chilling effect on our services exports and may be contributing to the continuing decline in the services surplus which began in 1982.

Survey Background

As an organization devoted to providing timely review of developments affecting international business, the NFTC wanted more information about the perceptions of services companies on the trade environment and policies. How do they view the international competitive position of U.S. service organizations, and is there any kind of consensus as to what should be done to enhance that position? The Price Waterhouse survey sought answers to questions such as:

- How widespread are non-tariff barriers to trade in services, what form do they take, and which are most serious?
- Are such barriers truly an increasing problem for our service companies trading abroad?
- How do service companies view the role and effectiveness of the U.S. government in promoting international trade in services?
- How do services companies rate the potential impact of various trade-related proposals on their international competitiveness, and what other proposals would they like to see implemented?

In August 1983 we undertook a survey of companies in the newly created Fortune 500 Services Directory who had some foreign operations. We received about a 35 percent response to the survey. I'm told that's a rather high response, and I believe it indicates a significant level of concern about trade in services issues.

Respondents fall into the categories of banks, diversified service organizations, diversified financial service organizations, insurance companies, transportation companies, and utilities. The greatest response came from banks representing 49 percent of the total response.

Our respondents ranged from less than $25 million to over $5 billion in terms of foreign source revenue. The percentage of total service revenues represented by foreign trade ranged from less than one percent to over 90 percent, with concentration in the less than 20 percent range. Collectively, our respondents do business in 64 countries and eight geographical regions. A number do business virtually worldwide, in as many as 40 different countries.

Rather than review all the results of the survey, we respectfully request that the report of the "Survey of Business Views on International Trade in Services" be made part of the hearing record.

At this point let me summarize the findings.

The respondents were very emphatic on several significant issues. For example:

- 72 percent believe other countries are taking unfair advantage of this country's open services trade policies;
- 82 percent believe the U.S. should not become more restrictive in its services trade policies;
- 86 percent believe other countries will retaliate if the U.S. institutes new restrictions on services trade;
- 73 percent believe the needs and problems of service organizations trading abroad are not adequately recognized by the U.S. government; and
- 85 percent are only guardedly optimistic about future services trade.

This lack of optimism for future services trade is significant in view of the fact that one half of the respondents experienced more than 20 percent growth in export trade between fiscal 1980 and 1982. It may also be related to the fact that two-thirds of the respondents see barriers to trade in services as an increasing problem and a large percentage feel government support of export trade is inadequate.

Survey Surprises

There were some interesting surprises while the survey was in progress. A number of companies wrote or called to say they were not going to respond because they did not feel their businesses fit into the "service" category. There could be several reasons for this. The one that occurs to me as most likely is that the self-awareness of the services sector may not be as clear as we think it is or would like it to be, especially if one is using Fortune's definition.

In developing its directory, Fortune defined a service company as one in which over 50 percent of sales are accounted for by services. A bank will have little trouble thinking of itself as a service organization, which probably accounts in part for the large response from banks. But what about a company that began as a manufacturer, gradually diversified into service lines, possibly associated with its product lines, and eventually slipped over the 50 percent border?

I believe the Fortune listing is a healthy reminder that the services sector is not made up only of "purely" service companies. Many companies that provide services do not view goods and services as mutually exclusive or separate their interests from those of the goods-producing sector.

Foreign Barriers to Trade in Services

In general, about 64 percent of all those responding indicated that foreign barriers to trade in services are an increasing problem, with a significant difference between the viewpoints of banks (54 percent of respondents) and other types of service companies (73 percent of respondents).

Thus about one-half to two-thirds of the companies responding are encountering increased difficulty in trading abroad because of practices in other countries, depending on the type of business. And, as one respondent pointed out, this does not take into account those companies for whom barriers represent a constant, although not necessarily increasing problem.

Two-thirds of all respondents see foreign barriers exclusively as the result of intentional protectionism. Only 6 percent believe the barriers result from policies which apply equally to all services companies but in fact discriminate against foreign firms.

The three principal barriers cited by respondents were restrictions on right of establishment or foreign ownership; restrictions on repatriations of fees, royalties and profits; and discriminatory tax policies.

Seventy-one percent of the respondents cited right of establishment or foreign ownership as a significant interference.

This response seems quite logical. Service companies would find this particular barrier a special problem since the provision of services often requires a sales or support or distribution system in the host country.

Restrictions on repatriation of royalties, fees and profits constituted the second most serious barrier. They were rated a significant interference by 49 percent of all respondents. Twenty-six countries were cited for imposing remittance restrictions serious enough to be considered a significant interference. Six countries were mentioned more than once: Brazil (9), Mexico (6), Greece (4), Venezuela (4), Argentina (4), and Colombia (3).

Discriminatory tax policies was the third most significant barrier for nonbank service companies. Banks regard restrictions on transborder data flow as the third most significant barrier, but only narrowly over unfair competition from government-owned operations in other countries.

In terms of all types of barriers representing a "significant interference," Brazil was cited 29 times for seven different barriers. Latin America as a region was cited most frequently with 16 references for five barriers.

This trend of increased barriers in the services sector coincides with a general increase in foreign government intervention in trade and investment matters documented by the general membership of the NFTC.

U.S. Services Trade Policies

Let me now turn to the respondents' attitudes on various existing and proposed governmental actions related to trade in services.

Despite considerable concern that other countries are taking unfair advantage of this country's open services trade policies, respondents believe that the U.S. should not become more restrictive, primarily for fear of retaliation in world markets.

The survey also revealed marginal enthusiasm for two proposals that have received considerable attention, the creation of a cabinet level Department of Trade and Industry and creation of a General Agreement on Tariffs and Trade (GATT) for services.

Only 27 percent of all respondents felt creation of a new Department of Trade would have a "significant positive effect." There was noticeably greater support for the proposal among banks 31 percent versus 19 percent for all other categories. At the same time, though, an additional 44 percent thought this initiative could have a "slight positive effect" on their competitiveness.

This reaction might indicate a somewhat skeptical view of governmental reorganizations, but also a hopeful sign that public policy concentration on the importance of trade may tip the trade balance positively.

Only 30 percent of all respondents felt creation of a GATT for services would have a "significant positive effect." On this question banks and other types of service companies were in close agreement. An additional 42 percent of the respondents felt this idea could have a "slight positive effect."

The most popular proposal for banks was reciprocity legislation requiring that U.S. regulators take into account a foreign country's treatment of U.S. service suppliers in licensing or regulating businesses from that country. Other service companies chose export incentives as their highest priority. Bilateral agreements with trading partners ranked second and amendment of the Foreign Corrupt Practices Act was third for both banks and other types of service companies.

Local content legislation and use of trade as a foreign policy mechanism were the most unpopular policies with both groups. They were far more vigorously opposed by banks. Sixty-four percent of banks rated local content proposals as counterproductive, as opposed to 33 percent of other services companies. Trade as a foreign policy mechanism, was considered counterproductive by 80 percent of the banks and 56 percent by all others.

In terms of additional proposals that respondents would like to see implemented, by far the most popular was expanded lending authority for Eximbank on terms more competitive with those offered by other governments. There were also calls for greater support by the government for the interests of U.S. companies doing business abroad, both generally and by specific departments, such as State and Commerce. Tax incentives for exports and overseas investment, plus removal of various disincentives, were also popular write-in suggestions. Taken as a whole, the comments generally indicate that the government needs to do much more to encourage services exports.

Views on Export Trading Companies (ETCs)

On the subject of increasing export trade, let me discuss the response that was a pleasant surprise to me as a strong supporter of the Export Trading Company concept. This is the area where the activities and viewpoints of banks differ most markedly from other service companies. On the whole, their attitude is far more positive than may have been anticipated when the ETC Act was passed. Of those responding to the questions, banks are the only category in which any ETCs have been formed:

- 82 percent of banks responding believe ETCs have business advantages, as opposed to only 7 percent of the companies in all other categories;
- 72 percent of banks responding believe ETCs can significantly increase U.S. exports, as opposed to 45 percent for all other categories.

The negative comments on ETCs appear to indicate a lack of complete understanding of the functions and purpose of an Export Trading Company. For example, respondents appeared to believe that ETCs are formed primarily to export their own goods and services rather than provide export-related services to other companies. It may be that more education regarding the potential of ETCs is required.

Data on Services Trade

The most interesting response in the area of data on services trade was the lukewarm attitude towards government collection of data from U.S. companies on trade in services and mandatory government collection in particular. The responses from banks and other types of service companies did not differ significantly.

- *51 percent of all respondents felt the data should be collected by the government.
- *67 percent felt data collection should be a private sector initiative.
- 66 percent of the respondents opposed mandatory government data collection.

Far more respondents were interested in having more data on international trade in services than were interested in more data on the domestic services sector (78 percent as opposed to 51 percent). The lack of interest in domestic data may be a reflection of a reluctance to provide such data themselves. For example, some respondents indicated a concern with providing data that is essential to their competitive position or would be considered proprietary in nature.

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*NOTE: This question was not presented in "either/or" fashion. Instead, respondents were asked to respond "yes" or "no" in each case: private sector collection and government collection. The above percentages add up to over 100 percent because some respondents answered "yes" to both.

Surprisingly, just over half of those responding (52 percent) felt that the activities of foreign service companies in the U.S. should be more closely monitored.

Conclusion

We believe that expansion of our services trade should be recognized as a key factor to increasing our country's international competitiveness.

The similarities between the impressions conveyed by the respondents to the survey and the views expressed in the 1984 NFTC policy declaration,"Sell American" provide strong evidence of the need to redirect our trade policies.

Let me briefly outline the similarities between the survey results and the NFTC policy declaration:

- Both urge the careful reduction of barriers to trade through greater utilization of multilateral and bilateral negotiations.

- Both urge increased support of U.S. exports by providing coordinated government assistance.

- Both urge the reduction of disincentives to exports in the form of unnecessary export controls and ambiguous interpretations of the Foreign Corrupt Practices Act.

- Both urge the avoidance of protectionist tendencies, but at the same time taking full advantage of U.S. trade remedy laws to combat unfair competition.

- Both urge consideration of the "reciprocity" principle in the servies area. For example, NFTC has actively supported passage of S.144, the "International Trade and Investment Act" and respondents supported the concept urging caution.

The similarities drawn from the opinions of service firms in this survey and other sector participants in international trade provide a guiding focus for the formulation of trade policy.

When discussing trade issues, it is not a question of either goods or services. It is a question of equitable treatment for each. The same attention that has been given to reducing barriers to trade in goods, should now be given to reducing barriers to trade in services. Trade in goods and trade in services support and contribute to each other. They are not exclusive of each other.

Particularly interesting to me was the marginal support for the creation of a multilateral framework for trade in services under GATT, which I personally view as a very important long-term goal. Only 30 percent of the respondents felt a GATT framework for services would have a "significant positive effect." An additional 42 percent felt it would have a "slight positive effect."

I am not surprised at this reaction but I am disturbed. I believe it shows a fundamental--and regrettably justifiable--lack of confidence in the existing GATT structure for goods. Provisions now in force are being blatantly ignored or subverted to the point of uselessness. We may well ask, "What's the use of extending GATT to services if it isn't working for goods?" My response is that the last thing we should do is abandon GATT.

Without a multilateral mechanism to work toward the progressive reduction and elimination of barriers, quotas will increase, and licensing requirements and customs regulations will be used with greater regularity against foreign participation in domestic markets. As a result, U.S. as well as service firms from other countries will face increasing difficulties in doing business abroad.

In short, we need a GATT for services. We already know from recent experience at the November 1982 GATT Ministerial Conference that it won't be easy to convince our trading partners to extend GATT to services. But this must be our long-term goal. And, while we work toward it, we must leave no stone unturned in developing other positive approaches to enhancing our international competitiveness in services trade. As we do so, however, we must tread a fine line between fairly protecting our trade rights and ill-considered retaliatory actions that may increase barriers rather than eliminate them.

Sell American

Proposals for the Revival of United States Foreign Trade and Investment

1984 POLICY DECLARATION
OF THE NATIONAL FOREIGN TRADE COUNCIL

SELL AMERICAN

To revive U.S. foreign trade and economic growth after two years of stagnation, the National Foreign Trade Council sets forth herein a series of policy recommendations. These are addressed to Congress and the Administration and also to the U.S. international business sector. Business and government must share the task of expanding international trade and investment.

Our country's goal should be to "sell American"—to open up foreign markets for American goods and services, press foreign governments to lower their barriers against U.S. exports and investments, and lower our own regulatory roadblocks to exports. At the same time, we must recognize that trade and investment are two-way streets and resist imposing new obstacles against foreign goods and investors.

The Council's recommendations embrace these elements:

I. Reducing barriers to trade and investment imposed by foreign countries,
II. Strengthening developing countries' economies,
III. Supporting U.S. exports and foreign investments,
IV. Reducing disincentives to exports and foreign investments,
V. Avoiding protectionism,
VI. Designing tax policies to promote competitiveness.

The U.S. as a Trading Nation

Our nation is increasingly involved in and dependent upon international trade. This growth has been accompanied by public realization that the competitiveness of U.S. goods and services in world markets has a substantial direct effect on employment levels, entire industrial sectors and regions, and ultimately on the nation's economic health.

While the United States is still a strong competitor in world trade, our merchandise trade balance is headed for its eighth consecutive annual deficit. Even with the offsetting income from exports of services and revenues from private overseas direct investments, the U.S. current account will again be in deficit in 1984.

Among the factors which have contributed to the decline in the nation's current account since 1980 are the recent worldwide recession, the strength of the dollar, and the heavy indebtedness of many developing countries. In addition, many nations have sought to encourage domestic industries by adopting protectionist measures and have stepped up governmental support of exports.

These developments, coupled with the growing manufacturing capability of the developing world, place strong pressure on American business, labor, and government to adjust to the new realities of a changing international economy.

Summary of Recommendations

The following summarizes the Council's policy recommendations for the expansion of U.S. exports and foreign investment.

1. The United States must intensify efforts to secure reduction of barriers to international trade and investment imposed by foreign governments, principally through the General Agreement on Tariffs and Trade (GATT), the Organization for Economic Cooperation and Development (OECD), and other international forums. Where recourse to such forums does not provide relief, the United States should engage in intensive bilateral negotiations, such as those recently conducted with Japan. The Council endorses vigorous use of Section 301 of the Trade Act and other U.S. statutes to combat restrictions imposed by foreign nations.

2. The United States should encourage efforts by developing nations to reduce their debt and restructure their economies to achieve sustained growth. It is in our national interest as well as that of developing countries to support the International Monetary Fund (IMF) and the World Bank and its affiliates, maintain the Generalized System of Preferences, and exercise leadership in reducing barriers which impede developing country exports.

3. Both business and government must act to improve the competitiveness of American goods and services. A pressing issue is the strength of the dollar, which has had a significant adverse effect on U.S. exports. Unless we narrow the gap between the federal government's revenue and expenditures, excessive budget deficits will continue to put upward pressure on interest rates, a major factor supporting unfavorable exchange rates. The nation's policies in respect of export financing and the service sector must reflect the necessity to expand exports. Greater Presidential efforts to develop a national consensus that trade is a matter of high priority are crucial to expansion of exports and foreign investment.

4. Disincentives to exports imposed by U.S. law must be reduced. The Export Administration Act, the Foreign Corrupt Practices Act, and statutes with commendable but overreaching safety, health, and environmental objectives require simplifying amendments to avoid discouraging exports without realizing legitimate benefits.

5. The nation must maintain a balanced export policy. On the one hand, the United States must exercise effective leadership among industrialized nations in resisting protectionist meeasures. If it fails to do so, the fragile consensus will erode among nations supporting a free and open international trading system. On the other hand, the United States should continue to invoke its trade laws to offset the impact of dumping, export subsidies, and other practices which are unlawful under international agreements.

6. Most importantly, our tax policies must seek to foster the free flow of trade and investment, and to promote rather than impede U.S. competitiveness in the world marketplace.

February 1984

RICHARD W. ROBERTS
President
National Foreign Trade Council

plify its negotiating approach. A new, briefer prototype treaty could be developed, emphasizing the essential provisions necessary to protect private investment, such as full compensation for expropriation, improved disputes settlement mechanisms, and national treatment consistent with international law. Other issues, such as right of establishment, might be dealt with in a protocol to the treaty committing both parties to further bilateral discussions of the issues.

Protection of Intellectual Property

Barriers to the dissemination of technology must be vigorously opposed. The Third World, against its own long-term interests, has promoted a number of programs in international organizations to alter the traditional terms of technology transfer and gain access to technology on unreasonable terms. These schemes would weaken worldwide protection of intellectual property; discourage inventors from disclosing their inventions by providing inadequate protection; discourage investments based on new patents; and operate as barriers to technology transfer by substituting mandated arrangements for freely negotiated contracts reflecting the mutual interests of both parties.

Intellectual property is protected internationally by the Paris Convention (International Convention for the Protection of Industrial Property), a treaty uniting most of the trading countries of the world, which has proved both durable and satisfactory since 1883. At a diplomatic Conference on Revision of the Paris Convention, developing countries have attempted to change the rules of the international patent system. They would drastically amend the Paris Convention, last revised at Stockholm in 1967. One proposal would exclude patented U.S. products from countries in which they are patented but not produced by U.S. manufacturers, with the local patent rights exclusively assigned to a local manufacturer. The Council urges the U.S. delegation to maintain its long opposition to this and other proposals which would weaken the Paris Convention.

After several years of negotiation under auspices of the United Nations Conference on Trade and Development, developing and developed countries are still far apart on provisions of a technology transfer code.. The Council urges the U.S. delegates to the UNCTAD Conference on an International Code of Conduct on the Transfer of Technology to continue to oppose code provisions which impose non-commercial and unacceptable conditions on technology transfer.

Performance Requirements

The Council is concerned about the increasing use of performance requirements, a form of government intervention which distorts trade and investment flows and promotes uneconomic allocation of resources. Performance requirements are imposed on multinational corporations by governments either as a condition for a new investment or as a prerequisite for financial, tax, or other incentives. Two common examples are local content requirements and mandatory export quotas. Distortion also can arise from requirements for transfer of technology to the host country on non-economic terms, and for uneconomic reinvestment of earnings in the host country.

We welcome the U.S. Government's current examination of performance requirements. The United States and the OECD should support multilateral efforts to identify and analyze performance requirements with particular emphasis on their international trade and investment effects and their long-term local economic effects. Negotiations for an international agreement to limit future performance requirements should recognize the impact on existing company/host-country contracts.

Until a multilateral agreement on performance requirements is negotiated, the United States should continue to press complaints under the GATT and pursue diplomatic representation with other countries to seek removal of discriminatory measures against U.S. investors abroad. Of particular significance is the 1983 decision by a GATT panel finding local content requirements imposed by Canada's Foreign Investment Review Agency to be inconsistent with GATT rules. The United States, based on this favorable conclusion, should now press other nations to reduce similar local content rules.

Codes of Conduct

The Council notes the positive contribution made by the Declaration and Guidelines for Multinational Enterprises adopted in 1976 and reaffirmed in 1979 by the Organization for Economic Cooperation and Development. The OECD Declaration contains the key elements necessary to a successful code: it recognizes the responsibilities of both companies and governments, is voluntary, and is based on sound, carefully reasoned principles. It calls upon governments to treat foreign enterprises in a manner consistent with international law and to accord national treatment to them. It also offers guidelines regarding labor relations, restrictive business practices, transfer of technology, taxation, and disclosure of information on corporate sales and other data.

The Council also supports the "Declaration of Principles Concerning Multinational Enterprises and Social Policy" issued by the International Labor Organization in 1977. The Declaration is a voluntary set of principles on employment, conditions of work, and consultations with employees and has helped to foster labor-management understanding and a stable investment climate.

The United Nations General Assembly in 1980 adopted by consensus antitrust guidelines for multinational corporations ("Set of Equitable Principles and Rules for the Control of Restrictive Business Practices"). Although the Code does not explicitly state that it is non-discriminatory and voluntary, its entire tenor and context underscore those characteristics.

There are several other proposals for a variety of international codes of conduct which do not incorporate the balanced principles applied in the OECD code.

We commend U.S. negotiators for continuing to insist that such codes be voluntary, non-discriminatory, provide for national treatment consistent with international law, apply to state-owned enterprises, and be balanced so as to refer to the reciprocal obligations of host governments. Furthermore, participants in these negotiations should take into account that multinational corporations currently operate within a framework of national laws, bilateral agreements between states, and voluntary international codes and guidelines, and that they conduct their operations with regard for the social and economic objectives of host governments.

The Council recommends that the U.S. Government proceed cautiously in continuing UN negotiations. It urges government to work with the business community to be certain that other UN codes would not harm U.S. economic enterprises before giving its assent to any of them.

Transborder Data Flows

Some countries have adopted or are considering restrictive regulation of the essential free flow of corporate information across national borders. Among the motivations for such restrictions are the desire to protect the privacy of individuals; to preserve jobs by requiring data processing to be accomplished domestically; to promote domestic manufacture of data processing equipment; to raise revenues by taxing data flows; and to prevent information regarded as critical from being stored or retained outside national jurisdictions.

The Council supports the 1980 OECD Guidelines Governing the Protection of Privacy and Transborder Flows of Personal Data. It urges member countries to endorse these guidelines and take them into account when developing policies. However, the Council opposes efforts by governments to arbitrarily restrict data flows. Protectionism, whether imposed on the flow of goods or information, closes national borders to competition, thereby raising the cost of the domestic product and depriving the protected economy of the benefit of lower prices or advances in quality and efficiency achieved in other countries.

European Communities

The Council supports the European Communities' goal of establishing a true common market which requires the coordination of economic policies among the member states. An important step in achieving this goal has been the harmonization of company laws within the Communities. Thus, the Communities are emerging as a significant influence in the regulation of multinational business.

However, major elements of the Communities' proposals go beyond harmonization and can be detrimental to the good of the Communities and the enterprises operating there. Some proposals differ significantly from existing American corporate law. There is valid concern that these actions may be taken as precedents for restrictive measures by other countries and international organizations.

An example of the broad scope of business regulation proposed by the Communities is the Directive on Informing and Consulting Employees (Vredeling Proposal) now before the EC Council of Ministers, which, if approved, would be detrimental to the international competitiveness of firms doing business in the European Communities.

Other proposed directives would impose upon manufacturers virtually absolute liability for defective products; would increase the liability of parent companies and their directors for the conduct of a subsidiary located in the Communities; and would mandate board of directors or management roles for the workers' representatives. All would increase the complexities of trade and investment within the EC and limit the flexibility of enterprises to respond quickly to changing conditions, possibly putting EC companies at a competitive disadvantage in world trade. This, in turn, would make it more difficult for the EC to attract new capital investment needed to preserve and create employment.

The NFTC played a constructive advisory role in the process which led to the adoption last May of the Seventh Directive on Group Accounts. Over time this proposed directive has moved from an unreasonable and burdensome requirement which did not accomplish its own stated goals to a practicable and useful directive which will contribute to harmonization without creating significant new burdens. The Council will continue to offer its collective experience and expertise in a similar manner in assessing other proposed EC directives.

The U.S. Government and European affiliates of American business should continue to express their concerns and consolidate their efforts to influence the direction of Communities' policies and company law directives.

II

STRENGTHENING DEVELOPING COUNTRIES' ECONOMIES

The indebtedness of developing countries continues to be a matter of grave concern.

The cumulative effect of two oil shocks, high rates of borrowing, a prolonged worldwide recession, extremely high interest rates, and growing protectionism in the developed world have caused the external debts, public and private, of developing countries to rise above $600 billion. Unprecedented programs to reschedule major portions of this debt have been necessary; as a result, prospects are for a relatively slow recovery of the economies of many debt-burdened nations. A consequence of the international debt crisis and measures of the debtor countries to cope is that U.S. exports to developing countries have fallen significantly.

To strengthen the international monetary system during a difficult period of adjustment and to preserve the purchasing power of developing countries, the United States should take two initiatives:

1. Continue to support efforts of the International Monetary Fund to assist developing nations confronted with declining reserves and balance of payments difficulties. IMF assistance should continue to be conditioned on the adoption of appropriate adjustment policies. U.S. representatives to international financial institutions should encourage diversification of the economies of developing countries, seek project evaluation based on sound economic principles, and promote policies of developing countries to attract private capital investments, both foreign and domestic.

2. Exercise leadership in reducing trade barriers in the industrialized countries. Unless developing countries are able to find markets for their products, prospects are for a continued recession, resulting in reduced capacity to import U.S. goods and services, reduced income from U.S. investments in developing countries, and continued monetary instability in international financial markets. Accordingly, our government should press for a renewal of the Generalized System of Preferences with appropriate mechanisms to reward countries which remove import restrictions. In addition, the United States should consider further measures to expand the export of goods and services from the developing world, and encourage other industrialized countries to do the same. Developing countries, for their part, should recognize the need for inflows of foreign capital and the advantages of improving the investment climate in the Third World.

III

SUPPORTING U.S. EXPORTS AND FOREIGN INVESTMENT

The importance to U.S. business of foreign trade and investment is illustrated by three facts. First, U.S. export sales plus the sales of U.S. foreign affiliates amount to more than $900 billion annually; so that American products account for a very large share of world production. Second, the book value of U.S. foreign direct investment amounted to more than $220 billion in 1982, the annual income amounting to about $85 billion. Third, U.S. services, such as the banking, insurance, transportation, and construction industries, contribute about $50 billion of income from abroad to the U.S. economy. In order to maintain and improve this position overseas, American industry must stay competitive.

The Council welcomes initiatives by Congress and the Executive Branch to help increase American competitiveness. The proposed Foreign Sales Corporation export tax exemption, to replace the Domestic International Sales Corporation (DISC) export tax deferral; the Export Trading Company Act; President Reagan's 1983 statement of positive support for U.S. overseas investment; diplomatic negotiations for the removal of foreign trade and investment barriers; and programs to reduce our own regulatory disincentives are all examples of essential government support for international business.

However, much remains to be done, notably in such areas as fiscal and monetary policy, export financing, and promotion of research and development.

Trade Reorganization

Departments and agencies of the U.S. Government responsible for various aspects of international trade policy must work together as a team in establishing and carrying out a trade policy which is coherent, consistent, and supportive of U.S. international business. The initiative of the Congress and the Administration in 1983 to develop a plan for restructuring the trade functions of our government provides a timely opportunity to focus on how best to achieve such a policy.

The Council endorses the main objectives of the plan: to promote coordination and consistency in trade policy formulation; to combine in a single entity the development and the implementation of trade policy; to elevate trade expansion to a high priority national goal.

ive of services; identify institutional and statutory disincentives to services exports; and prepare corrective legislation when it is found needed.

The Council supports legislation such as the "International Trade and Investment Act" (S.144), passed by the Senate in 1983, which clarifies that barriers to services abroad can be dealt with under the retaliatory provisions of Section 301 of the Trade Act and provides specific objectives for international negotiations to eliminate such barriers.

Productivity and Industrial Policy

In the search for ways to enhance U.S. competitiveness, "industrial policy"—i.e., government direction of investment to or support for industrial sectors deemed in need of assistance—has been offered as a solution. Proponents of industrial policy point to increasingly strong competition from foreign producers and to the substantial roles which some foreign governments play in economic development. They argue that if the United States is to stay a strong competitor in the world marketplace, increased direct government intervention is essential.

While agreeing that changes in U.S. economic policy are necessary to stimulate economic growth and restore the competitiveness of U.S. industry, we reject the industrial policy prescription as formulated above.

First, we reaffirm our belief that private enterprise, operating in a free market, has done and will continue to do a better job of creating jobs, fostering economic growth, and raising the standard of living. It is the responsibility of management to increase the productivity of American industry. Improved competitiveness will depend on capital investment in modernized plant and equipment, increased commitment to quality production, more efficient production techniques, prompt application of new technology, and improved labor-management relations. These are the tasks of private enterprise, with a minimum of government intervention.

Second, the achievements of foreign governments in fostering industrial growth, particularly the government of Japan, are over-rated. Foreign government subsidization and support of domestic industries have often proved unsuccessful, sheltering domestic producers from competition and diverting resources to non-productive sectors.

Finally, and possibly most important, industrial policy would inevitably become distorted by the political process, with consequent misdirection of economic resources.

In summary, we believe that the operation of market forces will continue to provide the most efficient basis for sustained economic growth. The Council supports the Government's current emphasis on policies which encourage personal initiative, private enterprise, and a free marketplace.

The following actions are recommended to strengthen the U.S. economic environment and enhance the competitiveness of U.S. industry:

1. Encourage private capital investment in plant, equipment, and technology through policies which eliminate investment disincentives and promote investments in more efficient plant and equipment.

2. Foster technological innovation through policies to stimulate research and development and the commercial application of new technology.

The Council supports legislation to remove uncertainties about the antitrust implications of joint research ventures.

3. Support development of the nation's human resources through coherent and comprehensive programs for education and worker retraining, with special emphasis on training in technology.

International Personnel Issues

Since U.S. companies draw on a wide range of talents in order to remain competitive, the Council advocates elimination of impediments to the free flow across international borders of managerial and technical personnel.

To facilitate the employment of selected foreign nationals in the United States, there must be greater efficiency in the services of government agencies, particularly the U.S. Immigration and Naturalization Service. The Council supports reform of the Immigration and Nationality Act through amendments which reflect the realities of U.S. business, including an Independent Immigrant category for the effective transfer of professional and managerial staff, and the waiver of two-year foreign residency for foreign students. The Council will continue to press for appropriate legislative changes in 1984.

Social Security Agreements—Legislation enacted in 1977 allows the U.S. Social Security Administration to negotiate bilateral social security agreements with foreign countries. These eliminate duplicate contributions by expatriate employees and their company to the social security programs of two countries, and recognize covered employment for benefit purposes of those who permanently emigrate.

Only three bilateral agreements are now in force—with Italy, West Germany, and Switzerland. The Council will continue to urge the Administration to conclude negotiations with other foreign countries, thus saving unnecessary payroll costs and improving the competitive posture of U.S. companies.

IV

REDUCING DISINCENTIVES TO EXPORTS AND FOREIGN INVESTMENT

Over-regulation by our own government continues to dull the competitive edge of American business. The Council welcomes steps taken over the past year by Congress and the Administration to reduce disincentives to international trade and investment. Regulatory burdens remain, however: export controls should be modified; antibribery laws should be clarified; environmental standards should be reviewed for cost and benefit effectiveness; and the application of trade embargoes should be subject to a congressional review process.

Export Controls

Export controls imposed for foreign policy objectives should be used with restraint, and with due regard for a realistic balancing of their effectiveness as instruments of foreign policy and their adverse economic impact on U.S. business and indeed on U.S. foreign relations.

The Council strongly supports amendment of the Export Administration Act of 1979 to provide for effective consultation with business, Congress, and our allies before a decision is made to impose export controls, and opposes proposals to impose sanctions against imports. The economic impact of proposed sanctions should be thoroughly evaluated before decisions are made. For example, foreign availability should be appraised before a product is made subject to export controls; embargoes usually fail because other nations supply substitute products.

Existing contracts should be exempt from foreign policy controls, except in cases of genuine risk to national security.

Amendments to export control legislation which would restrict U.S. investments in South Africa would, in the Council's opinion, be counterproductive toward eliminating apartheid and would set a dangerous legislative precedent.

Extraterritoriality

The United States should exercise restraint in seeking to regulate conduct or persons in foreign countries. The extraterritorial application of U.S. antitrust, antiboycott, export control, and antibribery laws to persons and events in foreign countries is an affront to the sovereignty of other countries and may violate accepted international law. Where the conduct of a foreign entity is in a foreign country and is consistent with the law and policy of that country, the unilateral exercise of jurisdiction by the United States in an attempt to prohibit such conduct or prescribe sanctions following the conduct raises serious international legal questions. The application of U.S. law to foreign incorporated persons on the basis of ownership or control by U.S. persons finds no support in international law and should not be attempted. When there is a problem with such U.S.-owned or controlled foreign subsidiaries, the United States should seek the cooperation of the foreign government involved.

Foreign Corrupt Practices Act

The Foreign Corrupt Practices Act of 1977 (FCPA) impairs the conduct of proper business activities and contains numerous ambiguities which present unnecessary risks to American businessmen engaged in business overseas.

The core of the problem is the possibility of prosecution of an American company for illegal payments made by foreign third parties without the knowledge or consent of the American parent. While the Justice Department to date has not brought criminal proceedings against any businessman on the ground that he had "reason to know" that an illicit payment was being made to a foreign official, the retention of the "reason to know" concept in the statute continues to be troublesome. Any new antibribery legislation must establish a clear line of responsibility between actions controlled by an American parent company and actions initiated by a foreign agent.

V

AVOIDING PROTECTIONISM

If the worldwide appetite for protectionism is to be curbed, the United States must itself set an example of self-restraint. Adherence to the rule of law in international trade and avoidance of protectionist measures at home are essential to the preservation of an open international trading system.

Unfair Trade Practices

The United States should not sit passively, allowing foreign competitors to utilize unlawful trade practices to gain advantage in our open economy. Continued vigilance is needed to protect American industries against such unfair trade practices as subsidized or dumped imports.

The GATT rules, the U.S. Trade Act of 1974, and other U.S. laws provide the means for countering unfairly priced imports with countervailing duties and other measures. U.S. industry should not hesitate to use these laws in defense against unfair practices. If they are not enforced, protectionist pressures will mount.

Congress should proceed with its review of antidumping and countervailing duty provisions to determine whether present law provides adequate response. The United States should refrain, however, from writing or enforcing its laws with protectionist intent, or violating the letter or spirit of the GATT. Some sectors of our economy are pressing for enactment of highly restrictive local-content laws to protect major industries against low-priced foreign imports. The temptation should be resisted. A number of "Buy American" provisions are already incorporated in federal and State statutes. However strong the arguments for protecting local businesses, these laws set a precedent for foreign buy-local laws restricting American exports. The enactment of such measures should be avoided in the future.

Targeting

To combat forms of foreign government assistance for exports which are not addressed by the GATT or U.S. trade laws, proposals are being advanced in the Congress to expand U.S. trade laws to cover such practices as "targeting" by foreign governments.

While recognizing that foreign government industrial policies have caused dislocations in a number of sectors of the U.S. economy, the Council advocates caution in expanding the U.S. list of unfair trade practices subject to countervailing duties or other sanctions. Sweeping legislation against foreign government "targeting" practices would invite retaliatory actions and would identify as unfair "targeting" many U.S. practices to support exports and industrial growth. In addition, the new definitions of subsidization which have been proposed would be inconsistent with the GATT and would lead to major disputes with our trading partners. Not all foreign government export expansion initiatives constitute "targeting" against which the United States can or should legislate.

Disruptive Imports

The escape clause provisions of the Trade Act, providing relief from injury caused by import competition, should be employed judiciously. When import restrictive measures are imposed, they should be temporary and phased out in a reasonable manner. All actions should be explained to foreign governments, and their trade impact should be clearly identified. Protective measures should be used sparingly to permit adjustment and adaptation by industries unable to meet competition from imports, but not to preserve forever a non-competitive, non-strategic industry.

Instead, American business and government should mobilize efforts to increase productivity, reduce governmental restrictions on private enterprise, enforce U.S. exporters' rights in the face of foreign trade barriers, work for realistic foreign exchange rates, and otherwise strengthen America's competitive capability.

Adjustment Assistance

Expansion of the American economy should be the first line of defense against protectionism. A realistic, effective program of adjustment assistance to unemployed workers is a second line of defense. Such a program should devote the majority of its resources to worker education and retraining, rather than a system of supplementary unemployment compensation. The program should make no distinction between trade-related unemployment and unemployment due to other causes. Automation, changing consumer preferences, invention of new products, and many other factors must share the blame with foreign competition for unemployment in particular industries. A national reassessment of our educational and vocational training systems with special emphasis on mathematics and science has been advocated by many. We agree with the need for such a reassessment, to develop the human resources needed to match international competition.

DISC

As demonstrated in a series of public and private studies, the Domestic International Sales Corporation (DISC) provisions of federal tax law can be credited with a substantial volume of U.S. exports and export-related jobs. Moreover, DISC is necessary to offset the competitive advantage flowing to our trading partners from their own tax systems. For example, the use of territorial taxing concepts, the use of value-added tax systems, or the absence of U.S. Subpart F-type provisions may give significant tax-based advantages to foreign competitors.

DISC has been the subject of attack by a number of signatories to the General Agreement on Tariffs and Trade. The claim has been that DISC is an export subsidy prohibited by the GATT and the Subsidies Code. Although the United States has not conceded that DISC violates GATT, it has agreed to "address the concerns of our trading partners." If a replacement for DISC were to become necessary, a DISC substitute that provides equal benefits should be in place before DISC is discontinued. Further, income that has been deferred under DISC should be exempt from taxation.

The Administration has introduced a substitute for DISC, a proposed Foreign Sales Corporation (FSC) to provide partial tax exemption for offshore export sales. The Council supports the Administration efforts to provide DISC-type benefits that are compatible with the GATT and endorses the concept of the FSC as a reasonable framework for a DISC replacement.

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The fourth priority is to eliminate unnecessary Federal restrictions on the use of services and find more cost-effective techniques to achieve socioeconomic goals which are presently pursued through the procurement system.

Again, the recent report of the National Academy drew upon a broad range of public and private expertise and made a number of interesting comparative analyses. They found that there were these differences in examining private sector and Federal practices:

Greater flexibility in planning and buying in the private sector. Annual arrangements are not a rigid requirement.

High stress on creativity by the purchasing department, based on strong expertise in understanding the needs of the user and the characteristics of the market.

More innovation and risk-taking is permitted and encouraged in the private sector, without the Government tendency to write rules to correct every mistake.

And, finally, less loading of the procurement process with extraneous objectives.

A further important need is to provide for the opportunity to experiment in trying alternative ways to conduct Federal procurement of services.

Again, the report of the National Academy provides some good examples. I would just single out two:

Initiatives to try new procedures to simplify the procurement of highly professional and technical services.

And more discretion to agency heads to enhance productivity by avoiding time-consuming and expensive cost comparisons where a government commercial activity can be converted to private-sector performance.

We need to upgrade the Federal procurement work force dealing with private-sector contractors and redefine relationships between program officers and procurement officials.

We also need to deregulate contractor costs and make Federal agencies more accountable for their actions.

Finally, government attitudes toward the services sector need to be dramatically changed from one of antagonism to a more cooperative working partnership.

In summary, the acquisition of professional, technical, and management services is sufficiently unique, as compared to the acquisition of goods, that the Government should give immediate consideration to developing a guidance document on how Government can obtain the best results from the use of highly skilled sources of services outside the Government.

Recognizing the inherent difficulty of measuring objectively the value of ideas and information, the Government must emphasize quality of performance over cost in the narrow sense. It must have a trained and technically skilled work force capable of dealing with the emerging services economy.

My own hope would be that procurement officials could begin to operate more like venture capitalists. They need to search out the effective performers with growth plans and future potential, not just established firms. Procurement programs should not be designed in the field of services to encourage permanent dependency on the Government, though they do want to maintain access and use specific capable private sources of expertise over a sustained period of time.

Better use of the private-sector services by the Government through improved procurement techniques holds real promise for achieving important national goals in more cost-effective, productive ways.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Hostetler follows:]

PREPARED STATEMENT OF JAMES S. HOSTETLER

Mr. Chairman and Members of the Committee:

My name is James S. Hostetler and I appreciate this opportunity to appear before the Joint Economic Committee to discuss the dramatic shift of the United States economy to services, to consider how national procurement policies affect the services sector, and to recommend improvements in the present system.

I am a partner in the Washington, D.C. law firm of Chapman, Duff and Paul. In this capacity, I have represented organizations and firms in the professional, technical and management services field, with particular emphasis on Federal procurement issues.

In the first day of these hearings by the Joint Economic Committee, the fundamental shift of the economy to a services-based economy was presented and interpreted. A number of key policy issues affecting the new services economy were identified. One of the most important areas in which the government can make a difference is Federal procurement.

Before addressing this issue, some background information may be useful.

WHAT ARE SERVICES?

An Historic Focus

For many years a persistent current in economic thought has distinguished between goods and services on the basis that activities resulting in goods are "productive" while those resulting in services are "unproductive" and inferior. Adam Smith wrote

> The labour of a menial servant...adds nothing to the value of nothing...The labour of some of the most respectable orders in society is like that of menial servants, unproductive of any value, and does not fix or realise itself in any permanent subject or vendible commodity which endures after that labour is past...In the same class must be ranked...churchmen, lawyers, players, buffoons, musicians, opera singers, etc.

In today's world centered on high technology and services related to high technology, this view is outmoded, if indeed it ever was valid. Nevertheless, among Federal policymakers, there remains a pervasive failure to appreciate the significance of service producers to the economy and to an efficient, effective Federal government.

Difficult To Define

Certainly, some of the problem stems from the difficulty of defining services. They are intangible economic commodities produced for sale or distribution through the market mechanism or established governmental or nonprofit institutions. Services being intangible cannot be transported, stored and distributed the way a piece of hardware can -- they must be provided to the user as they are being produced (equipment repair, surgical operation, theatrical performance) or provided over a period of time (education, professional, technical and management services, health care, research and development). Thus, services are end products or products of intermediaries and the services sector represents a diverse array of industries each of which has its own unit of measurement (students educated, patients cared for, advice provided, information disseminated). While the costs of providing the service can usually be defined and data on costs developed, the benefits are often difficult to define in monetary terms and statistics and measures on productivity enhancement and benefits to the economy really do not exist in adequate form.

It may be helpful to classify services by their relationships to goods, since goods and services are often closely related. Certain goods are required for the production of most services, and vice versa. Based on a GATT Secretariat study, the relationships have been classified as follows:

> Category One: Services embodied in goods (e.g., motion picture films, sound recordings, books and computer tapes).
>
> Category Two: Services complementary to trade in goods (e.g., shipping, including port services, handling and storage; other transportation (air, rail, road, inland waterways) including handling, warehousing and storage at loading and delivery stations; insurance and reinsurance of cargo for fire, theft and similar risks; banking related to trade in goods such as the financing of imports and exports; brokerage, such as transport and insurance brokers; and advertising for products traded internationally).
>
> Category Three: Services that substitute for trade in goods -- (e.g., franchising, chartering, leasing, and repairs and maintenance).

<u>Category Four</u>: Services that are traded <u>without a relationship</u> with goods (e.g., banking, other than that related to trade in goods; professional services such as accounting, architectural, engineering, legal and medical; real estate; telecommunications, data processing and information services; and travel).

It is this last category -- services without a relationship to goods -- that will be the focus of my testimony this morning.

<u>Data Not Adequate</u>

Another reason for the general failure to recognize the significance and value of services is the absence of helpful data. The Standard Industrial Classification codes lump services into a few classifications. The Federal Procurement Data System provides little ability to identify diverse services provided under contracts. In fiscal year 1983, Federal procurement expenditures were over $175 billion. While almost half of this amount was expended primarily for services, we have few measures of the various types of services actually produced.

LEGISLATIVELY IMPOSED BARRIERS TO THE USE OF THE PRIVATE SERVICES ECONOMY

Difficulties in definition, inadequate data and an historical focus on goods have resulted in an ironic situation. The United States has been transformed to a services economy marked by dramatic, rapid and constant changes and improvements in technology. The government's need for these services planning of a procurement to award. While generalizations are risky, government on the average requires three times more time to make a procurement than the private sector -- and time is money.

WHY RESTRICTING GOVERNMENT ACCESS TO PRIVATE PROFESSIONAL, TECHNICAL AND MANAGEMENT SERVICES IS NOT SOUND NATIONAL POLICY

I do not suggest that government procurements can be in all respects as flexible and pragmatic as private sector procurements. Levels of funding are a legitimate concern at a time of high deficits. Waste, fraud and abuse are not to be tolerated. Yet, the very component of a program mission which can yield the most profound returns in terms of enhanced productivity, efficiencies and quality results should not be singled out for arbitrary cuts or limits.

In recent years, Congress itself has recognized the need for professional evaluations, analyses and studies to aid it in developing the information and insight required to monitor and refine Federal programs and program initiatives. Congressionally mandated studies range from evaluations of methods for reimbursing Federal health care costs to assessments of critical material and mineral needs related to national security. In the Budget Reconciliation Act for FY 1982, 38 special studies and analyses were required. Yet in the same legislation funds available for professional and technical services were reduced by $500 million without regard to overall program needs and expenditures.

Not only does the judicious use of private sector sources of professional, technical and management expertise provide the Congress with needed analyses and information, but agencies themselves have achieved immense savings in program operations and systems acquisition from private sources. Consider the following two examples from among many cited by the Department of Defense during recent Congressional testimony:

- A professional services firm formulated a lower cost, more survivable alternative to the AUTODIN II data communications network using state-of-the-art technology. Based on the contractor's findings, a full-scale review of the AUTODIN II program was directed to evaluate in detail the cost, security, survivability and effectiveness of AUTODIN II and the alternative concept. That option, now termed the Defense Data Network, was found to be more survivable and cost-effective than AUTODIN II, which was terminated. Ten-year cost-savings of $75 million are estimated. The cost of the study was $155,000, yielding a benefit-to-cost ratio of about 485 to 1.

- A contractor evaluated the feasibility of the potential savings and mission impact of consolidating duplicate base support functions in Panama. As a result of the methodology developed and its application to installations in Panama, the Defense Department estimates that 158 personnel positions and potential annual savings of $7.3 million may be realized when implementation is complete. In addition, as a result of the techniques and methodology developed under this particular contract, a standard methodology for conducting base support consolidations worldwide can be developed.

The fact is that expenditures for outside services as a matter of course pay for themselves many times over.

The Director of DOD Contract Studies and Management Support Services, in testifying before the Subcommittee on Defense of the House Committee on Appropriations, made this statement:

> The Department of Defense undertakes contract studies to provide a factual and analytic base for aiding in decision-making; to assess the effectiveness of existing policies, programs and practices; and to acquire new ideas and knowledge. The contract studies covered by these program elements influence almost every area of defense policy-making, planning, operations, acquisition, programming, and budgeting.
>
> Studies are performed by commercial firms, not-for-profit institutions, and universities to enable the Department to take advantage of: special areas of expertise which are neither available nor necessary on a full-time basis within the government; industrial and academic talent; and experienced professionals. Studies are initiated, approved, monitored, and reviewed by senior Department of Defense authorities to ensure the product is required, will be beneficial to their needs, and, upon completion, distributed as widely as possible to satisfy the needs of others, thus avoiding duplications.

The effective use of outside professional, technical and management services by defense and civilian agencies is critical to better government. These expert services assist Federal departments and agencies to

- Evaluate and improve operations or procedures.
- In the case of the military, validate requirements, tactics, strategy and doctrine, identify vulnerabilities, deficiencies or weaknesses in our forces and systems and those of our potential enemies so corrections can be made in the core of our forces and exploitation in the case of enemy forces.

- o Increase and improve effectiveness, efficiency, productivity or savings in the use of our resources.
- o Provide a rationale and priority for allocation of resources.
- o Acquire new ideas and knowledge.
- o Identify longer term issues and problems by examining key policy and program issues.
- o Analyze options and alternatives to support policy, program, budget, and acquisition decision-making.

In assessing the government's use of private sector services, it should be remembered that the process of assembling the best skills to engage in problem solving is, itself, of utmost importance. These outside services are an essential management tool in a modern government. Costly mistakes in procurement of costly and complex systems can often be avoided. Policy initiatives can be formulated with improved chances of success by the wise use of private expertise. Reasonable expenditures for outside services will pay a substantial return. In the case of many categories of services which lend themselves to clear comparisons of the relevant cost of performance by Federal employees and by private organizations, this substantial return is direct and easily measurable. During the first eight months of FY 1983, the Navy conducted cost comparisons of 190 different service functions involving 3,584 jobs. In 103 functions involving 2,362 jobs, the studies indicated savings exceeding $56 million over three years through commercial contracts for the services.

PROCUREMENT WORKFORCE

As procurements become more complex -- both from the procedural burdens imposed and from the sophistication of the services acquired -- the government finds it increasingly difficult to acquire and retain a first rate procurement staff.

The problem of low-graded low-status procurement professionals has been repeatedly addressed since the 1972 Report of the Commission on Government Procurement. Current problems faced by Federal agencies, which are restricted from recruiting entry level employees from outside the government for vacant procurement positions, make a sensible, efficient procurement system unattainable.

WHY NOT LEVERAGE PROCUREMENT EXPENDITURES?

One of the most important ways that national policy influences innovation and enterpreneurship is by means of government procurement. One industry which clearly owes much of its development to Federal purchasing is the electronics industry. Studies have shown that many new technologies owe their creation and early development to government contracts. Unfortunately, the process is mostly accidental. For example, until Congress enacted the Small Business Innovation Development Act, the critical area of Federal research and development contracts was left to established firms in the main. Many innovative smaller firms were largely ignored. Government has not shown itself able to relate consistently or effectively to new entrepreneurs or technologies in the services economy.

THE PROBLEM STATED

In short, when it comes to Federal understanding and use of the private services sector, the most dynamic and growing area of the economy, we find:

- o Seriously flawed or nonexistent data and information to guide Federal procurement policymaking.
- o An adversarial relationship between government and the private sector.
- o A highly regulated system of procuring these services, full of statutory and policy restrictions and complexities leading to delay and expense.
- o An inability to attract and retain talented Federal employees responsible for administering the system.
- o A failure to leverage substantial Federal procurement expenditures in ways that would strengthen the services sector and benefit the economy nationally and internationally.

In view of these facts, what can be done?

A PLAN TO IMPROVE FEDERAL ACCESS TO AND USE OF PRIVATE SECTOR SERVICES

Fortunately, over the last fifteen years, there has been an unprecedented effort to mount a meaningful procurement reform effort. Numerous studies have been conducted, hearings held and initiatives taken, including the Report of the Commission on Government Procurement in 1972, numerous

States, new laws and policies are needed to govern competition, both direct and indirect, among governmental units, nonprofit organizations and taxpaying businesses.

All major independent studies have strongly urged Congress to enact legislation mandating a national policy of reliance on the private sector. In this session of Congress, Senator Rudman has introduced a bill, S. 1746, which would accomplish this important goal. No final Congressional action appears likely this session, but every effort should be made to pursue this goal in 1985.

In the meantime, an existing OMB Circular A-76 recognizes as government policy reliance on the private sector for needed goods and services. This complex directive has enormous potential, but after years of trying, the Executive branch implementation of this policy has yielded modest returns. I am attaching two articles from the Government Executive which explain why. (Appendices A and B). Only a strong Congressional mandate holds promise of significant productivity gains under implementation of an improved policy.

Further, there is a need to reappraise whether the cost comparison concepts embodied in the present A-76 can be meaningfully applied to professional services. Since these services represent knowledge (ideas are the product), they logically should be treated like research and development, a specific form of professional service which is exempted from A-76. The quality of a service is what is most important. The reputation of the producer of the service should be a key component in the procurement transaction. To place proper emphasis on quality and reputation, a special guidance document which does not use cost comparison methodology should be developed. This guidance document should evolve new principles to acquire quality services in cost-effective ways.

3. Assess the Role of the Nonprofit Sector in Federal Procurement of Services and, at a Minimum, Eliminate Unfair Advantages

Since World War II there has been an explosive growth in the government's needs for skilled services. In meeting those needs, the government has turned without hesitation to nonprofit organizations as well as tax-paying organizations for assistance. It is no accident that during this same period there has been an explosive growth of nonprofit organizations. The Internal Revenue Service estimates that there were over 780,000 active nonprofit organizations as of June 30, 1983. It is remarkable that during the recent recession the private nonprofit sector added new employees in numbers exceeding 50 percent of those laid off by the profit-making sector during this same period. The source of this data is the highly respected Yale Institution for Social and Policy Studies. The Yale research also shows that average annual earnings of employees of nonprofit organizations during the decade from 1972-1982 grew 10.4

percent faster than the earnings of workers generally. These are extraordinary findings. Particularly important to note is that the mix in the nonprofit sector is changing with traditional "donative" nonprofits, such as the Salvation Army, which rely primarily on charitable contributions for their operating revenues, being replaced by so-called "commercial" nonprofits. These commercial nonprofits derive their income from the sales of services they produce. The table appended to this testimony (Appendix C) shows the trend in selected areas of service activity. To the extent that government subsidizes this commercial nonprofit competition through the corporate income tax exemption in the Internal Revenue Code, postal rate breaks, grants and an array of other benefits, it raises fundamental issues of equity.

Unfortunately, in turning to the commercial nonprofit sector, government has paid scant attention to formulating even-handed policies to assure that the competition is fair. In Federal procurement, there is no government-wide policy to assure that in evaluating the true cost of a nonprofit bid, its tax-favored status is taken into account. Recently, OMB for the first time recognized this inequity by modifying OMB Circular No. A-76 to take this factor into account in comparing the cost of a nonprofit bid with the government's cost for purposes of making a determination as to whether conversion to private sector performance is required. These same principles should be extended to all procurements by an appropriate amendment to the Federal Acquisition Regulation.

4. Eliminate Unnecessary Restrictions on the Use of Services and Find More Cost-Effective Techniques to Achieve Socio-Economic Goals

The recent report of the National Academy of Public Administration drew upon a broad range of public and private expertise. Particularly valuable was a comparison of private and federal practices. Virtually all experienced commentators stressed these differences.

- Greater flexibility in planning and buying in the private sector. Annual arrangements are not a rigid requirement.
- High stress on creativity by the purchasing department, based on strong expertise in understanding the needs of the user and the characteristics of the market.
- More innovation and risk-taking is permitted and encouraged in the private sector, without the government "tendency to write rules to correct every mistake."
- Less loading of the procurement process with extraneous objectives.

While the Executive branch and Congress have taken the lead in deregulating major sectors of the economy to gain the benefits of private sector efficiencies, they have added regulations in the Federal acquisition of services.

I have already summarized recent legislatively-imposed restrictions. The Executive branch has done its share to impose new regulations on the services sector. The Defense Department, for example, has extended the same detailed and burdensome procedural requirements imposed by OMB on "consulting" services to govern professional and management services. Included in these requirements is approval at the General or Flag officer level for procurement of professional services, management services, and special studies and analyses.

More generally, the recent report of the National Academy of Public Administration found 52 socio-economic statutory and regulatory requirements placed on the procurement process. The issues are not whether these goals are valid, but whether their method of application is efficient, economical and cost-effective; whether other means of meeting these objectives might be considered in lieu of contracts; and whether the original means and statutory ground rules need reassessment.

In addition then to stating a broad policy of reliance on the private sector and assuring a fair role for taxpaying services businesses as opposed to commercial nonprofits, the Congress should develop more cost-effective techniques to foster socio-economic programs through the procurement process and should carefully assess whether procurement of services might not be enhanced by fewer rather than more legislatively mandated or administratively imposed restrictions. I endorse the specific recommendations in the NAPA report.

5. <u>Provide for Extensive Experimentation for Alternative Ways to Conduct Federal Procurement of Services</u>

In shaping government procurement to use private sector services effectively, it is essential that tests and demonstrations on a broad scale be undertaken. These initiatives might include for example --

- New procedures to simplify the procurement of highly professional and technical services. For example, in the recently enacted Small Business Innovation Research Program 20 page limits on all proposals have worked well.
- More discretion to agency heads to enhance productivity by avoiding time consuming and expensive cost comparisons where a government commercial activity can be converted to private sector performance.
- New methods to foster socio-economic programs through procurement with comparative evaluations as to how they work.
- New ways to give the contractor a free hand to manage his project.

While the Office of Federal Procurement Policy in OMB has authority to develop and test innovative procedures, it cannot waive any provision of law to conduct an experimental program. This limitation sharply curtails the kind of bold innovations which are needed.

6. <u>Upgrade the Federal Procurement Workforce Dealing with Private Service Contractors and Redefine Relationships Between Program Officials and Procurement Officials</u>

Strenuous efforts are needed to fill vacancies and to correct deficiencies in the skills and responsibilities of the Federal procurement workforce, particularly in the civilian agencies. It is distressing that the Office of Personnel Management has not recognized this important need and provided leadership in attaining it. But it is not enough to replenish, upgrade and improve the procurement workforce.

There is a need to reconsider the working relationship between program officials desiring services and the procurement officials providing technical support. Unlike private sector employees, program officials desiring services are not responsible for the selection of the contractor, for administration of the contract or for the quality and ultimate usefulness of the contract deliverable. What accountability exists is dispersed among many people who should be advisors to the program official responsible for deciding that services are to be acquired.

It is extremely important in the acquisition of intangible property -- knowledge -- that the outside services source and the government client communicate. The government client must be able to assess the utility of the contractor's conclusions, and the contractor must be able to convey his or her results in terms the client can understand. When the task is not simply to inform, but to propose change and assist in its implementation, then an even more complex working relationship must evolve. To make this possible senior program officials involved in deciding what services are needed must also be responsible and strictly accountable for all contracting decisions. In procuring professional, technical and management services, agencies must be versed in the complexities of dealing with service procurements and the fact that expertise, quality and reputation will count for much more in terms of ultimate benefits to the government than pure per manhour of effort or, indeed, overall contract price.

If program officials are to be fully accountable, they must have broad discretion to specify services which are needed, how contractors are selected and what form the contracting relationship should take. Over-regulation of the selection process helps to avoid responsibility for selection decisions and the resulting contract performance.

7. Deregulate Contractor Costs and Make Federal Agencies More Accountable for their Actions

The government's regulation of contractor costs has discouraged cost-effective performance, diminished accountability of Federal employees, and developed an adversarial relationship between buyer and seller. The program official must be accountable for the price the government pays, but not for the contractor's internal cost operations. The Federal government not only must deregulate contractor costs, but also assume responsibility for its own actions. Currently, when the government breaches its contracts, a contractor must continue working, carrying the excess costs, and hope to recoup a portion of his expenses after months and years of claims and litigation. When the government withholds contract payments pending a final audit, which often is not conducted until three years later, the contractor often pays substantial interest on money borrowed to replace funds due from the government. As long as commercial contract rights and remedies do not apply to government contracts, Federal officials will avoid proper responsibility.

8. Change Government Attitudes Toward the Services Sector from a Negative Adversarial Approach to a Genuine Working Partnership

Both Congress and the Executive Branch all too often approach procurement of services with the attitude that the contractor may not do the best job and probably will be overpaid in the process. The system is adversarial in the extreme, with constant audits to be sure that nothing is amiss. This approach hardly builds confidence, promotes efficiency, or results in a timely undertaking. Contrast this government attitude with commercial practices. Buyers use suppliers of services in whom they have confidence. While progress is monitored, unless problems develop, the supplier of a service is given wide discretion to get the job done. When the service is performed well, there is an effort to establish a long-term relationship. There is much more of a shared effort to achieve a result. While the government market cannot be in all respects the same, every initiative to root out fraud, waste and abuse should be matched by an effort to create new forms of cooperation and facilitate service to the government by firms of all sizes. Our foreign competition can teach us how to do better -- we should try to emulate them more in this respect.

A Final Word

The acquisition of professional, technical and management services is sufficiently unique, as compared to the acquisition of goods, that the government should give immediate consideration to developing a guidance document on how government can obtain the best results from the use of highly skilled sources of services outside the government. Recognizing the inherent difficulty of measuring objectively the value of ideas and information, the government must emphasize quality of performance over cost in the narrow sense. It must have a trained and technically skilled procurement workforce capable in dealing with the emerging services economy. It must do better in evaluating the money savings, policy changes, better alternatives, and improved programs which flow from well-conceived and managed use of qualified private sector professional services organizations. Only then will government build a proper relationship and reliance on private sector services firms.

In the new services economy, procurement officials need to operate more like venture capitalists. They need to search out the effective performer with growth plans and future potential, not just the established firm. Procurement programs should not be designed in the field of professional services to encourage permanent dependency on the government, though maintaining access and using specific private sources of expertise over a sustained period

The next revision was made on October 18, 1976, after the Office of Federal Procurement Policy was created in OMB and became responsible for the Circular. It specified factors to be used for calculating the cost of Government fringe benefits, including a factor of 24.7% for Civil Service retirement. This new factor, compared to the 7% rate of agency contributions to the retirement fund (which had been used in cost comparisons), produced strong opposition from Federal employee groups as the Carter Administration was taking over the White House and OMB. Consequently, the Circular was revised again on June 13, 1977 to change the retirement cost factor temporarily to 14.7% while a thorough review of the Circular and cost comparison guidelines was conducted.

Following this review, and receipt of public comments on draft changes, the Circular was extensively revised on March 29, 1979. This revision transformed the policy of reliance on the private sector to a policy of relying on the least costly method of acquiring goods and services needed by the Government. It defined "governmental functions", which are to be performed only by Government personnel; prescribed criteria by which Government activities can be authorized without regard to cost; and directed that all other commercial activities be subjected to comparative cost analysis to determine whether they would be continued or converted to contract performance.

To support this dramatic shift to reliance on relative cost, OMB issued a comprehensive Cost Comparison Handbook, designed to ensure valid and equitable comparisons between the costs of Government and contract performance.

There were numerous other changes in the 1979 revision, most intended to impart "balance" to the guidelines in response to concerns expressed on behalf of affected Government employees.

- Agencies were encouraged to maximize efficiency of the Government activity before conducting a cost comparison,
- a cost differential was introduced favoring continuation of Government activities,
- estimates of every conceivable conversion cost were charged to the cost of contract performance,
- appeal procedures were established,
- successful contractors were required to give a right of first refusal of employment to displaced Government personnel, and
- cost comparisons were integrated into the procurement process to ensure that contract costs would be based on firm, enforceable bids or proposals, even though the Government cost remained a nonbinding estimate.

Outside of DOD, implementation of the new guidelines was disappointingly slow—agencies delayed for months, and even years, the issuance of implementing instructions and training of personnel to conduct cost comparisons. DOD, fully aware of the advantages of the program (from past experience) in saving money and personnel spaces, implemented the new procedures more rapidly. As initial cost studies were conducted and most of them resulted in conversions to contract performance, advocates of in-house performance discovered several loopholes in the implementing instructions which could be used to shift cost figures to favor Government performance. They also learned to structure work statements and contract terms to discourage contractors from bidding or to force them to include large contingencies in their bid that would inflate the cost of contract performance.

At the same time, Congress, under pressure from Federal employee constituents and other special interest groups, began to include exemptions from contracting out in authorizations and appropriation bills. DOD was prohibited from conducting any cost comparisons for the first half of FY-83, and prohibited from contracting for fire protection and security services for the entire year despite their estimate that this restriction would cost them $50 million in unnecessary costs. The General Services Administration was prohibited from contracting for guard or custodial services during FY-83, at a cost of $15 million to the taxpayers. Despite these unnecessary costs, Congress has extended the moratorium on contracting out fire protection and security services in DOD for two more years, and is in the process of extending or expanding the restrictions in GSA.

Government contractors and potential contractors, both large and small businesses, had been encouraged by the rhetoric of *Circular A-76* to compete for the needs of their Government, and had invested scarce capital and other resources in responding to solicitations for cost comparisons. They saw these resources wasted as cost figures were manipulated to protect in—house activities, and administrative appeals of improperties in the cost comparison process were summarily dismissed. Even more disheartening was the experience of those companies which won the contract competition, won cost comparison with the Government, and then were denied a contract award because of a provision in a statute that had just been passed by Congress.

It is not surprising that industry became frustrated and disillusioned with the implementation of *Circular A-76*.

Several minor revisions to the Circular in 1980 and 1982 were helpful, but could not correct the major deficiencies in implementation procedures. At this point, OMB undertook another extensive review and revision of *Circular A-76* and its cost comparison guidelines to try to restore credibility to the program.

This brief history brings us up to date, and to the most recent revision of *Circular A-76*. As usual, this occasion has prompted many Washington observers to comment on the changes made, usually without investing the time and effort necessary to analyze the new Circular and compare it to the 1979 edition which it replaces. Little can be determined from reading the Circular alone—the most significant provisions are found in Part I (Policy Implementation) and Part IV (Cost Comparison Handbook) of the Supplement; lengthy documents which discourage all but the most dedicated analysts.

It is amusing to see the complex changes that have been made in the implementation guidelines for this policy summarized by the media headlines as "OMB Makes it Easier for Agencies to Contract Out!" Actually, the extensive changes made in the Circular and its procedures in 1979 and 1983 have served primarily to *restrict* the authority of agencies to convert Government commercial activities to private sector contract performance. From the initial policy announcement in 1955 until March 29, 1979, *Circular A-76* and predecessor directives stated that it was the policy of the Government to rely on the private sector for commercially-available goods and services—any decision by an agency to contract out was consistent with the policy and required no further justification. All the restrictions were applied to Government competition with private sector—as an exception to the policy; an in-house commercial activity had to be justified on the basis of cost or one of the other specified criteria.

By comparison, consider the steps required today before an agency can convert a Government activity to contract performance:

(1) Determine whether the activity meets the Circular definition of a "governmental function"—if so, contract performance cannot be considered regardless of relative cost and efficiency.

(2) Determine (in the DOD, where approximately 80% of our Government commercial activities are found) whether or not performance by Government employees is required for national defense. DOD is still trying to develop criteria for rational and consistent determinations on this exemption, but has estimated that 75% of their commercial activities will be continued in-house in the name of national defense.

(3) Determine (in a Government hospital) if Government performance is in the best interests of patient care—if the agency medical director determines that it is, contract performance cannot be considered.

(4) Determine if there is a satisfactory commercial source available for the product or service—if the Government has been able to perpetuate a monopoly (such as production of helium), contract performance cannot be considered.

(5) Determine if commercial performance would result in an unacceptable delay in delivery of the product or service—if so, contract performance cannot be considered.

(6) Determine if contract performance would result in sufficient cost savings to justify conversion to contract performance. This requires:

• Preparation of a performance-oriented work statement for the activity, and a management study to determine the most efficient method of Government performance.

• Development of an estimate of the cost of most efficient Government performance, and solicitation of competitive bids or proposals for contract performance.

• Comparison of the cost of Government performance with the cost of contract performance, including the cost of contract administration and all conversion costs.

(7) Award a contract if the total cost of contract performance is less than Government costs by 10% of the Government personnel cost; otherwise cancel the solicitation and continue the Government activity.

Circumstances under which contracts can be awarded without the cost comparison are very limited; the other tests cannot be by-passed. An agency *may* convert an activity to contract without a cost study if:

• the activity involves fewer than 10 full-time equivalent employees,

• the contract will be awarded under a preferential procurement program (such as small business, Federal Prison Industries, handicapped workshops, etc.), or

• the agency has a documented basis for assuming that contract performance will be less costly; such as the GSA experience which shows that the cost of contract custodial services is consistently lower, by 50%, than in-house performance.

Considering the failure of agencies to convert any significant number of Government commercial activities to contract performance during the twenty-four istration published an elaborate 90-page handbook to give the cost comparison technique a facade of legitimacy and to overwhelm objections to its validity or ultimate purpose. The disastrous results it could produce have seldom been challenged.

But first, what is the potential use of this new cost comparison tool? In Defense alone there are 15,000 commercial and industrial activities spending $17 billion a year. And, the Armed Services Committees have made cost comparisons a matter of law. So Defense cannot, as some agencies are doing, ignore cost comparisons. Almost half the cost comparisons made to date under the new circular favor in-house retention.

When the Federal Government competes against its own citizens (using their money no less) many significant and long lasting detrimental effects are inevitable. Here are some of the more glaring errors and paradoxical results of utilizing the new *A-76* guidelines.

- Cost comparisons alone are too narrow for decision-making because a sound business choice must also consider quality, reliability, timely delivery, and flexibility to meet changing demand.
- Cost comparisons themselves are unreliable. Government accounting systems are not designed for business activities and do not enable true cost comparison with private firms. Secondly, there can never be an equal understanding between the ongoing in-house operations and interested private firms about the specific work to be done and the required standards of performance.
- Cost comparisons do not reflect long-term considerations. For example, they penalize the private firm for startup cost although it is a one-time occurrence.
- Cost comparisons do not recognize the absence, on the Government side, of incentives to take risks, innovate, adapt to new technology, and cut costs. There is neither carrot nor stick to motivate in-house activities.
- Cost comparisons ignore the painful fact that each in-house business shrinks the tax base and shifts the tax load to others. Private firms pay various local, State, and Federal taxes; Government entities do not. One supports the tax base; the other burdens it.
- Cost comparisons ignore accountability. If the in-house business activity does not satisfy its captive Government customers or, if it performs at a loss, there is no recourse for the immediate and pain consequences that face the private sector firm.
- Cost comparisons contribute to a longstanding Government/industry adversarial relationship—they tend to exacerbate conflict between Government and its citizens engaged in private enterprise.
- Cost comparisons strain the Government's already damaged credibility. How can the Government claim to favor a private-enterprise policy but threaten contractors with frequent in-house cost comparisons? How can the same agency (1) decide to conduct business activities in-house, (2) structure cost comparisons with private firms, and (3) then act as a fair judge of these "paper" competitions?
- Finally, applying the new 90-page cost handbook in all its excruciating detail across all Government agencies plus resolving conflicts, contractor protests, congressional inquiries, GAO reports, etc., represents a serious drain on limited agency resources.

In the long term, Federal in-house business activities, like other monopolies, are not geared to emulate innovative firms in the open marketplace in terms of cost, responsiveness, and product improvement. This fundamental characteristic of private business has helped to sustain this country as a unique economic force. To use a simplistic cost justification tool is short sighted, ultimately destructive and does not make either good sense or cents.

The fatal misstep by the Carter Administration (the OMB Office of Federal Procurement Policy) was the attempt to balance *A-76* politically; that is, to develop implementing procedures pleasing to both private industry and Federal Employee Unions. Attempting to balance them is self deluding. Nonetheless, the result was to give our highest policy makers a crutch. Now, faced with constituent pressure Congressmen do not have to choose between private enterprise and Federal Employee Unions—they can just let the cost comparisons and all those who administer them take the heat.

In the early 70's, Congressional, Executive and private sector members of the Commission on Government Procurement—despite all their differences—reached a consensus in one basic area:

- **That a clear national policy statement was needed in law.**
- **That this policy should state a basic reliance on the private enterprise system wherever reasonable prices are available.**

If the Congress adopted this simple straightforward policy, it would be easy to implement. Each agency's procurement system, in its market research function, could simply identify business activities transferrable to a functioning commercial marketplace. The Commission's "reasonable price" requirement would be satisfied and Federal policy held consistent. Exceptions would be legitimate Government functions (such as printing money) or maintenance of a core capability if the particular product or service is critical to the agency's direct mission performance.

For in-house operations without a functioning commercial marketplace the above analysis would not be automatically to stay in-house. Instead, whenever possible, a viable, competitive market should be developed by the affected agency. The newly developed private capability will, with the many aforementioned benefits, always be preferable to in-house retention. This issue is a key to the overall policy's implementation; it precludes the normal preference for the "status quo"; and it requires positive action to overcome common place inertia and develop competitive sources.

With the increasing size of Federal, State, and local governments, about one-fifth of the nation's workforce, and thus a large part of the voting public, are now government employees. Because of their number, these Government employees are a political force. Thus there is an urgent need for a stable national policy, embodied in law, which can be constantly referred to in response to pressure groups from both sides, and which does not vary from one Administration to the next.

In summary, the current policy to justify cost comparisons of in-house with private business operations: (1) violates a basic tenet upon which our country was founded; (2) uses as its rationale a tool which is itself inaccurate, incomplete, shortsighted and otherwise innocent of value; and (3) produces progressively detrimental economic conditions.

If the Reagan Administration expects to make real progress in this field, the Executive and the Congress must get back to basics. To resolve this longstanding problem all they need to do is to establish a clear policy that *simply* and *briefly* states a reliance on the private sector when reasonable prices are available, and establish temporary management teams in the larger agencies to oversee an orderly transition of in-house activities to the private sector.

If savings on past transitions hold up (about 20%), the potential government-wide cost reduction is $6 billion plus a healthy expansion of the tax base and revenues.

three years for those DOD functions converted to contract in FY '79 and FY '80.

The consensus of views from many in industry and Government is that the Government is not standing by its own policy of "reliance on the competitive private sector to supply the products and services needed by the Government" (found on page 93 of the President's Budget Revisions for FY 1982). The real question is "Who is competing with whom?" or "Is the Government in the throes of becoming a big business in competition with the private sector?"

William Russell, former member of the Commission on Government Procurement and former Deputy Assistant at OFPP (responsible for implementation of the Circular) explains that, historically, the policy points to private sector reliance as far back as 1955. "Despite this strong expression of policy and recognition of the importance of private enterprise in maintaining our economic strength, the 1979 revised circular then goes on to provide detailed guidelines for cost competition between agencies and the private sector."

Now Vice-President of Government Relations at RCA's Service Company Division, Russell explains that the dicotomy between Administrations developed as a result of the failure of prior directives to effectively implement the policy. "Although a strong philosophical and economic rationale can be presented for the premise that reliance on competitive contract performance is more economical than use of sole source Government activities, opponents of the policy have contended that direct Government operations are less costly and therefore, in the national interest."

Burt Hall, also a former staff member of the Commission on Federal Procurement and a Group Director with GAO's General Government Division thinks the problems with the policy are compounded by the fact that "for the past 50 years the Congress, several Federal Commissions and various Administrations (Republican and Democrat) have taken widely divergent positions about the extent to which Federal activities should legitimately duplicate or substitute for similar private sector activities." Hall thinks since the issuance of the policy in the 50's, subsequent revisions have weakened it. Among these: cost comparisons (which he says are exceptions to the policy), administrative complexities and burdensome paperwork requirements.

Another view from former Administrator of OFPP Hugh Witt (now Vice President/Government Liaison with United Technology) reiterates this concept, "I naturally was disappointed when the rewritten *A-76* policy was held up a year while the Carter people took their own look at the contracting-out issue. Needless to say I felt vindicated when their version came very close to the one I had issued. This vacillation is typical of the treatment the basic policy has received over the years. It is one reason why very few Government employees feel they have to take *A-76* very seriously."

Edwin Geesey, whose views on management problems are outlined later in the article, thinks the "chaotic administration" of the program is due to the lack of attention to planning the entire three to five year effort covering all commercial and industrial functions. This planning is designed to facilitate optimum productivity and performance, regardless of the comparative outcome. "The resulting fragmentation of services into small or unrelated solicitations very often works against the objectives of productivity enhancements and savings resulting from the economies of scale," he adds.

One of the prevalent problems associated with the implementation of the policy is that "Congress has not yet stepped up to the problem," explains Burt Hall. In agreement is Russell Richardson, of the Committee on Contracting Out (a coalition whose sole intent is contracting out the Federal requirements for goods and services). To Richardson, who voices his independent views on the improper application of the policy, Congress is "the single most critical obstacle."

"For years it has evaded or thrown back attempts by various Administrations to curtail or eliminate inefficient and costly functions. Despite Congressional bromides offered to rationalize these actions, the fact remains that our legislature operates as a tight fraternal organization. Federal procurement actions have wide political implications both real and perceived. Too many decisions are made for the benefit of local constituencies on the basis of 'I'll vote to protect the Federal jobs at your Base 'X' because I know you'll remember it when I need Federal funds for a dam in my State or district.'"

What Richardson points out is that Congressional circles love to cry "waste and fraud" and hang their claims on the Government procurement process implying that the crooks come from the private sector. "The truth is that you rarely have a bad contract or misconduct between the Government and a contractor without the involvement of misconduct, bad judgement, inadequate control or other elements on the part of the responsible Government employees, procurement specialists and monitors. Yet it remains popular in Congress to criticize the mechanisms and extol the virtues of legislative solutions." He calls it "legislative erosion" or Congress' fundamental ambivalence with respect to supporting corrective actions needed to give the policy teeth. To Richardson, discipline, not rules, are needed.

Government Unions' Clout

Russell Richardson fears that 1981 is already showing signs of "a further rash of those legislative initiatives which promise utopian solutions, but too often mask an intention to maintain the status quo, or worse, in deference to the strong political pressures applied by the Federal employees and their unions" and he hopes the Republican mood may indicate "an intolerance to the use of Federal procurements as pawns on political chessboards."

Burt Hall lists five reasons why executive agencies and policymakers are biased toward continuing and/or expanding in-house activities: (1) all the people involved in the activity in question are deciding whether it should continue (2) to justify their existence and enhance appreciation, the Government employees have long fostered a distrust of private sector willingness or capability to produce at a reasonable price (3) substantial, wide ranging power bases are filled with people who naturally want to keep their positions or influence (4) action entailing confrontation and considerable effort is hardly preferable to tranquility and leaving things as they are and finally (5) Congressional considerations of this issue have suffered from giving undue attention to the self-serving arguments of labor unions and other special interest groups favoring in-house activities under the guise of Federal worker welfare.

Russell Richardson cites an industry study, based on Government published data for the years 1965 through 1976 in which Federal purchases for goods and services as a percent of the total Federal budget dropped from 53% in 1965 to 34% in 1976—a reduction of 19%. During this same period the Federal workforce remained stable or flourished.

His concern is for the taxpayer who, he says has been badly served over the past several decades. "It is evident when the 19% reduction is factored by the billions of dollars involved and the lack of real competition, the impregnable job security of Federal employees, and the built-in inability of Government to generate motivation approaching that of the profit and loss statements of industry" he adds.

Edwin Geesey thinks the problem the agencies are having implementing the policy stems from a lack of dedication by top management and a lack

Senator JEPSEN. Now Mr. Dwight Ink, chairman of the Special Panel on Revitalization of Federal Management, National Academy of Public Administration.

Your prepared statement will be entered into the record as if read. You may proceed in any way you desire.

STATEMENT OF DWIGHT INK, CHAIRMAN, SPECIAL PANEL ON REVITALIZATION OF FEDERAL MANAGEMENT, NATIONAL ACADEMY OF PUBLIC ADMINISTRATION, WASHINGTON, DC

Mr. INK. Thank you, Mr. Chairman. What I would like to do is read portions of the testimony.

The effectiveness of Federal procurement systems is very significant when one realizes that taxpayer funds spent through contracts is increasing very rapidly, from about $57.5 billion in 1972 to, as Mr. Hostetler has indicated, about $175 billion today, close to one-fourth of the total Federal budget.

He outlined the Academy findings on the difference between private and Federal contracting. I would like to comment briefly, Mr. Chairman, on several of the principal findings of the Academy regarding the causes of the problems, the causes of the differences to which he alluded. And I would like to request, Mr. Chairman, that consideration be given to introducing the report of the Academy for the record in these hearings.

Senator JEPSEN. It will be entered into the record.

[The report of the Academy referred to follows:]

Revitalizing Federal Management: managers and their overburdened systems

An assessment of how excessive controls constrain Federal managers.

A panel report of the
National Academy of Public Administration

November, 1983

Preface

What can be said to the opinion makers of America to persuade them that the functions of the Federal government—the personnel and procurement and budgeting and printing operations, to cite four examples—warrant the same intense scrutiny that editorial writers and think tanks and corporate strategists and others devote to issues of public policy?

Over a year ago, several Members of the National Academy shared with a few Federal officials responsible for departmental management their concerns that cumbersome and overgrown Federal management procedures are increasingly interfering with effective government action. They concluded that, while efforts are underway to reduce the role of government and make major cuts in Federal personnel and budgets, the time is ripe to begin a parallel drive to get rid of burdensome procedures and thus reduce unnecessary and hidden costs. Subsequently, eleven Assistant Secretaries for Administration and five of their counterparts from the independent agencies organized themselves as a special Council and contracted with the National Academy to conduct a study of major administrative burdens on the Federal manager and to make recommendations that would simplify administration, encourage more effective management, and preserve accountability and consistency. A Panel of nine members and friends of the National Academy conducted the study, which was administered for the Council by the Department of Transportation.

The National Academy's panelists selected the specific topics for careful study on the basis of their own experience in public service and of extensive interviews inside the participating agencies. Staff reports on each of nine topics were distributed to the participating agencies, to the central management agencies (OMB, OPM, and GSA), and to the appropriate Congressional committees. The nine topical reports concern:

(1) Procurement
(2) Personnel Management
(3) Budget Process
(4) Personnel Ceilings
(5) Information Processing Technology
(6) Travel Management
(7) Building Space Acquisition and Management
(8) Printing
(9) Property Management

This final report, *Revitalizing Federal Management: Managers and Their Overburdened Systems*, summarizes the nine topical reports and goes further with the Panel's specific recommendations on what is needed to achieve fundamental changes in managerial philosophy and practice in the Federal government.

I want to thank the National Academy's panelists for their work on this project and, in particular, to recognize the special efforts of the Panel Chairman, Dwight Ink, and other panel members and staff who "volunteered" above and beyond the norm. My thanks to these panelists are for more than their hard work; their report, *Revitalizing Federal Management*, will be a central part of the National Academy's escalating efforts to focus executive and legislative branch attention on the operations of the Federal government.

J. Jackson Walter
President

Foreword

One of the important messages which the American public is striving to convey to its leaders at all levels of government is that somehow governments must be less costly and deliver better results.

Many people—especially those running for office—argue that the principal fault must lie with the entrenched bureaucrats who are perceived as slow moving, resistant to new leadership, and more interested in preserving a complex bureaucracy than in streamlining government.

What is bitterly ironic is the fact that Federal managers, both political and career, typically regard themselves as captives of a series of cumbersome internal management "systems" which they do not control. These systems have tended to become so rigid, stultifying, and burdened with red tape that, in the view of these managers, their capacity to serve the public on a responsive and low-cost basis is seriously undermined. The Panel fully agrees with the government managers' assessment of the difficulty of administering programs under current conditions. Managers in the private sector are not so constrained.

Every substantial organization needs systems and procedures to organize and direct its activities. But, over many years, government has become entwined in elaborate management control systems and the accretion of progressively more detailed administrative procedures, often heavily centralized. This development has not produced superior management. Instead, it has produced managerial overburden, barriers to the responsiveness of government, and a tendency to drive up the cost of government as agencies press for more staff and office space and computers to keep up with this volume of redtape. The individual Federal manager now must cope with thousands of pages of procurement, personnel, fiscal, and other regulations over which he has little or no control.

Many of the restraints and regulatory requirements which now make it so difficult for Federal managers to function have their origin in commendable efforts to prevent or control waste, abuse of authority, or corruption. Others are designed to make management actions and processes also serve government objectives of a social or economic character. Unfortunately the cumulative impact of an ever increasing number of procedures, findings, appeals, and notifications is to jeopardize the effective execution of the basic programs which the managers have been charged with carrying out. Moreover, regulatory requirements, once adopted, tend to be retained long after they have ceased to make any constructive contribution to program management.

As these administrative systems have evolved in the Federal government, they have increasingly been used to control or regulate some piece of the process and have become less useful as tools for the manager on the firing line. And, as the systems have become "locked in" by statute, regulation, and precedent, they have become rigid and very difficult to change. In contrast, far more emphasis has been given in the private sector to the decentralization of responsibility and leadership in combination with central guidelines and evaluation.

When lost in procedural quagmires, the administrative process loses much of its intended meaning. Procedures overwhelm substance. Organizations become discredited, along with their employees.

Another distressing consequence of this overburden is that government managers feel a frustrating loss of relevance and control. Thousands of dedicated men and women who should be the government's greatest resource for excellence and innovation feel they are cogs in some "system" which neglects their true management needs and which they individually cannot change. More and more of their time is spent in coping with the process or defending against criticisms of specific flaws or failures in the execution of thousands of detailed processes. Because there are many times more details than a manager can cope with personally, there has grown up an unhealthy reliance on these systems and the technical experts who operate them.

The Panel believes that the negative impact of this Federal internal redtape on the capacity of managers to manage has reached serious proportions.

The true cost of administrative redtape is impossible to express in dollars and cents. First is the obvious slowing of governmental action. There is the resultant pressure for more staff to keep up with the workload. More and more oversight regulations and mechanisms are put in place to monitor the processes. Professional managers and their employees become frustrated, and the career service has greater difficulty in attracting and retaining able men and women. Accountability for programs and expenditures becomes diffused. The impact of the voter is weakened by this confused accountability and the public is the ultimate loser in this process.

This report addresses a part of the total pattern of the Federal government about which both the political and career leaders agree—that the internal management processes of the Federal government have become so complex and rigid they must be changed. Most of the past studies

This report deals in its various sections with problems of overburden and obsolescence which now plague the budget process, the Federal personnel system, the procurement/acquisition system, and procedures for managing computers, real property, supply and equipment services, printing, and travel. Each of these management systems has its own problems, but all are part of a total framework of management principles and doctrine which heavily influences how the Federal government manages its affairs. The major premise which generated this study was the belief, shared by a broad spectrum of Federal managers, that Federal management systems are now overregulated in the sense that, by accretion, each has acquired an overburden of controls, limitations and constraints, reviews and approvals, data requirements, and other mandates, which, in total, significantly reduce their value and effectiveness. In this process of accretion we have been losing sight of the fact that these systems are not ends in themselves but exist to serve their more important purpose as tools for managing Federal programs.

"The ultimate consequence of neglect is not simply to make the lives of bureaucrats more difficult. Instead, the delivery of Federal programs becomes . . . more costly and less effective."

This report is not the documentation of crisis. None of the major management systems of government is about to collapse. But it is a diagnosis of the consequences of neglect and indifference, both of Federal managers and of the systems which control them.

The systems of government are becoming obsolete or falling into disrepair faster than we currently know how to fix them. The ultimate consequence of such neglect is not simply to make the lives of bureaucrats more difficult. Instead, the delivery of Federal programs becomes slower, less responsive, more costly, and less effective. Waste, mismanagement, and even fraud becomes more evident. Where systems become dysfunctional—where they become difficulties to be overcome rather than aids to help managers manage more effectively—then professionalism of the public service is eroded and some people turn passive and indifferent.

How has this condition of overburden and internal overregulation come about? What needs to be understood before the right kinds of corrective measures can be identified? How should overall systems concepts and processes be changed?

Loss of Managerial Control

The term "manager" as used in this report is intended to refer to those officials who are delegated authority to direct Federal activities, commit the government to actions, obligate and expend public funds, and supervise the workforce. Of necessity it includes Cabinet Secretaries and other agency heads, and it also includes several thousand other political and career people who serve as executives, managers, and staff directors, most of whom function under specific delegations of authority from their own agency heads.

The term "management systems" is a general term which applies to a range of formally defined techniques to be used by managers in carrying out their broader management authority. The sponsors of this report chose for detailed assessment the budget, procurement, personnel, information management, real and personal property, printing and travel systems because of their importance as management tools and the belief that they typify what is good or bad about the quality of Federal management overall.

The main sources of formal authority in government flow from laws and from the delegation of Presidential authority. These authorities normally are given to an agency head, who is held accountable both to the President and Congress for running his/her agency and properly carrying out its business. This vesting of authority is extremely important in a government of separated powers, and indeed every statute, Executive Order, and regulation must clearly state what authority officials are empowered to exercise.

Many such statements are general in character since they rely on the principle that agency heads should be given sufficient latitude to exercise their discretion and judgment in the management of their organizations.

A longstanding counterpoint to the granting of authority is the concern about accountability. Government officials are considered to have a special obligation to account for the manner in which they exercise their public powers and spend public funds, and thus statutes, Executive Orders, and regulations also usually attempt to define how and to whom this accountability must be rendered.

Thus, a careful formal structuring of authority and responsibility through a legally mandated framework of statute and regulation has become one of the fundamental characteristics of government. This principle has been carried through into the further implementation of Federal management systems, but in this context formality and structure come into conflict with the reality of what is needed to achieve excellent and cost-effective management.

"The greater the number of procedural requirements to be met, and the greater number of people who are involved in any action, the less a manager can be held accountable for an action.

The Panel of the National Academy of Public Administration found that, although these systems vary substantially in purpose and mechanics, they shared many common characteristics and general conclusions can be formulated about them. These conclusions are profoundly disturbing. The Panel came to feel that the evolution of the development and use of these systems over many years has resulted in excessive procedures, thus creating a serious impairment in the exercise of general management authority throughout the Federal establishment. In fact, *the Panel believes that the whole focus of the government's institutional apparatus for management is pointed in the wrong direction and urgently needs rethinking and redirection.* As management systems have developed, they have caused a loss of authority and control and have confused and vitiated the capacity of managers to carry out their main lines of delegated authority. In the process, management systems have all too often become generators of, or major contributors to, the overregulation and overburden of the managers role. The greater the number of procedural requirements to be met and the greater the number of people who have to be involved in any action, the less a manager can be held accountable for an action.

How Management Systems Weaken Management

What is most difficult for many people to understand is that *management systems are not management.* Such systems are tools for the use of managers, and in some cases, may help prevent bad management, but they cannot themselves create good management any more than a box full of expensive tools guarantees good craftsmanship. The major thesis of this report is that the most important and most effective way to achieve better management in government is to improve the performance of its managers and that to a large extent management systems not only fail to meet this test, but in fact have become dysfunctional from the manager's point of view. Following are the principal constituents of this thesis.

- *The design and control of management systems are too centralized, either within agencies or in the central agencies (OMB, OPM, GSA).* A large proportion of the issues and problems which this study identified center around this theme. For many reasons, the trend of recent years has been in the direction of greater centralism—that is, the concept that each system must be centrally defined and mandated by one of the central agencies for governmentwide use and then centrally enforced, with changes centrally controlled. Management failures often do not result in attempts to correct management problems, but in new legislation or regulation placing new restrictions or requirements on all agencies.

  This system does have advantages. It achieves a high order of uniformity and consistency of interpretation, and Presidents and Congresses have tended to regard central systems as easier to understand and hold accountable. Central agencies have often worked hard to exercise their stewardship in responsible ways.

  But the overwhelming view of managers is that centralism contributes to an overvaluing of the system itself at the expense of its usefulness to managers. Each system has its powerful central agency sponsor and defender, and each becomes the subject of laws and regulations which vest it with great authority. There is no comparable process at work which defends and guards the role of the operational manager. Governmentwide uniformity becomes a stronger motivation than flexibility. The use of systems as instruments of central control overpowers the need to delegate authority into the hands of the line manager. And equity (the concept that all actions must be handled in the same way) obscures the fact that management responsibilities differ vastly across government and could benefit greatly from flexible, adaptive systems.
- *Systems are too negative and constraining.* Federal management systems tend to be regulatory and proscriptive, to deal with process rather than substance, and to preclude deviations and flexibity. They are constructed to preclude certain bad management practices and not necessarily to foster good management. They employ essentially negative devices of constraint, regulation, compliance, inspection, review, etc.
- *Excessive checks and balances become counterproductive.* Checks and balances are essential in our form of government, and there have been enough examples of abuse of power to make this clear. The question, therefore, is not whether they are needed, but how much of such protection is required and how it can be brought to bear without impairing effectiveness. The Panel believes that the accumulation of such protections has, in total, become excessive and has often been represented as the answer to poor management in situations where the emphasis should more realistically have been placed on strengthening management. Highly cumbersome systems generate counterefforts to end run or circumvent them, or worse, to manipulate them, thus increasing the very abuses they are intended to curb.

  Client interests seek to lock in practices which they prefer and exclude alternatives. The technical masters of each system display a normal tendency to perfect their own product. Any single action may be justified in itself, but the cumulative effect has been to create systems which heavily constrain the capacity to manage.

"Systems have become sources of power, and efforts to change them become struggles for creation or transfer of power."

- *Systems are too rigid.* Systems have become sources of power, and efforts to change them become struggles for the creation and transfer of power. In the face of these conditions, attempts to change governmentwide systems have become highly complex efforts to negotiate consensus among conflicting internal interests. And, because most programs have major impact outside of government with client groups, state/local governments, contractors, and individual citizens, further broader consensus is often needed with these interests and usually with Congress as well. But, in fact, it has become almost impossible to negotiate change. Management systems issues lack a natural constituency in political terms, and even inside government, reform efforts are not popular. Even comparatively modest changes are beyond the managers' authority, and major investments of effort and political capital are required. Where central agencies are unwilling or unable to lead such efforts or where change efforts fail, management systems have experienced protracted periods of neglect and potential obsolesence.

- *Management systems are too "expensive."* Strong central systems become very demanding in terms of the people needed to run them and the paperwork requirements they impose on their users. They also require too much servicing and maintenance. The greatest cost, which is impossible to measure, the indirect cost of adverse impact on effective program operations.

The Top Priority: Restoring the Role of the Manager

The easy conclusion to draw from this diagnosis of management systems problems is that better and more extensive effort is needed to reform them and make them more effective. This report in fact draws that conclusion, and most of the recommendations in subsequent chapters are aimed at achieving that purpose. But a second, more serious, and more important conclusion to be drawn, which deals not with systems themselves but with managers, is stated as follows: *The major causes of the widely perceived decline in Federal management center not around systems or policy but around adverse impacts on people. In the context of this study, the people most concerned are line and staff managers, and the net effect of the overburden and overregulation which this report describes has been to seriously impair the tools with which they are equipped to do their jobs, the managerial flexibility they are permitted, and their motivations for high performance.*

"As systems have become dominant and controlling, managers have lost a vital capacity to adjust to what has been a very dynamic political and societal environment."

This report is full of examples of this kind of system frustration. The budget process, for example, is notorious for making major changes in programs or management responsiblities and then failing utterly to recognize the collateral changes needed in management funds or personnel to implement those changes. Program directors may make important grant or contract decisions only to see months pass while these actions languish in complex procurement or grant-making procedural pipelines. Huge backlogs of claims or appeals stack up in in-boxes because of detailed, complicated administrative procedures, inadequate workforces, and obsolete data-handling equipment. Managers who are trusted to sign off on multimillion dollar grants and contracts are not trusted to approve $100 travel vouchers for their staff. Managers who supervise hundreds or thousands of employees are not considered capable of selecting their own people. Field staffs who manage important programs are considered incompetent to judge what office space they require.

The general governmentwide preoccupation with big management control systems has forced managers into that same preoccupation, and far too great a proportion of the managers' time and energy is spent on attempting to cope with literally thousands of pages of the detailed "nitty-gritty" of these procedures. Managers clearly are not fully in charge because often systems are in control. The power to act and decide is broken up and diffused. Managers cannot be held fully accountable for their programs because important authorities are locked into external procedures which must be obeyed. As systems have become dominant and controlling, individual managers have lost a vital capacity to adjust to what has been a very dynamic political and societal environment. Instead of being responsive to client needs, they must defend the status quo or send urgent appeals for change up long tortuous staff channels to remote central agencies. Thus, where too much authority is taken away from the government's managers and lodged in externally controlled systems, a critical dimension of the effectiveness of those managers is lost. Both employees and outsiders see them as ineffective, and managers themselves lose motivation for high performance and instead often become frustrated and defensive.

". . . the leadership of the Federal government has failed adequately to understand the negative consequences of the cumulative effects of overelaborate and overregulated systems on the thousands of line and staff managers."

In the opinion of the Panel, the leadership of the Federal government has failed adequately to understand the negative consequences of the cumulative effects of overelaborate and overregulated management systems on the thousands of line and staff executives and managers who are the real strength in the implementation of public programs. In the preoccupation with creating and defending strong central systems, the manager in government has been made less effective and far less motivated to carry his or her organization to high levels of excellence and productivity.

It is truly amazing how little the Federal government as a whole perceives or understands about this critical human resource. Despite their critical value, Federal managers do not receive the kind of careful preparation for their jobs which characterizes the best of private sector companies. There is a serious lack in the Federal government of the kind of positive reinforcement, recognition, and prestige which is so widely used elsewhere to encourage managerial excellence. Instead, Federal managers are all too often seen as "the problem," and overly regulatory systems and procedures are built on lack of trust for the government's own leaders. Such systems may sometimes prevent bad management, but they cannot create good management.

The NAPA Panel concludes that the whole framework of current Federal management policy which emphasizes highly centralized and regulatory management systems is simply pointing in the wrong direction. The best approach to solving the present conditions of managerial overburden and deterioration lies not in further hardening of the central system controls but in a deliberate "turnaround" of this policy to one of finding positive, constructive ways to build up the role and capabilities of its managers. In this way thousands of people all over government can regain a sense of being fully "in charge" and accountable for their own responsibilities and be given positive motivations and assistance to revitalize their own performance and that of the organizations they lead.

CHAPTER TWO

Conditions for Sustaining Successful Management Reform

The NAPA Panel is convinced that, despite often valiant efforts to solve specific management problems, the last decade has been a period of declining managerial effectiveness in the Federal government. Efforts at improvement have been increasingly sporadic, poorly planned, and inadequately backed and staffed. Most importantly there is a wealth of evaluation and diagnosis of management problems which is simply not being effectively utilized, largely because the Federal government lacks the will and the capacity to agree on and implement its own reform.

". . . there is a wealth of diagnosis . . . which is simply not being used, largely because the Federal government lacks the will and the capacity to agree on and implement its own reform."

At the Panel's suggestion, the General Accounting Office studied 12 governmentwide management initiatives undertaken between 1970 and 1980. Their report concludes that these initiatives failed to achieve their objectives for a number of reasons: rapid turnover in Executive Branch leadership, a lack of real consensus on what constitutes good management, lack of careful implementation planning and execution, and lack of adequate staffing and management attention to management concerns. The report concludes that this record calls into question the viability of the current role of OMB.

Succeeding chapters of this report once again set forth an agenda of specific recommendations for reform. The Panel strongly believes that a vigorous and successful effort to act on these recommendations would greatly unburden Federal processes and benefit program performance without loss of essential policy direction. But the Panel also believes that the poor record of performance in recent years is symptomatic of deeper problems which must be addressed before the Federal government again becomes capable of taking full advantage of any management reform initiatives. What is urgently needed is a "turnaround program"—a strong, positive, continuing effort to modernize government and a deliberate strategy to restore the conviction that a fundamental rebuilding of the institutional capabilities of government is an urgent and valid public need.

The major conditions for bringing about this turnaround program are summarized below.

Energizing the Talent Base

The Federal workforce is a tremendous talent base. In terms of education, training, and experience, it is the equal of any government in the world and superior to most. Top private sector executives who have served in government usually leave with a new respect for the quality and capabilities of the Federal people with whom they have worked. Leaders in Congress learn to respect the knowledge and judgment of career people. Why then has this talent base not been more successful in maintaining the highest management standards? Part of the answer is revealed in the frustration which those managers themselves express about central management—the frequent lack of leadership, the spastic and transient interest in operations, the lack of help and followthrough on management problems, and tension between political and career leadership, especially during the first year of most incoming administrations. There are strong emotions too about the negative effects of rigid, heavy-handed, centrally controlled management systems. Individual managers and supervisors feel helpless to change these systems themselves or even to adapt and change their own local controls in the face of systemwide rigidities.

"Instead of a system which unleashes and motivates thousands of managers to improve their own effectiveness, we have a system of slow painful change in a few areas driven by central agency staff projects."

Generating management reform, governmentwide and from the top down, has had the unfortunate consequence of intimidating and frustrating agency management improvement initiatives. Instead of a system which unleashes and motivates thousands of managers and supervisors throughout government to improve their own effectiveness, we have a system of slow painful change in a few areas driven by central agency staff projects. Even when these central efforts are well conceived and intelligently pursued, they still deal with management problems on too narrow a base, and do not keep up with the total pace of change across all systems. There are also many good management improvement programs and projects within individual agencies, but many of these cannot be fully implemented without coming up against the constraints of some centrally defined system.

The most powerful answer which the NAPA Panel sees to the solution of pervasive government overburden and obsolesence is to create a new environment which seeks to shift the center of concentration and effort for management reform into the hands of a broad range of senior and mid-level managers and supervisors, and to use the authority of the President and the leverage of the central agencies to motivate this executive/manager level and support its initiatives.

Recent surveys of the attitudes of Federal employees continue to show that most like their jobs and believe them to be important and worth doing. But "the system" does not fare so well. Employees appear frustrated about the workings of their own management and feel that it is burdensome and ultimately negative and stifling. It would be difficult to overstate this sense of frustration—the feeling that Federal executives and managers have lost control over their own performance and have seen an unstoppable shift of authority toward systems controls which are too remote and unreachable. As a result, they feel that the system reduces their own effectiveness and impairs their ability to serve the public.

The critical elements of leadership in management appear to wither in the face of a preoccupation with process. The tools are endlessly "perfected"; the manager who is expected to use these cumbersome tools believes himself to be ignored. The picture which emerges is not just a loss of authority but a loss of motivation toward higher performance or adaptation to change. Management systems are not management. Systems regulations and constraints can help avoid some negative results, but they cannot produce achievement and success. The most serious consequence of the management systems which this report studied is perhaps the least measurable—the degree to which these overregulated and overburdened processes have stifled individual enthusiasm and initiative and substituted rigid central control for individual flexibility and innovation.

"Management systems are not management."

This same problem is evident when examined from outside the government looking in. Much of the criticism about Federal management comes from citizens or client groups, from state/local governments, and from contractors, all of whom either do business with the government or are the recipients of Federal grants or services. This criticism is recorded in many ways—Congress, the media, client group complaints, and internal evaluations, audits, and investigations—and while some of it is unwarranted, much of it is painfully true. Much of it deals not with big policy issues but with very routine practical problems, including backlogs, interminable procedural delays, complicated and burdensome paperwork, foul-ups, and poor customer service attitudes. But one of the great strengths of the career workforce is—or should be—that it is on the firing line and has direct contacts and links with its clientele. This workforce learns from its clientele and is usually the first to know what's wrong and what to do about it.

The public is entitled to demand good and effective service. Federal managers find it difficult to explain to the public why problems can't be solved or necessary corrections made because of controls and constraints from somewhere in the upper reaches of the bureaucratic hierarchy.

The future for the Federal government appears to be one of much more stringent budget and workforce limitations than in the recent past. This environment will put a great premium on ways to make the government more effective and productive. The NAPA Panel recognizes that the Federal workforce is not perfect and has its share of poor workers. But the performance capacity of the workforce often is left unchallenged and largely untapped. A most important condition for turning around the problems of Federal management is to change the motivations of this workforce and to bring it more fully into the management reform movement. This will be a long-term effort; problems which have been years in the making cannot be solved overnight. But this is the kind of reform which can begin immediately and which can have immediate payoff.

"Federal managers find it difficult to explain why problems can't be solved . . . because of constraints from somewhere in the upper reaches of the bureaucratic hierarchy."

Another critical condition is the quality of leadership—of both careerists and political appointees. The highly management-oriented nature of many Federal programs makes it urgent that people placed in top positions have the knowledge and experience to provide real management leadership and that their tenure in these positions be dependent upon their managerial performance.

It is beyond the scope or capabilities of this report to define how such a turnaround program can be done, but it is clear that the first move must be a signal of leadership and support from the government's political leadership. In this view, the NAPA Panel makes the following recommendations.:

- The President is urged to adopt as a guiding management policy of his Administration that efforts of individuals to improve management are wanted and encouraged at all levels in the Federal government and that his Administration is willing to consider changes in central management systems to free up managers to be more effective.

A new, stronger focal point for management leadership is needed and must be created.

- The role of central management agencies must be shifted away from detailed regulation and control toward policy leadership and performance evaluation.
- Specific efforts should be initiated to evaluate each management system to identify and remove constraints on managerial effectiveness. Individual managers and supervisors must be persuaded that these efforts are real and not merely symbolic.
- The greatest care should be exercised in appointing into positions which require high management skills both political appointees and career executives who have genuine management experience and ability and who will be motivated to produce effective management results.
- Future changes to such systems must draw more fully on participation and help from program and staff managers so that they have a direct say in how these systems will be designed to serve their needs as managers. A very good model is the series of task forces being used by the Office of Federal Procurement Policy in its procurement reform program, where both procurement experts and program managers are helping to design procurement system changes.

In summary, the greatest potential for releasing the Federal government from its present overburdened and overregulated management is to place a whole new concentration and emphasis on optimizing the role of the manager; centrally directed projects for reform should be designed to encourage and support a far larger array of initiatives throughout the agencies, consistent with a more clearly designed set of government objectives and strategies.

Creating Stronger Management Motivations for Political Leadership

It appears to be increasingly rare to find political leaders who have the experience to understand the need for management reform and the motivation to spend part of their precious time in coping with such problems. When political leaders are indifferent or even hostile to management changes, the career staff see them as high-risk ventures and are far less likely to advocate them. This is particularly true where changes can be achieved only by persuading one of the central agencies to act or by getting the Congress to change a law. In these political forums, even a very small political minus seems to outweigh substantial managerial pluses. This Panel believes that the public wants and expects serious efforts from its leadership to improve management; therefore, in the long run, good management is also good politics.

Even where Executive Branch political leadership does support management initiatives, the frequent change in leadership tenure, averaging roughly 18 months, often means that such support may vanish in midproject, with a high likelihood that the new appointees, once again preoccupied with their own political objectives, will fail to support management projects sufficiently to keep them alive. Soon, another election intervenes, and the cycle of proposals, education, and persuasion begins again. In this manner, months and years may pass, while Federal managers struggle to find among political leaders the right combination of interest, motivation, and timing which will actually cause reforms to be carried out, a combination which very rarely occurs.

"It appears to be increasingly rare to find political leaders who have the experience and the motivation to spend part of their precious time in coping with such problems."

This cycle helps to explain why inadequate management often has persisted without correction. When this happens, those affected by Federal programs become increasingly frustrated; they are simply unable to understand why decisive action never quite occurs. Often, when these frustrations cannot be adequately satisfied, interest groups will "flank" both the political and career managers and go to the White House or Congress to get action. The down side of this kind of political attention, however, has often been that, in trying to solve a narrow short-term problem, the creation of new laws or regulations locks in solutions which constrain management flexibility and build in obsolescence for the future.

In the Federal government, political leadership involvement in all matters, including management matters is very deep. It is therefore critical to find ways to encourage among politicians the kinds of motivations which will result in their support for continuing, sustained managerial reforms at a higher level of priority than presently experienced. How can this be done?

In the Executive Branch, the most relevant answer appears to be emerging in the context of the Reform '88 Project, with two objectives which should be strongly supported.

- Certain reform objectives are defined as Presidential initiatives, which not only gives them backing from the top but creates the political motivation for Cabinet Secretaries and other agency heads to give these initiatives priority in their agencies. This greatly reinforces the hand of those people in the agencies responsible for carrying out reform projects.
- Reform '88 has been explained as a strategy to achieve management reform for the longer term and it seeks deliberately to devise reforms which can survive political transitions. It is not possible to preempt future political decisions, but it is certainly feasible to design reform efforts so that they have sufficient value and credibility that future Administrations are likely to continue them. The Panel fully supports this intent and emphasizes that the success of fundamental management reform is heavily contingent on acceptance by political lead-

ers that management systems change is a continuous and often long-term process.

Recommendations:

- The NAPA Panel supports the intent of the Reform '88 Project to develop a management reform strategy for the long term and recommends that OMB maintain an inventory of approved management initiatives which it presents and justifies to future political leadership in the Executive Branch as a means of gaining their acceptance and continuity of support.
- The Assistant Secretary for Management Group and the Inspectors General (through the President's Council on Integrity and Efficiency) should be asked jointly to develop and maintain a system for an inventory and justification of management reform and management improvement projects in departments and agencies. The objective is to have these officials act as a continuing source of knowledge of management effectiveness activities and a neutral advocate of these activities with future political leadership on behalf of the overall government.
- The House Government Operations Committee and the Senate Government Affairs Committee should regularly be supplied with these inventories so that they may serve as an informed central point of reference in the Congress about important management initiatives which warrant Congressional support over the long term.

Strengthening the Institutional Base

Where management systems are as highly centralized as they are in the Federal government, the role of the central agencies is critically important. This report strongly advocates a turnaround in managerial philosophy which points toward maximum feasible reliance on and delegation to line program managers, plus a policy of galvanizing a broad range of these people toward greater efforts for management effectiveness. Yet even within this more decentralized concept, the role of the central agencies remains critical but different.

All of these central agencies are complex institutions, with responsibilities so broadly defined that almost any imaginable role is legally open to them. Each in its own way is a facilitator, a regulator, and a provider of services to the Federal establishment. Generalizations about them are difficult, since exceptions are easy to find and their perceived roles change over time.

However, the Panel believes that its assessment supports two important general conclusions:

- *The present central agency institutional base is too weak to sustain a continuing high level of governmentwide reform, and therefore this base must be strengthened.*
- *This strengthening must take place in specific ways which support the concepts of greater continuity of reform effort, greater decentralization and delegation of authority to managerial levels, and greater systems flexibility and simplicity.*

The central agencies of the Federal government will continue to play a key role in Federal management for the foreseeable future. Their strength and necessity lies in the fact that they are (or should be) agents for the President in carrying out his role as Chief Executive Officer of government in seeing that the laws are faithfully executed.

But whether or not the central agencies are carrying out specific initiatives of the President, there is a longer term continuing management leadership role which must be sustained. The role of the central agencies can be structured and defined so that it facilitates and supports a more balanced partnership with the executive agencies. While the charter of the study does not extend to a full analysis of the organization of the Federal government management roles, the conclusion is unavoidable that a stronger central agency organization to lead Federal management activities is a mandatory condition precedent to the success of such activities now and for the future. Without this stronger central leadership capability, we believe that the Federal government will continue to fail to realize the full potential of any of its efforts for future management reform. We further believe that this leadership is of equal importance, whether management intiatives emanate from the White House, the Congress, or from within the agencies themselves. The weakness of such leadership creates a clear pattern of decline in the effectiveness of central management systems. Unfortunately this tends to be translated into a related sense of neglect in agencies as well. The best central agency leadership is one which makes it clear that the value of effective management is very great and helps motivate and shape similar values all over government.

"The conclusion is unavoidable that a stronger central agency organization is needed to lead Federal management activities . . ."

The NAPA Panel has been forced to conclude that the Federal government's pressing needs for broad-based and continuing management reform cannot be achieved through the existing combination of OMB, OPM, and GSA organization and approach and that two major changes must be made.

First: The current management role of OMB should be transferred to a newly created Office of Federal Management reporting to the President, which would become the organizational framework for providing a more powerful and responsive leadership for management reform and improvement for the entire Federal government.

Second: The missions of the central agencies must be rebalanced to strengthen and revitalize the broad governmentwide policy and oversight roles which only they can perform and to deliberately divest themselves to the greatest extent possible of these roles which involve centralized regulation and control. To achieve this second change:

- Central agencies must serve as the agent of the President in his role as Chief Executive Officer, advise the President on management matters, develop governmentwide management policies, and prepare recommendations to the President on crosscutting management policy issues.
- The central agencies should be responsible for Federal systems design, redesign, modernization, and improvement and for directing the use of uniform central systems, but only where a clear need can be demonstrated for such governmentwide systems as opposed to individual agency systems. Even then, the central agencies should mandate only those systems elements necessary to achieve reasonable consistency of purpose and uniform procedures where necessary. Directives should be redesigned to emphasize results or performance objectives and should avoid detailed procedures which attempt to structure the means by which objectives are achieved. This policy closely parallels the objectives of the current Reagan Administration program for regulatory reform. *The NAPA Panel advocates that the Federal government should adopt a policy for its internal operations in which the fullest and most complete delegations of both line and management systems authority not needed for the proper exercise of its redesigned central agency responsibilities should be made to the governmental unit where actual operational management is exercised.*
- The central agencies should build up their capability to provide the President with a full and continuous evaluation of the management systems of government—to know where they are not being effective and to identify how they must be corrected or improved. In a more decentralized environment, most agency improvements will be the responsibility of agency heads.
- Each of the central agencies must provide far more active leadership in management research, innovation, experimentation, and the introduction of new managerial technology. Each central agency should be given explicit statutory authority *and adequate resources* to conduct such research; to undertake management experiments, tests, or demonstration programs; and to fund such programs through contracts or interagency agreements. Indeed, every Federal agency would benefit from similar experimentation authority through its own enabling legislation.
- With respect to management in the departments and agencies, the central agencies should actively encourage and assist agency management reforms; and particularly in new or smaller agencies, they should provide direct assistance for management needs.
- Particularly for the immediate future, the central agencies should concentrate their efforts on making management systems and techniques more relevant and of greater direct support to Federal managers and on addressing the critical ways in which the managers themselves must be prepared to take on these more demanding roles.

Creating the Office of Federal Management

Since World War II, the pivotal role in Federal management matters has been assigned to the Office of Management and Budget and its predecessor organization, the Bureau of the Budget. BOB/OMB has attempted to maintain a general management capability along with its primary role as the President's budget staff. During several periods of its existence, the management organization has performed exceptionally well. It has successfully carried out management projects of importance to every President and has attempted to maintain a general stewardship over management activities throughout the Federal establishment.

In its earlier years, agencies came to rely on BOB/OMB as a key source of governmentwide initiatives for keeping Federal management modern and up to date. In recent years, however, there has been a growing concern that, even while OMB continues to be capable of occasional excellent performance, it has irretrievably lost its overall effectiveness as governmentwide leader in management matters. Students of BOB and OMB have always recognized that its primary concern on behalf of the President has been the Federal budget process. This had been regarded as both a strength and a weakness in terms of OMB's management role. It is a strength because the budget gives the OMB Director a powerful voice in all government activities, with direct and continuing access to the President, and powerful leverage to deal with agency heads from a position of strength. It has always been hoped and expected that these strengths would be brought equally to bear on the managerial agenda; and from time to time, depending on the President's own interests and the Director's sensitivity to management problems, this

". . . major reform efforts point out the fundamental fact that the Federal government suffers not from the failure to diagnose its problems, but from a failure to implement. . . ."

has been true. The disabling systemic weakness, however, has been that the budget and related national economic issues have usually proved to be all-consuming. In recent years it has become so intense that it has almost totally preoccupied critical OMB leadership, draining away time, interest, and staff from the managerial initiatives. Further, the annual focus on the budget and the lack of concern with management matters clearly has a chilling effect on many management initiatives. Therefore, even when an Administration such as that of President Reagan seeks to take the initiative for management reform across a broad front, it finds OMB no longer has the talent base nor the recognized capacity for leadership to sustain such major efforts.

Nor does it appear likely that, in the forseeable future, the budget preoccupation will decline, and therefore proposals and arguments for building up and revitalizing OMB's "management side" seem less hopeful and less realistic.

Meanwhile, the need for strong sustained management reform leadership becomes more pressing. The Reagan Administration's ambitious Reform '88 Project and the recently emerging findings of the President's Private Sector Survey on Cost Control serve only to emphasize the breadth of the management reforms which are needed and the paucity of the resources available to take implementing action. Both of these major reform efforts point out once again the fundamental fact that the Federal government suffers not from a failure to diagnose its management problems, but from a failure to implement the changes which it already knows it requires.

The NAPA Panel has been forced to conclude that the Federal government's pressing needs for broad-based and sustained management reform can best be accomplished by the creation of a new Office of Federal Management in the Executive Office of the President and reporting to the President, which should become the framework for providing a more powerful and responsive leadership for management reform and improvement for the entire Federal government.

What should be the broad role and purposes of the new Office of Federal Management?

- First, to optimize the role of the President as Chief Executive Officer of government.
- Second, to inform the public and the Congress of the imperatives for effective Federal management and to facilitate the relationships between the Congress and Executive Branch with respect to the machinery of government.
- Third, to instigate the development of sound, long-term management planning and policy governmentwide and in all agencies.
- Fourth, to lead the drive for a major improvement in the management capabilities of the government both centrally and in the departments and agencies.
- Fifth, to lead the drive for refurbishment of government management systems.
- Sixth, to take leadership in management innovation through experimentation, test and demonstration programs, and adoption of new management concepts and technology.

The Office of Federal Management should be given Presidential authority and sufficient resources to *implement management change*—either through its own resources or by preparing plans and proposals for Presidential approval which define and mandate the implementation of priority management reforms by other Federal agencies. This authority should include the capacity to establish (and if necessary, fund) task forces, special project offices, advisory groups, consultants, or other resources needed to carry out this implementation role.

The Office of Federal Management would inherit from OMB such important functions as the drafting of non-budget related Executive Orders, management circulars, and other means for conveying Presidential direction on management subjects. It would include the present Office of Federal Procurement Policy and would coordinate responses to GAO audits of governmentwide applicability. It would also administer the requirements of the Paperwork Reduction Act. It would represent the President in Congress in cooperation with the White House Congressional office on government organization and management matters and would coordinate preparation of Administration management related legislation.

The role described for the Office of Federal Management extends from strategy to implementation. It is intended to be the one organization to which the President can turn which can develop an overall, long- and short-term strategy for government management. But it must also be able to convert that strategy into action, largely in the form of specific management improvement programs and projects. Reform '88, the increasing volume of GAO and IG reports, the reports of the President's Private Sector Survey on Cost Control, and this NAPA study once again demonstrate that there is a backlog of unresolved management problems and a wealth of management improvement ideas and opportunities, all begging for the kind of broad-ranging, experienced, highly competent leadership which an Office of Federal Management could provide. Its institutional role must be to loosen up the system, dislodge entrenched interests, motivate the Federal workforce to greater effectiveness, and recreate the capacity to innovate. Its role should be to lead, to promote, and to assist—far less to regulate, control, or enforce. To fulfill these functions, its role must be clearly defined as a broad range of responsibilities of sufficient importance that the President will give its Director direct and continuing access, and the stature and support needed to deal with Cabinet officers and the Congress. To carry out this role, the Office of Federal Management must be given a far stronger core of top leadership positions, a broader organizational structure, and a revitalized senior career staff of higher calibre and more stability, and of broader experience and institutional knowledge about government.

"The Office of Federal Management . . . is intended to be the one organization to which the President can turn which can develop an overall, long and short term strategy for government management."

Recommendation:

The NAPA Panel recommends that the President submit legislation for the creation of a new Office of Federal Management having the authorities and responsibilities described above.

This recommendation is not intended to reduce the capacity of the Office of Personnel Management or the General Services Administration to render services to the departments and agencies of the Executive Branch. However, the question must be answered as to the management policy roles of each of these agencies. OMB has always considered that its role and authority is Presidential and thus includes all activities of the government. This means that OMB has, in the past, involved itself in OPM and GSA responsibilities—regularly through the budget examination process and selectively with respect to management issues. This involvement has often caused apparent conflict or confusion. The NAPA Panel believes that the proposed Office of Federal Management should assume the management leadership responsibilities of OMB and should continue to serve as the single agency which can advise the President on all Federal management matters. There is no reason to believe that the new Office of Federal Management would impair these other central agencies, and each would continue to be fully responsibble for its own policy areas as defined by the President and relevant statutes. Said another way, the President would look to the Office of Federal Management for management policy and objectives for the whole government and—within that framework—to OPM and GSA for policy and implementation in their respective areas.

The whole pattern of conclusions and recommendations of this report rests on the premise that, if the Federal government really wants to achieve general and broad-based reform of its management and create an environment in which managerial excellence is demanded and expected, then it must place top priority on its managers rather than its systems. In the chapters on specific systems which follow, the general diagnosis of systems problems is more fully explained and illustrated. A large number of recommendations are made which would greatly unburden systems and make them more useful and flexible for managers to use. But the Panel recognizes that as systems are redesigned to place greater reliance on managers, there must be a recognition that, in many cases, managers themselves are ill-equipped and ill-prepared to fulfill these more demanding roles. There must therefore be a parallel and equally serious effort to upgrade managerial skills and to create a new climate of motivation and reinforcement at the highest levels of government.

The Panel also recognizes that many efforts for management reform founder because of the failure to implement action. It is not unreasonable to point out to these same Federal managers that they can become the most powerful means through which such reforms are accomplished. Much of what is proposed can be achieved if managers are willing to create their own initiatives and become a stronger force within government for solving the problems about which they have so long complained.

CHAPTER THREE

The Overburdened Budget Process

If there is a single cement that holds the Federal government together, from the bottom of the agency hierarchy to the U.S. Congress, it is the Federal budget. For agency program managers and staff directors, the budget is the vehicle for their implementation plans and a request for authority. For the President and his Executive Branch leadership, it is a compellingly important means to seize initiative and to convey direction. For the Congress, it is the starting point for its authorization and appropriations process. Because it requires choices and decisions as to who gets what, it is a source of great power and of almost intolerable conflict.

The budget is neither an art form nor a science. It is a management process or system, and like all such systems, it should not be an end in itself but should be made to serve the broader, more important roles and objectives of the people who use it. The ultimate test of public service is whether the public is well served; thus, the best Federal budget system is one which aids and facilitates the accomplishment of Federal programs.

It is the conclusion of the Academy Panel that the Federal budget process is seriously overburdened and that in the increasing preoccupation with the dollar and policy issues of the budget, the system itself has been undervalued and badly needs modernization and simplification.

The Federal budget process is not close to failure, but it is in trouble. The NAPA Panel believes that both the Congress and the President have an obligation to act now to reform the process and that many practical and realistic ways for reform are possible. The recommendations of this report are aimed at:

- How the overburden of the Congressional authorization and appropriation processes can be reduced, and the system made a more effective means for Congressional decisionmaking.
- How the burden which the Congress necessarily places on the departments and agencies can be made less burdensome and more productive.
- How the budget process within the Executive Branch can be streamlined, simplified, and made a more effective tool for program management.

Budget Reform in Perspective

One of the lessons learned and relearned from history is that the very importance of the budget/appropriations cycle makes it a system which is extremely difficult to change. Unless there is a climate for change, opportunities are limited for a report of this kind to lead to action. It is therefore important to examine and understand the current broader arena of budgetary reform and to show how the prospects for reforming the budget process, as proposed in this report, can adapt and contribute to the budget reform initiatives being pursued in the broader arena.

In fact, we appear to be a in a period now of great political and economic turmoil, where the sate of the economy and the reality of large intractable budget deficits are creating a growing sense that the budget/appropriations system no longer is adequate to meet the greater demands being placed on it. Where available tax revenues are a reasonably close match to budget needs, the budget operates mainly as a distribution system, and its conflicts deal primarily over relatively modest marginal increments of change. Now, however, when there are far more serious disparities between Federal fund availability and perceived needs, the budget process is forced to become an allocator of scarcity. This in turn heightens political conflict and places greater strain on the budget process itself. Since the budget process cannot be permitted to founder, system users must resort to such expedient measures as continuing resolutions. This intensifies the search for ways to strengthen the process at the point of greatest stress and to jettison some of the procedural overburdens which reduce its effectiveness.

". . . the budget process is forced to become an allocation of scarcity. This in turn heightens political conflict and places greater strain on the process itself."

In Congress, in the General Accounting Office, and in the Executive Branch, significant efforts are underway to reassess current budget/appropriations mechanisms and to explore both fundamental reform and systems repair and renovation. In 1974, the Congressional Budget and

Impoundment Control Act provided important new procedures and additional Congressional structure and staffing to deal with the budget in a total strategic sense. The Act instituted a requirement for a budget resolution in late spring which set spending targets for each major budgetary function, along with revenue projections. It scheduled a second resolution for September with the expectation that reconciliation actions would be approved to bring spending and revenue proposals into line with Congressional intentions concerning the deficit for the fiscal year beginning October 1.

The Act also created budget committees in each House, which have membership from appropriations, authorization, and tax committees. The principal responsibility of these budget committees is to formulate the spring and fall budget resolutions. At the same time, the Act created the Congressional Budget Office to provide the whole Congress with analyses and projections which would assist it in acting on the budget with a better understanding of its consequences and impact.

Recently, the Committee on Rules established a Task Force on the Budget Process which initiated an extensive series of hearings on the budget process, including an assessment of the Congress' experience in implementing the 1974 budget system changes. In addition, hearings were held last year to consider the establishment of a 2-year budget cycle and a Federal capital budget. Budget hearings were also held last year by Senator Roth, Chairman of the Senate Government Affairs Committee.

The Comptroller General of the United States has created a Budget Process Task Force within GAO to reexamine the government's total financial management system and to undertake intensive studies of major agency financial systems. He has already testified before Congressional committees on a broad range of potential budget reforms.

In the Executive Branch, OMB has made selected aspects of budget, accounting, and financial systems of government a priority under its Reform '88 management improvement program. An earlier Reform'88 project reviewed all OMB Circulars, including A-11 "Preparation and Submission of Budget Estimates" and A-34 "Instruction on Budget Execution." OMB itself has revised and simplified much of its A-11 Circular and is committed to efforts for further improvement of that process.

The Assistant Secretaries for Management Group—representing senior management officials in the Cabinet departments and several of the larger independent agencies, as well as OMB, GSA, and OPM—is the sponsor of this report. It too has already made recommendations for reforms in budget preparation. Although few of the initiatives described above have yet culminated, they have already begun to lay out a much clearer diagnosis of many of the problems and malfunctions of the budget, both for the Congress and the Executive Branch. The NAPA Task Force accordingly used this data to identify those issues relevant to our primary concern: the overburden of the process and the barriers it places in the way of effective management. We added the results of our own interviewing and questionnaires used primarily to solicit the views of senior government program managers and budget officials about the budget process from their perspective and how the system needs to be improved.

Almost without exception, those views were negative. They echo strongly the same consensus building in Congress and elsewhere: the need for budget reform is great and growing. Over and above the important debates about the substantive issues captured in the budget, action needs to be taken to repair the process itself.

Congressional Budget Reform

The range of issues now being considered for Congressional budget reform is formidable. It includes all of the apparatus of the Congressional Budget and Impoundment Control Act of 1974, including the roles of the first and second budget resolutions and the reconciliation process. In addition, current hearings deal with the mechanics of the appropriations process, the feasibility of separate budgets for such things as entitlement programs, a capital budget, an "audit" budget, changes in impoundment control, a biennial budget cycle, planning horizons, economic assumptions, and other issues.

Views on these issues often differ substantially, but on one issue there is close to consensus: the Congress finds itself with a budget/appropriations process which has become overly complex and excessively detailed and yet which conveys the frustrating sense that the Congress still has no more than a marginal tool for meeting its own and the Nation's needs. On the one hand, as one witness states,

> "The symptoms which cause concern about the process are much more the result of basic underlying budget problems—an underfinanced budget and a rapid shift in budget priorities—than of procedural inadequacies."[1]

On the other hand, many other witnesses are building a record of concern about the process itself and how it reduces the effectiveness of the Congress and levies an overburden on government agencies. Many of the motives which have contributed to this overburden are both sound and understandable. Far from the Congress neglecting its responsibilities, its strong sense of obligation has led to such an elaboration of process that the total cumulative effect is now being recognized as a problem in itself.

The Problems of Annual Budgeting

Much is being said in current debates about the growing gap between "top-down" budgeting, played out through the budget resolutions and the reconciliation process, and the more traditional "bottom-up" approach, which culminates in the extensive apparatus of the appropriations subcommittees. Irrespective of the pros and cons of these

[1]Alice Rivlin, Director, Congressional Budget Office, in testimony before the House Rules Committee. See "Hearings Before the Task Force on the Budget Process, p. 415, GPO, 1983.

two, for the Federal program manager, the disconnections between authorizations, reconciliations, and appropriations seriously frustrate all efforts toward program planning. Unfortunately, many managers have come to accept this situation as "normal" and inevitable—a circumstance which the Panel finds unacceptable.

Further, the growth in the use of annual authorizations during the last 30 years substantially complicates this situation. Prior to 1950, only military construction and foreign assistance were authorized on an annual basis. The authorization for most major agencies and programs were permanent, with the Congress able to make changes whenever necessary. In the next 2 decades, 10 more major agencies or programs were put on annual authorizations. Since 1970, an additional 18 agencies or major programs have been shifted to the annual authorization basis.

"From the operational perspective of the program manager, the Federal budget is unrealistic, inflexible, or simply unnecessarily burdensome."

When a program must be reauthorized each year, both the Congressional authorizing committees and agency leadership and their program managers assume a heavy burden in conducting hearings and issuing a committee report, which may diminish the time and effort available for broad programmatic planning, strategic analysis, and assessment of program performance.

Annual authorizations have not only become more detailed but have begun more extensively to overlap the substance of what agencies are required to provide to appropriations subcommittees. This is evidenced with authorization committees placing spending "floors" on line items. This blurring of authorization and appropriation has been further obscured by the overlay of the budget resolution and reconciliation process.

A serious issue now being debated is the issue of the *realism* of the budget process. As one Senator put it,

> "It has been my experience that our present budget process has become increasingly unrealistic. Annual budgets and appropriations have not really worked for years, and the additional requirements of the Budget Act have made matters worse. The time has come to face up to the reality that, in our complex modern society, government economic planning, budgeting, and appropriating cannot be done constructively in a twelve month period."[2]

The NAPA Panel agrees with this view; we believe that 12 months is too short a time frame for either the executive or legislative branches of government to do thoughtful resource allocation, though it recognizes the importance of a yearly opportunity for the President to propose—and Congress to determine—necessary adjustments.

[2]Statement of Sen. Wendell H. Ford (Ky.). See "Hearings before the Task Force of the Budget Process of the Committee on Rules of the House of Representatives, p. 363. U.S. Government Printing Office, Washington, D.C. 1983.

From the operational perspective of the Federal program manager, the Federal budget process is perceived to be unrealistic, inflexible, or simply unnecessarily burdensome. The real world of the Federal manager is certainly not a 1-year world. Major weapons system development programs in DOD, government construction programs, and federally financed construction (such as water and sewer programs, highway and transit construction performed by states and local communities) all clearly function on a multiyear basis. Ideally, the best budget process would be one in which an entire project plan would be developed and justified to the President and the Congress and a single full authorization and appropriation for the project be made for its entire life span. Indeed, much of this multiyear "life-of-project" funding has been successfully used in DOD and elsewhere in government. Similarly, basic scientific research, advanced technology development, and many applied technology and hardware demonstration programs require more than 1 year to complete and thus have received advanced appropriations, at least in the form of "no year" funds in recognition of the time considerations.

"The real world of the Federal manager is certainly not a one year world."

Most Federal entitlement programs and other grant-in-aid activities in which state or local governments are the administrators are further examples of where Federal funding on an annual basis is not realistic. The Congress reserves the right to withdraw or modify its legislative mandate, but as long as a given program remains stable, longer term budgetary planning and execution affords substantial advantages to Federal managers, state and local governments, and the public.

Even normal administrative operations of government—its payroll, rent, utilities, and operating expenses—continue from year to year. Such expenses are dealt with in terms of incremental budgeting (pluses or minuses at the margin), and a case can be made for a far less laborious continuing authorization and appropriation mechanism which recognizes this fact.

The clear preference of the program manager is for an authorization/appropriation outcome from the Congress which fosters program stability, which channels authority and funds in a manner permitting most effective management and which does not threaten the continuity of grants, contracts, or direct Federal workforce performance. These managers are also concerned that current budget processes are procedurally overburdened and are costly in dollars, staff, and the preoccupation of people's talents.

The central question is whether the Congress would find it feasible to accept some accommodations which meet these managerial needs without feeling that it is sacrificing essential elements of its own control. The kinds of accommodations which would have real impact are

- Waste and mismanagement occur as results of hurried actions by administrators to obligate funds in drastically shortened time periods.

Given the overburden of work which this unfortunate sequence of events creates, it is clear that the taxpayer is paying for added workforce to cope with it.

The Biennial Budget

The fate of Federal programs and the responsibilities of Federal managers are locked in with the appropriations outcomes of the Congress in a "mutual success-failure" relationship, and late appropriations are a cross which everybody bears. Many options are being considered which would reduce the Congressional workload and the attendant Executive Branch overburden, but only one really stands out as likely to have a real and lasting impact—the idea of a biennial budget.

"Many options are being considered which would reduce the Congressional workload and attendant Executive Branch overburden, but only one stands out as likely to have real and lasting impact—the idea of a biennial budget."

It is beyond the scope of this report to judge whether a biennial budget is politically acceptable and feasible for the Congress. However, it is certainly technically feasible within the Executive Branch, and the NAPA Panel strongly recommends that both the Executive Office of the President and the Congress work in close coordination to consider its adoption. The most highly recommended course of action from the point of view of Federal operations would be general adoption of a 2-year budget/appropriations system. The hearings already completed before the House Rules Committee Task Force on the Budget Process have produced a high order of discussion and debate and a great deal of sympathy for this course, as have earlier hearings in the Senate Government Affairs Committee. Both the current and previous Comptrollers General and the Director of the Congressional Budget Office have spoken in favor of the prospective advantages of the 2-year cycle.

Although there are those who are concerned that a biennial budget could lead to some loss of Presidential and Congressional control, the Panel believes that adequate opportunities for off year adjustments could be built into a biennial system.

Recommendations:

The NAPA Panel recommends that adoption of a biennial budget offers the most significant opportunities for substantial relief of the overburden now endemic in the process. Because such a major, fundamental change would be difficult and challenging, a number of years of concerted effort would be required to bring it about. Without retreating from this ultimate objective, the Panel recommends several steps which would permit progress toward that objective:

- OMB should identify those Federal activities which would benefit most significantly from a biennial budget system and those where conversion to such a system could be most easily achieved.
- OMB, GAO, and the Congressional Budget Office should jointly design a model biennial budget system and analyze how it would operate so that the Congress and the President would have a better means for understanding its feasibility. Real participation should be obtained from agency managers and budget officers in the development of this system.
- Congress and the President jointly should immediately select a number of agencies or programs in which a biennial budget could be implemented on a pilot basis.
- If the pilot projects are successful, the President should propose in consultation with Congress enabling legislation to convert the entire Federal government to a biennial budget system over an appropriate time period.

Improving Budget Formulation

While major future changes in the budget process are being considered, many procedural elements of the budget warrant immediate improvement. Even if the current budget process were functioning perfectly, it still represents a formidable demand on the departments and agencies. It is unfortunately true that meeting the demands of the process has all too often led to a preoccupation with detail and an accretion of procedural apparatus. For the Federal agency official trying to respond, there is often conflict, duplication, overlap, and confusion among the separate data flows as well as with definitions, formats, scope, and timing of information, and with ill-defined or conflicting data elements and accounting structures. This means added burdens to explain and reconcile disparities and uncounted opportunities for errors to creep into the process.

Of even greater significance, however, is the tendency for each new detail to be built into the system and perpetuated into the future. In both the internal Executive Branch budget and in the Congressional appropriations process, an examination of their categories and subcategories often shows an elaboration of detailed pockets for data which bear little relationship to either sound budgeting or real management. Becoming committed to this level of detail can, in turn, lead to further tracking of these small budget amounts during budget execution and inevitably to a further demand for reports, statistics, schedules, obligation and expenditure reports, plus a good deal of informal staff tracking and followup. Concommitantly, rigidities and blocks built into the budget at very detailed levels significantly reduce the judgment and freedom of action which a manager normally is expected to exercise.

The NAPA Panel suggests a number of actions aimed at reducing the detailed process and paperwork.

Budget Automation

In "the good old days" in the old Bureau of the Budget, there was one budget per year. The professional staff would complete its work with the submission of the President's Budget to Congress in January or early February. The Budget examiners could then count on having time to visit agencies and to do program analysis until the tempo began to pick up again in the late summer when the next cycle of the budget process would begin.

That world is apparently gone forever. In recent hearings, Sen. Roth summarized current reality:

> "Last year (FY 82) Congress raised a revised second budget for FY 81, a first budget resolution for FY 82, a budget reconciliation bill, several appropriations bills, two continuing resolutions, a second budget resolution, and a supplemental appropriations bill."

The volume and complexity of budget formulation and presentation requires greater systems discipline than ever before. The NAPA Panel endorses the emphasis which OMB is placing on automation of the budget process as one of the priorities of the Reform '88 program. The development of micro- and minicomputers and more effective ways to transmit data electronically is proceeding so swiftly that it amounts to a revolution. The Federal government simply can't afford to be left behind. Industry experience is showing how dramatically costs can be cut and labor hours diminished by intelligent use of this new technology.

But despite the importance of the budget system, its full automation is not a foregone conclusion and will not happen spontaneously. The system is designed and administered within the Executive Branch by OMB, but there is a strong overlay of Congressional needs, especially in the Congressional Budget Office and the appropriations committees. These institutions, which are the actual proprietors of the process, are understandably cautious about changing it further, especially in these times of high budget conflict. A further complication lies in the fact that each of the major users of budget inputs has been free to design its own data base.

The President's Budget Accounts Listing has 1,250 separate accounts covering 180 pages. While there is a uniform set of accounts in general use, the subsidiary definitions of program elements may vary substantially. Reconciling this data base would be helpful in any event, but the new opportunities being created by automation make such reconciliation almost mandatory. More powerful data processing capability could be used to cope more effectively with current demands, but if the data base is excessive and poorly conceived, it merely avoids the problem to put it into a more effective computer. The opportunity exists now to combine a number of desirable objectives into one program to automate the budget.

Recommendations:

The NAPA Panel recommends that OMB, Treasury, and GAO (authorized by the Congress), undertake a joint venture budget automation project having the following objectives:

- Develop a set of common data elements behind the account structure into a computer program which would encompass the data needs of all users of the budget process, including uniform definitions, commonly acceptable data elements, and interchangeable computer software.
- Using this base, make a major collateral effort to simplify present data demands which overlap, duplicate, or are no longer necessary. The existence of a carefully conceived data base, properly controlled but available to all users, would go far in reducing the present "messiness" of this overburden.
- Integrate the budget from the lowest agency levels, through the central agency budget organizations, to OMB; also develop a central interface between OMB and the data in use in various elements of the Congress.

OMB's Role in Budget Formulation

OMB is the crucial force in any attempts to simplify budget formulation within the Executive Branch, and it has shown its own recognition that the budget process overburden exists and must be dealt with. OMB appears strongly committed to further highly desirable steps to complete the automation of its budget preparation process and to extend the automation program back upstream to the stages of budget policy analyses and agency negotiations. OMB Circular A-11, "Preparation and Submission of Budget Estimates," is the "bible" which directs the process, and OMB has been increasingly willing to invest some of its precious staff time in purging many of the marginal requirements which have accreted within the system. In addition, OMB recently chartered a study by agency people of further potential improvements.

"OMB's willingness to take the lead in budget formulation . . . and automation . . . is the key."

OMB's willingness to take the lead in budget formulation improvements is the key. If that effort can be sustained and if OMB continues to use the help of the agencies and listen to them, there appear to be many good clean-up ideas which can be implemented. The NAPA Panel believes that the following recommendations have the greatest potential for cutting the budget overburden:

- OMB can and should limit the amount of detail it demands—across the board. Much detail is collected to support excessively detailed budget scrutiny—the "minibudgeting" which agencies find so time-consuming. Other details appear to be the residue of obsolete needs which have never been purged from the system.
- OMB should avoid burdening the budget by using it as an information system. That is, agency people

not particularly like this authority because it is properly concerned that funds are indeed used for the purpose for which they are made available. Yet the Congress has in fact made many specific provisions for reprogramming authority. Table B shows examples of some of the thresholds established by subcommittees of the Senate Appropriations Committee.

"There appears to be a significant opportunity to . . . reduce the number of actions in the budget execution process by rethinking the level of reprogramming and fund transfer authority given to agencies."

Similarly, within certain limitations, Congress has granted a number of agencies the authority to transfer funds from one appropriation account to another. Not only does this authority increase the flexibility for the Federal manager, but at times it also reduces the need for supplemental appropriation requests, relieving the appropriations committees of special hearings and action on these requests. The Departments of Defense and Energy and NASA have fairly flexible transfer authority; those of Interior and Agriculture, VA, and GSA are very limited; Justice, Labor, Commerce, Treasury, and State have no authority to transfer among accounts. The Department of Energy's authority permits a transfer of up to 10 percent of an appropriation, but no appropriation can be increased by more than 10 percent. Congressional notification in advance of any Energy Department transfer is required.

Although we recognize the legitimate concerns of Congress, we believe that all agencies should have at least some limited transfer authority. Such authority promises to reduce the demands on Congress and the consequent workload on its committees and staff and to expand agency flexibility and management effectiveness.

The Senate Appropriations Committee handles from 500 to 600 such actions each year. There does not appear to have been a good recent assessment of this authority, and given recent inflationary trends, many of the thresholds for triggering this authority are very low, as are the amounts which can be shifted in relation to the total appropriation amounts.

TABLE B
Senate Appropriations Committee Reprogramming Authority Limits

Subcommittee	*Thresholds*
Defense	$5 million in Personnel, Operation and Maintenance appropriations $5 million in procurement line items $2 million in an RDT + E appropriation
Energy & Water Development	
Department of Energy	None
Corps of Engineers	Up to 15% of Budget Authority (BA)
Foreign Operators	None
HUD-Independent Agencies	$250,000 or 10% of BA
Interior	$250,000 or 10% of BA
Labor-HHS-Education	
Labor	None
HHS	$500,000 or 5% of BA 10% for Indian Health Service 7% for FDA 5% for NIH
Education	None
Military Construction	$1 million or 25% of appropriated amount
State, Justice, Commerce	$250,000 or 10% of BA
Transportation	"Non-substantive" changes
Treasury	$500,000 or 10% of BA

Recommendations:

The NAPA Panel recommends that:

- The Congress adopt a policy of more extensive granting of reprogramming and transfer authority to agencies, both to augment agency program management flexibility and to reduce the burden of such actions which require Congressional attention.
- To initiate this process and to give the Congress a sound basis on which to act, the appropriations committees in both Houses should sponsor a study by GAO of reprogramming and transfer authority governmentwide for the purpose of moving toward maximum feasible use of this authority where it will aid effective management.
- At a minimum, appropriations committees immediately revise current reprogramming and transfer authorities to reflect recent inflationary factors and require that only significant reprogramming actions need be reviewed by their respective subcommittees.

Delegation of the Apportionment Process

Most Federal managers contacted in this study did not consider the apportionment process particularly onerous. On the other hand, some staff noted that the process does not serve a useful purpose in the vast majority of cases and feel that the process lends itself well to management by exception. It is in the self-interest of agency managers to prepare financial plans that do not involve a deficiency. For the vast majority of accounts, the quarterly apportionment therefore involves no significant issue in terms of the objective of the Antideficiency Act. In addition, if OMB did not see the necessity to apportion an account, it would not need a monthly report on obligations for that account. This would eliminate the preparation and transmission of a vast number of reports. Most agencies prepare the report on obligations solely for OMB because they have their own internal reports on their financial plans which are more detailed and more useful for management purposes.

Recommendation:

OMB should automatically apportion all accounts that have not created and are not expected to create apportionment problems. For these accounts this monthly report on obligations should be waived. OMB should seek legislation authorizing the delegation of apportionment authority to agency heads with power to redelegate.

Establishment of Thresholds for Deferrals and Rescissions

The Impoundment Control Act of 1974 requires executive agencies to report all impoundments no matter how significant. As Louis Fisher points out in his book on *Presidential Spending Power*, Congress took this approach because the members were dissatisfied concerning agency compliance with legislation enacted in 1972 requiring the reporting of impoundments. The Congress concluded that the Administration had underreported, particularly on controversials impoundments. The requirement to report small impoundments places an undue burden on agencies to prepare reports, on OMB to process them, and on GAO and appropriations committees to review them.

The 1974 Act defines two types of executive impoundments: "deferrals" of obligations from the current fiscal year to a subsequent fiscal year; and "rescissions" involving a rescinding of budget authority, that is, an actual cancellation or reduction of an existing appropriation.

During fiscal year 1982 there were 19 Presidential messages containing 195 deferrals and 32 rescissions. The first two messages were transmitted in the first month of the fiscal year and contained 84 items. These items did not arise because of changing policies or priorities. For the most part, they were routine deferrals involving multiyear accounts where it was known in advance that a portion of the obligations would occur in subsequent years. For the first two messages, 50 percent of the items were less that $500,000, and 35 percent were less than $100,000; several were for $1,000.

GAO has recommended that thresholds be established for deferrals and rescissions. The appropriations committees have had 9 years' experience with the Impoundment Control Act and should now be prepared to adopt some reasonable thresholds. However, the recent Supreme Court decision invalidating legislative veto statutes has made the deferral provisions of the Act inoperable. The Act requires that deferrals be submitted to Congress, where either House can disapprove it by passing an impoundment resolution. Therefore, this entire procedure will require Congressional reevaluation.

"The stringent procedures for referrals to Congress may have a chilling effect on potential genuine savings within agencies thru economics or management efficiency or productivity improvments."

The stringent procedures for referrals to Congress may have had a chilling effect on potential genuine savings within agencies through economies or management efficiency or productivity improvements. Even recognizing the need to assure full expenditure of appropriated program funds, it would be worthwhile to consider some form of flexibility in the procedures for reviewing deferrals or rescissions which would build back into the system incentives to encourage this cost-effective behavior.

Recommendation:

OMB should recommend legislation to establish thresholds for reporting deferrals and rescissions. Such thresholds should be similar in amount to those for reprogramming.

The appropriations committees should experiment with special provisions that would provide incentives for managers to save a portion of their annually appropriated funds. Permitting agencies to retain a portion of the funds saved through increased productivity and cost saving would be a step in this direction.

to the Congressional requirement and serves as the basis for a number of substantial task force efforts of government procurement offices. These task forces are developing more detailed action plans for reform of the procurement system across a wide range of systems issues, from authority of procurement executives to upgrading of the workforce. In addition, the procurement reforms defined by OFPP have been made one of the initial priorities of the Reagan Administration's Reform '88 project, aimed at achieving long-term fundamental reform of the major systems by which the Federal government manages its affairs.

Given this wealth of up-to-date material, the NAPA Panel found that it was not necessary to do an assessment of the Federal procurement system from the ground up. Instead, it takes advantage of the 1982 OFPP report and the work of its current task forces, but adds its independent views and recommendations as to additional steps which would make the procurement system more effective and less burdensome.

Procurement Responsibilities

The procurement system, like most other management systems in the public sector, is driven by conflicting forces. On the one hand, it is a tool of management and is expected to facilitate bidding, contract negotiation, and contract management. On the other hand, it has increasingly become a regulator, guardian, and protection mechanism to assure integrity of the process. This role is essential, but if it is overplayed, the system becomes less responsive to the legitimate needs of the program manager, who is by definition an action agent trying to get things done.

"The most significant issue in the apportionment of procurement authority is to strike a reasonable balance between the use of the system as a facilitation of action, and its defensive protectionist purposes."

Similarly, there are different forces behind agency attitudes about delegations of procurement authority. The active manager and contract officer wants procurement authority at the level where the action is—where contracts are negotiated and managed. Some headquarters people may not fully share this view since they define the system, and they are charged with making sure that policies are being followed and that all of the regulatory and protective measures are in place and functioning.

As Federal contracted activities have expanded and state/local contracting under federally-funded programs has grown, there has been an increasing movement by the Congress toward a single uniform procurement system for all of the government, with a central Office of Federal Procurement Policy, a single uniform body of authoritative regulation (the Federal Acquisition Regulation), and a tendency both in Congress and the Executive Branch to think in centralist terms.

The existence of these competing forces driving the procurement system is a permanent phenomenon. The reforms of the past decade and those being currently pursued call simultaneously for greater decentralization of authority and for strengthening the hand of the central system; for a single uniform regulation but for greater freedom and flexibility for the managers and procurement officers in the trenches. The most significant issue in the apportionment of procurement authority is to strike a reasonable balance between the use of the system as a facilitator of action and its defensive protectionist purposes.

The NAPA Panel's questionnaires and extensive interviews with both line managers and procurement officials strongly suggest that there is deep concern with the continued growth in the regulatory uses of the system. A number of factors are seen to contribute to this concern:

- A pattern evolving over many years of expanding the role of the procurement system as a vehicle for implementing and enforcing of many socioeconomic policies of government. (This subject is discussed in more detail later in this chapter.)
- A normal tendency to bureaucratize the process through an accretion of detail and a failure to spend the time and effort to unburden procedures and keep them as simple as possible.
- A buildup of the regulations and controls dealing with contract bidding and source selection. The tough decisions about who wins and who loses has led to the installation of added mechanisms to guarantee equal treatment, deal with protests, and guard against improprieties in selection decisions. This has, however, made the system much more cumbersome and protracted.
- A serious concern that this buildup of onerous and excessive mass of complicated and expensive processes and procedure is driving off potential contractors and reducing competition and contractor quality.

This trend toward excessive regulation of the system has also been fully recognized by the Office of Federal Procurement Policy (OFPP) in OMB, and it has become a central concern of its current procurement reform program and a part of the Reform '88 project. President Reagan's Executive Order 12352, dealing with reforms which do not require change in legislation, mandates major efforts within the Executive Branch to simplify, upgrade, and automate the system. OFPP estimates that as we move toward issuance of the consolidated Federal Acquisition Regulation, the 6,300 pages found in current regulations of DOD (DAR), NASA, and GSA (FPR) may be pared down to about 2,400 pages. This will contribute to genuine reductions in the administrative overburden of the system.

Recommendations:

- **The NAPA Panel strongly supports Executive Order 12352 and its work program and commends OMB** for making procurement reform a priority under its Reform '88 program.

- OFPP is urged to concentrate the efforts of its task force on ways to increase the degree of delegation of procurement authority to the operational level which matches program management authority, with a minimum of higher level review, concurrence, and approval. This would contribute greatly to reductions in paperwork and time delays in processing.
- OFPP is urged to continue to increase the effectiveness of procurement executives in reforming agency procurement systems in accordance with responsibilities assigned to agency heads by the President.
- The NAPA Panel recommended that the Congress in its current session actively consider Administration legislation aimed at further improvements in the procurement system. Specifically, we advocate that the Congress agree to amend the existing basic procurement statutes to:
  —Revise the definitions of competition to provide for effective competition with due regard for the nature of the services required.
  —Eliminate significant inconsistencies between the Armed Services Procurement Act and the Federal Property and Administrative Services Act, especially those concerned with the small purchase threshold and multiyear contracting for supplies, equipment, and services.

"The greatest momentum for procurement reform in recent history is now in progress. . . ."

The Statutory Reauthorization of the Office of Federal Procurement Policy

The capstone recommendations of the Commission on Government Procurement in 1972 were to (1) create a leadership structure founded on a statutory Office of Federal Procurement Policy, headed by a Presidential appointee, and (2) achieve unified policies through merging the Armed Services Procurement Act and the Federal Property and Administrative Services Act into a single statute.

During the first period of its existence—between 1974 and 1979—OFPP devoted its energies to seeking a single statute and initiating some of the other reforms advocated by the COGP. It was not, however, until the reauthorization in 1979 (P.L. 96-83) that a formula was found for launching significant progress. Congress triggered this formula by requiring OFPP to develop and submit a blueprint for (1) a Uniform Procurement System, (2) a Uniform Management System, and (3) a statutory base for the future. This has been done, culminating in the report dated February 26, 1982, to the Congress, signed by OMB Deputy Director Edwin L. Harper. Mr. Harper added one more significant dimension to the leadership formula by announcing plans for Executive Order 12352, signed March 17, 1982. The stress placed on unification of the statutes has been replaced by mandating reform actions within the framework of existing statutes.

The Executive Branch has now been at work for more than a year on the program of comprehensive reforms envisioned in the report and the Executive Order. The greatest momentum for procurement reform in recent history is now in progress, supplemented in the Defense Department by the 32 "Carlucci Initiatives." The Executive Order program has launched six task forces to cover organization, process, and workforce improvements which already involve 131 specialists from 26 agencies. *The Academy Panel recommendations are designed to add to this agenda of reforms or to supplement some of the initiatives.*

"It would be a misfortune to lose the current momentum by allowing a major change to occur in OFPP's charter or organizational location."

It would be a misfortune to lose the current momentum by allowing a major change to occur in OFPP's charter or organizational location. It is apparent that the implementation of the current task group efforts will be just beginning by September 30, 1983, and that reform efforts must be sustained over longer periods of time before they become reality. The Panel would not normally support legislation which specifies internal elements of an organization, but the need for the unambiguous identity and adequate budget support, currently provided by OFPP, should remain assured. In taking this position, the Panel endorses the high degree of participative management which now exists—including the retention of regulatory authority by DOD, NASA, and GSA, and their agreement to complete and maintain the Federal Acquisition Regulation.

Recommendation:

In order to sustain reform momentum and capitalize on the opportunities which lie ahead, the Panel strongly recommends that Congress reauthorize OFPP—essentially in its present form, but with a mandate broad enough to sustain the current program of reforms and the Panel recommendations. Exhibit 1 contains the excellent policy summary found in H.R. 2293 proposing the reauthorization of OFPP. This policy stresses the importance of competition as the first priority and other steps needed to strengthen and simplify the procurement process. It is achievement of this total system of reform which the Panel strongly advocates.

The Case of OMB Circular A-76

OMB Circular A-76, revised on March 29, 1979, defines the steps which must be taken to determine whether a given Federal function or activity is best performed by an in-house civil service staff or contracted out to the private sector. This has become a procurement issue largely because, in the absence of other management procedures, the procurement process became the home for this issue since the first policy push to contract out started in the 1950's, and procurement people had the skills to assess the cost effectiveness of the private sector alternative. Initially, both line managers and procurement officers complained that the A-76 procedures have become extremely costly and time consuming. But as the NAPA study team dug deeper, it found that much of this concern was being effectively addressed through the work of the OFPP interagency task force.

It is generally conceded that many Federal programs and purposes cannot or should not be carried out by Federal employees. The best understood examples include:

- Large-scale manufacturing where the capital plant, managerial experience, and base of skilled labor already exist in the private sector.
- Finite projects where the short-term use of private sector capability is cleary wiser than buildup of permanent civil service staff.
- Use of special skills outside of government (for example, scientific research) where the Federal government does not possess the needed skill base.

Similarly, there are other activities which are generally conceded to require Federal employees to perform them. These include definition and justification of Federal policies, control of its finances, preparation and defense of its budgets, and indeed management of its contracts.

Even these two groupings of Federal functions are nebulously defined, but between them lies a very large grey area of activities which might well be performed either by Federal employees or by private companies through contract arrangements. It has been estimated that at least some 500,000 person-years worth of Federal activities, largely of blue collar effort, fall within this grey area. Beginning in the 1950's when the range of Federal programs began to expand, there have been several waves of policy emphasis to remove from Federal performance those functions which could be better performed and/or more cost-effectively performed in the private sector. Originally, this was a policy based almost entirely on estimates of cost effectiveness. Gradually, that policy has given way to a more effective analytical effort aimed at maximum productivity benefit to the government. Today, the process is comparable to what companies call "make or buy" analysis. It starts with a careful definition of the tasks and how effectively they are being performed in-house. This includes an assessment for possible improvements of in-house performance. Then a full cost analysis is performed, and a show-down competition conducted with private sector bidders. If the government's cost is not more than 10 percent higher than the best private sector bid, the work is retained in-house. Otherwise it is placed under contract for a specific period of years with a new review at the end of that time.

"Originally, this was a policy based almost entirely on estimates of cost-effectiveness. Gradually, that A-76 policy has given way to a more effective analytical effort aimed at maximum productivity benefit to the government."

This process has gained widening acceptance as being effective and offering a fair means of answering the question of what should be contracted and what should not. About half of the studies are resulting in contracts; half result in retention in-house. About 8 percent savings are realized in-house, and about 20 percent savings are realized when work is contracted.

Not all agencies have brought these procedures up to full effectiveness, and a great deal of work remains in achieving this goal. A good deal of disenchantment continues to exist over the long lead times required to make these studies and the burden of paperwork and analysis involved. What captured the attention of the NAPA study group, however, was the huge cost saving potential which can be realized through the discipline of these A-76 determinations—estimated at $1 billion or more per year if fully realized.

Recommendations:

- **The Academy Panel recommends that OMB, through the Administration's Reform '88 initiative, bring to the attention of agency heads the potential of the A-76 program and commitments from agencies to accelerate the conduct of necessary A-76 studies and decisions as an effective cost reduction and management improvement program.**
- **OMB should build up its capability to provide leadership through training and technical assistance and serve as a clearinghouse of case studies and best agency techniques.**
- **The Director of OMB should invite the Comptroller General to become a full partner—along with OMB, OPM, and GSA—in establishing a Joint Productivity Management Improvement Program patterned after the Joint Financial Management Improvement Program.**

This approach would draw on the talents built by GAO over the past decade and obtain legislative branch participation in a mission of common interest. GAO's interest in productivity enhancement began under Comptroller General Staats and has been encouraged by the Joint Economic Committee over the years. The joining of resources and leadership among the Comptroller General, the Director of OMB, the Director of OPM, and the Administrator of GSA would bring a powerful leadership force to bear. A precedent for this type of shared leadership exists today in financial management.

The Effectiveness of the Procurement Workforce

In the 125 interviews conducted during this study of Federal procurement, the importance of a highly skilled workforce was stressed by every group interviewed:

- *Procurement executives* were concerned with a declining workforce occurring under personnel freezes, without a decline—in fact, sometimes an increase—in volume of contracts. The restrictions on funds for travel and training were cited by some as a problem; and the current emotional debate over classification standards has added to these concerns. Current deterrents to the hiring of college graduates give rise to fears of future deterioration.
- *Line executives* were generally concerned with the need for more creativity on the part of procurement personnel in advance planning and assistance in framing the best procurement strategies—practices long familiar to industry and business managers.
- *Congressional staff* members were concerned with whether agency heads and other appointed executives entering government have an understanding of the size and complexity of the procurement process and with their need for awareness of public policies governing competition and the socioeconomic laws and regulations which the procurement system implements.
- *Private sector* individuals and organizations having insights both into Federal and non-Federal purchasing practices were universally concerned with the need for a procurement workforce adequate both in numbers and professional skills.

The OFPP report transmitted to Congress in February of 1982 also tackles the procurement workforce issue at length, offering a blueprint for workforce reform which includes:

- organizing for career management programs, including the role of the Federal Acquisition Institute in assisting executive agencies in procurement workforce issues;
- ensuring proper classification of positions as a joint effort of OPM, OFPP, and the agencies;
- recruiting and selecting qualified individuals;
- strengthening procurement intern programs;
- training the procurement workforce (agency procurement executives are expected to develop agencywide master plans);
- appointing qualified contracting officers using certification and warranting procedures; and
- establishing accountability requirements and incentives for quality performance.

Executive Order 12352, signed by the President on March 17, 1982, generally confirms these assignments of responsibility, and the OFPP task groups, now fully at work, are giving attention to systems certification criteria, the studies of procurement executives, and the range of actions needed to professionalize the procurement workforce. The scope of the latter task force includes intern programs, contracting officer qualification programs, the procurement infrastructure, procurement career development programs, education, recruitment standards, procurement research programs, performance incentives, and small purchase career development.

". . . a growing imbalance between the procurement workload and the staff to do the work . . . a staff which is undertrained and underexperienced."

Why is this an issue relevant to the purpose of this report? Because the general perception has now been clearly stated that significant improvements in the procurement system cannot fully be realized unless its workforce improves significantly. Even if all of the reforms of the procurement system discussed in this report and elsewhere were implemented, there would still be weaknesses in system performance attributable to workforce deficiencies, such as:

- a growing imbalance between the procurement workload and staff to do the work,
- a staff which is seen as undertrained and underexperienced for its responsibilities, and
- a failure of line management to back career development in the profession, and thus a decline in its attractiveness as a career field.

These deficiencies over time lead to degradation of performance. The sophistcated skills of procurement strategy formulation, contract negotiation, and contractor monitoring are degraded, and routine operations take even longer, cost more, and are less effectively performed. This performance degradation is especially serious in procurement management where delays can have major cost consequences.

It can be argued that there is nothing special about the procurement workforce and that every group of Federal employees is vulnerable to the same concerns about understaffing and neglect of skills and training. To some substantial degree, workforce degradation is experienced by other employees, and that fact is an indictment of the Federal personnel system generally which is more fully addressed in Chapter Five of this report. In any event, because so much recent work has been done in the procurement arena, the experience of the procurement workforce is a telling example of how management systems can deteriorate through neglect of human resources.

Recommendations:

- **The Panel in its Interim Project Report on Procurement has made numerous recommendations as to how the procurement workforce can be upgraded and professionalized. While these recommendations are too numerous and detailed to be included here, the overall conclusion they generate is that** agency management has either failed to recognize how extensive this human resources problem has become or that it has been unable or unwilling to take the necessary actions to stem the tide.

- The NAPA Panel endorses the blueprint for action defined by the OFPP report of 1982 and summarized at the beginning of this section. It recommends that OFPP continue through its task force on workforce development to develop proposals for upgrading the workforce, including executive development programs and orientation seminars for program managers. At the same time, the Panel acknowledges that the principal staff arm for line management in personnel matters comes from personnel officers in agencies and from OPM for the whole government.
- The NAPA Panel recommends that the OFPP task force become a joint OFPP/OPM program to work with agencies to develop a Workforce Improvement Action Plan, which would become the basis in each agency for the certification by the agency head that the procurement system is fully effective.
- The Civil Service Reform Act of 1979, which created OPM, clearly intended that it become more actively engaged in positive, constructive personnel management development and assistance throughout government, as an arm of line leadership. The Panel therefore recommends that, if the concept of a "workforce improvement action plan" can be successfully developed for the procurement workforce, the plan be made the prototype for similar development efforts for other workforces.
- To further the concept of a workforce action plan, the Panel recommends that OPM initiate a program to show agencies how to plan and implement workforce improvement development programs and that OPM—through its own training centers or through institutions like the Federal Acquisition Institute—take the lead in training both line managers and functional staff officers in more effective workforce development.

Test and Demonstration Authority

A major thesis of this entire report on Federal deregulation is that bureaucratic systems have become exceedingly hard to change, and unless there are powerful change agents at work, systems risk becoming rigid and eventually obsolete. It has also been pointed out that, in the Federal government, where management systems are centralized with mandated uniformity, individual managers are constrained from innovating or experimenting, except on purely local operational procedures.

"The Panel feels that the test and demonstration authority may be its most important recommendation. . . ."

One of the most productive opportunities for future reforms of procurement is authority to try new practices which are carefully planned and controlled. Provisions for piloting more efficient and cost-effective techniques could be similar to those included in the Civil Service Reform Act, which provides for advance notification to Congress and opportunity for public comment. The Panel feels that the test and demonstration authority may be its most important recommendation in the procurement area since the types of matters which should be considered have long-range potential, affecting every aspect of the procurement process.

Recommendation:

The Panel recommends that OFPP's reauthorization act contain test and demonstration authority broad enough to permit major statutory and regulatory waivers for extended periods in whole agencies.

This test and demonstration authority need not be confined to OFPP or to procurement systems and procedures. Such authority could be included in the authorizing statutes for those departments and agencies in which contracting (both direct and through grant programs) is particularly important. In this context, tests could be developed in coordination with OFPP for innovative forms of contracts, "fast tracking" of bidding and source evaluation pipelines, improved contract administration techniques, stronger financial management systems and controls, better contract management and oversight, automation of auditing techniques, expedited voucher certification and payment, and other new approaches aimed at improvements in program performance.

CHAPTER FIVE

New Concepts for Personnel Management

The Federal Personal Manual (FPM) has eight thousand eight hundred and fourteen pages. If regulations generated good personnel management, the Federal government would have the best personnel system in the world.

But instead, when managers and personnel experts all over government were consulted, they simply reaffirmed what is common knowledge—the frustrations with the system are general and profound. Even experienced personnel officers admit that nobody really understands those 8,814 pages. They certainly are not understood by managers, nor do they describe a personnel system which works for them or for their employees in the workplace where a personnel system should really pay off. In sharp contrast to successful personnel systems elsewhere, Federal managers do not feel that the system is designed to meet their needs, but see it as just another set of obstacles they must overcome in doing their jobs.

In fact, the personnel system doesn't seem to work very well for *anybody*. Because of this, the NAPA Panel was asked to make the personnel systems a central priority in its study.

"If regulations generated good personnel management, the Federal government would have the best personnel system in the world."

The reactions of various personnel system users can be summarized as follows:

Executives and line managers feel almost totally divorced from what should be one of their most important systems. They regard themselves as being required to operate under a system which is imposed on them from outside their own agencies, and they feel that they play almost no role in the development of that system, either governmentwide or within their own agencies. They feel they have little or no voice in how the system functions and thus have no sense of responsibility for whether it works well or poorly. They recognize that 8,814 pages of FPM means that the system rests in the hands of the personnel specialists, many of whom have only a tenuous grip on their own processes. Finally, and most significantly, managers have become passive and indifferent. Lacking any sense of relevance in personnel matters, they seldom feel any reward (or penalty) for how they handle personnel situations, spend far too little time on them, and frequently resent the time they do spend because it seems bureaucratic and unproductive. Yet no decisions made by these managers are more important.

"In fact, the personnel system doesn't seem to work very well for *anybody*."

Personnel specialists spend far too much time in the mechanical or procedural elements of the system: interpreting the 8,814 pages of the manual, supplementing them with additional hundreds of pages of procedures within their own agency, and administering the paperwork and reporting which the system demands. They believe that they are left with far too little time to consult and work with line managers or employers in positive personnel work, such as recruitment of high quality people, sound employee evaluation and merit pay determinations, and design of intelligent programs for employee development, training, promotion, and transfer. This preoccupation with process also makes more difficult the exploration of cooperation with unions in creative approaches to positive employee incentives.

The Office of Personnel Management operates approximately 70 percent of all examining operations, directly conducts training programs, administers compensation and fringe benefits programs, and runs the Federal retirement system. It also attempts to keep the manual up to date—often unsuccessfully. It relies heavily on standard procedures, preapprovals of agency plans, and audits of individual positions and even individual actions, as system controls. When it develops personnel policy, it is often not able to obtain sufficiently broad inputs from managers and executives in addition to its network of personnel officers. And, it spends minimal time in personnel research and development activities or in exerting its role as the Federal government's personnel system leadership, a role which was intended as an important element of the Civil Service Reform Act.

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The Present System

The staff studies on which this report is based makes many specific recommendations for reform of the Federal Personnel Manual. But the NAPA Panel strongly believes that "hacking away at the underbrush" is not a feasible solution to the problem of personnel system ineffectiveness. *A more advanced concept of personnel system value and accountability is needed which goes beyond the advances of the Civil Service Reform Act by placing responsibility for effective personnel management squarely in the hands of the manager, and not in the personnel organization.*

At present, accountability is divided and varies by functional areas within personnel management so that no one is fully accountable. For example:

- Only the agency head has the authority to hire, promote, train, and fire employees, but this must be done following specific procedures laid down by OPM and frequently with OPM approvals of plans or individual actions.
- OPM and agency position classifiers usually have the final say in position classification while the line manager is accountable for determining duties, assignments of duties, and work results.
- Delegations to agencies and within agencies for personnel management vary greatly by functional areas (hiring, promoting, training, separating). Delegation to line managers to act on personnel matters without approval by or formal coordination with others is the rare exception rather than the rule.

These muddied relationships prevail in a government personnel system once highly centralized but in which substantial decentralization took place before and during World War II and again during the Korean War because decentralization was recognized as vital to the success in the war effort. Congress and Presidents have also conceded the need to exempt special government activities from the general civil service: the Tennessee Valley Authority in 1933, the Atomic Energy Commission and the medical functions of the Veterans Administration in 1946, NASA in 1958, the Postal Service in 1970, the U.S. Railway Association in 1973, and the Synthetic Fuels Corporation in 1980. Legislative branch agencies and some security agencies have their own non-civil-service merit systems.

Despite these centrifugal tendencies, there were centralizing forces at work from the 1950's on—notably the recentralization of examining authority in the Civil Service Commission in the 1960's. However, when Congress reconstructed the statutory foundations of the civil service in the Civil Service Reform Act of 1978, it provided authority for the Director of OPM to delegate most of his functions to agency heads.

The basic argument for a centralized, procedurally oriented personnel system is that the Federal government is a single employer, and equity and efficiency demand such a system. However, past decentralizations and exemptions show a clear recognition that the government is *not* a single employer and that flexibility in personnel management delegations to agencies is necessary if they are to administer Federal programs successfully.

On the basis of its overall assessment, the Panel developed several basic assumptions about necessary conditions for further personnel systems reform:

- Effective deregulation is possible only through maximum delegation of authority to agencies with:
  —the relinquishing of detailed controls by the central agency and
  —the decentralization of operations within agencies.
- To carry out this concept, it is essential to hire, develop, and retain the highest quality of executive and managerial leadership—both political and career.
- Executive leadership should be given full responsibility for personnel management and held strictly accountable for actions and results.
- The central personnel agency (the Office of Personnel Management) should provide positive leadership on behalf of the President by:
  —issuing broad guidelines;
  —carrying out far-reaching research and development efforts directly or in cooperation with agencies;
  —monitoring and evaluating personnel management effectiveness within agencies, and, where necessary, withdrawing delegations of authority;
  —actively enforcing sound personnel management through recommending changes to the President and the heads of agencies when it finds system problems in the agencies; and
  —encouraging and assisting agencies to develop strong positive personnel programs.
- The Merit Systems Protection Board will have to be vigorous in its role and competently staffed, particularly in its merit systems review functions.

"Executive leadership should be given full responsibility for personnel management and held strictly accountable for actions and results."

A New Conceptual Framework

A new conceptual framework is proposed which is based on consideration of some of the characteristics of successful private sector personnel programs, but, to a surprising degree, it is simply a turnaround of the negative reactions to the Federal personnel system summarized above. In this new framework:

Federal executives and managers must take a more direct and active role in personnel management. (Many of their counterparts in highly successful private companies spend on the average of *more than 50 percent of their time* on the development of people.) The Federal system must delegate more "hands-on" authority to these managers and deliberately draw them more into the design of personnel systems and programs, so that the managerial needs will dominate design rather than procedural concerns. Managers must, within established guidelines, take greater control over critical personnel processes, such as recruitment of talent and the classification of positions as to grade and work content, and ultimately must be held accountable for the success or failure of personnel management.

It must be reemphasized that the basic intent of this concept is to shift the center of gravity for personnel program effectiveness away from the professional personnel organization and into the hands of the managers. The focal point for the personnel program is the workplace. Both managers and employees know how complex and interactive this workplace can be, but it is here that the real utilization of an organization's human resources takes place. People are motivated not by systems but by leadership, the value of the job, the chance to contribute and to achieve, and the sense of being needed and rewarded. Federal supervisors managers and executives cannot afford to be hampered by their own personnel system, nor can they remain indifferent to and unskilled in personnel matters.

"Managers must . . . take greater control over critical personnel processes such as recruitment of talent and the classification of positions. . . ."

Professional personnel staff must consult more thoroughly and extensively with agency leadership and line managers to give them professional guidance and assistance and to obtain—in fact demand—clearer signals about what management wants from its personnel programs, and they must monitor programs and personnel operations on management's behalf. This is more of a staff function rather than a line function, and it presumes some shifting of personnel operations (notably recruiting, classification, performance evaluation, and merit pay determinations) into line organizations. But it is also a personnel responsibility of a higher quality and ultimately of far greater value to the organization.

The Office of Personnel Management must concentrate less on detailed procedures and focus more on providing direction, leadership, and evaluation. This can be made possible by delegating most operations to the agencies in every feasible way. OPM would continue to design the overall personnel system and give greater emphasis to monitoring and evaluating the conduct of personnel programs throughout the government on behalf of the President. In addition, OPM would continue to guide and review basic compensation and classification systems, and approve certain key individual executive personnel and political appointment actions, as well as labor contracts which are nation- or organizationwide in scope, along with general oversight of labor relations.

Table 1 describes these functional roles and relationships more explicitly in the form of a functional model.

Recommendations:

To develop this new concept and partnership, the Panel recommends that:

- OPM and agencies establish and operate under a clear and consistent set of relationships with each other.
- OPM act for the President in developing and guiding a positive personnel program to be carried out by the agencies, and in sponsoring research and development on useful innovations.

OPM adopt broad guidelines which permit agencies to have the flexibility to develop and implement personnel programs responsive to their management needs.

- Agencies select and develop career executives and managers who will be competent and willing to exercise the major personnel management responsibilities recommended in this report.
- Executives and Line Managers:
  —Take more active roles in personnel, particularly in selection and development of effective employees;
  —Help tailor personnel programs to meet their needs;
  —Develop a greater sense of personal responsibility for the design and operation of the system;
  —Receive rewards based on involvement;
  —Be held accountable for effective use of authority delegated to them;
  —Participate in developing policies which are approved by the head of their agency or organization.
- Within agencies, personnel offices:
  —Provide staff assistance to top management in the formulation of agency personnel policies and standards;
  —Serve as consultants to executives and line managers, as well as provide staff help in recruiting, training, and other personnel functions.

"One of the unfortunate consequences of past personnel practices is that a significant proportion of Federal managers and first line supervisors move into their jobs without adequate training or preparation to exercise their personnel responsibilities."

One of the unfortunate consequences of past personnel practices is that a significant proportion of Federal managers and first line supervisors move into their jobs without adequate training or preparation to exercise their personnel responsibilities. The recommendations of this report call on managers to upgrade their human resources role and would require more direct attention to personnel processes. If real progress is to be made in bringing about the decentralization concept, it is imperative that special efforts be made to train and motivate managers to fulfill their new role. Such special efforts would be warranted if only to repair past neglect, but it becomes an imperative

TABLE 1

The Functional Model

Application of concepts that have been successfully applied in industry and in Federal organizations not subject to Civil Service led the Panel to construct a model division of responsibilities against which present relationships can be evaluated. The Panel recognizes that achieving the roles and relationships proposed will take an extended period of time, will have to be phased in, and will involve a learning curve on the part of all participants.

Central Control and Leadership. OPM and OMB as staff agencies to the President should exercise the following functions:

Function	*Focal Point*
Principles, objectives, and standards for personnel management	OPM
Program evaluation	OPM/MSPB/GAO
Salary schedules, compensation systems, and fringe benefits	OPM/OMB
Control on salary expenditures	OMB
Control on numbers of executives	OPM

Agency/Department Personnel Management. Responsibility for all other functions would be shared as outlined below:

	OPM	*Agencies*
1. *Recruiting and Examining*	OPM delegates recruiting and examining to agencies. Where examining involves "common positions," OPM takes lead in cooperation with interagency groups or the primary employer in the area and monitors process and results.	Agency staff carry out recruiting and examining with line manager involvement. Where OPM has the lead because of "common positions," agency staff and line people participate with OPM in the process. In both situations, OPM monitors process and results.
2. *Classification*	OPM assigns development of qualification and classification standards to interagency groups or predominant employers. Standards so developed are subject to OPM approval and deal primarily with the "journeyman" level. OPM issues guideline standards for positions above the journeyman level. OPM monitors process and results.	Agencies assign staff and line persons to participate in the development of standards. Each agency adopts guidelines for positions above the full performance (or journeyman) level consistent with its management needs and organizational alignments. Agencies apply the standards, carrying out good classification and position management practices, and constantly evaluate and provide feedback on the classification system and its application. OPM monitors results and reports on them in program evaluation reviews.
3. *Merit Protection, Merit Pay, Equal Employment Opportunity, Training, Performance Appraisal, Incentive Awards*	OPM issues broad guidelines and places its emphasis on evaluation. MSPB evaluates Federal merit system against statutory principles.	Agencies implement programs under OPM guidelines and do self-evaluations of subordinate and field organizations. Line managers participate in all developmental, implementation, and evaluation activities.
4. *Labor Management Relations*	OPM provides general guidance and provides data and analysis on FLRA decisions.	Agencies implement program under OPM general guidance. Line managers participate in all LMR activities.
5. *Adverse Actions*	OPM provides general guidance and data analysis and guidance. MSPB decides appeals.	Agencies carry out adverse actions with line management involvement and considerable staff advice and support on specific actions.
6. *Program Evaluation*	OPM issues evaluation criteria when policy guidance is issued. Prior approvals are kept to minimum required by law. Reporting requirements met through automated systems. Evaluation may be done by OPM or by agencies with reports to or checks by OPM. GAO and MSPB also evaluate programs. OPM enforces standards: withdraws authority, imposes special controls, or reports to agency head or Congress where abuse or misuse of authorities occur or where personnel programs don't measure up to recognized standards.	Agencies reflect evaluation criteria in their programs; develop automated information systems to assist executives and line managers in program evaluation.

for the future. No significant improvements can be achieved in human resources utilization, personnel program innovation, or reduction of procedural overregulation until managers are properly prepared to accept their more important roles. This need also represents a significant new challenge as well for OPM and the professional personnel staffs in the departments and agencies. They too must "shift gears" and place themselves in more of a service relationship to line leadership than in the past.

Such changes can't be made overnight. The course laid out in this report will require many years to bring about. OPM continues to be guarded in stating that "OPM favors delegations if these are consistent with law and OPM's mint and fiduciary responsibilities." But clearly the pace at which this change is implemented could be much greater if OPM and agency leadership can be linked together in a partnership to develop plans for achieving these objectives.

Recommendations

- The NAPA Panel recommends that OPM take the lead in planning and promoting a major program to strengthen the personnel role of Federal managers throughout government by implementing the recommendations of this report.
- It also recommends that agency heads adopt the policies of this report which call for greater delegation of authority for personnel matters and that immediate action be initiated to train and motivate all supervisors and managers to prepare them for the assumption of this stronger personnel role.

Major Findings and Recommendations on Specific Personnel Functions

Within the framework of the substantial personnel system changes described above, the Panel has developed a series of more complete and specific recommendations for improvement in major parts of the overall personnel system.

The Classification System

Findings:

- A majority of classification standards are out-of-date and inadequate.
- Controls on results of the classification process are outside the authority of line managers.
- The classification process itself is heavy with red-tape and invites adversarial relationships.

The classification process, under the Classification Act of 1949, involves the application of governmentwide standards to individual positions in virtually every occupation and pay level within each occupation in the Federal government. The results set both the grade and pay level for each position in the organization and the qualifications required for each position. Yet in today's world, it is virtually impossible to develop and maintain standards that will fit the great diversities found in duties, organizational alignments, and levels of responsibilities found among the 1,500,000 white collar positions in the Federal government. This is illustrated by the fact that for the 430 white collar occupations in government, 40 percent are covered by "new" classification standards using a factor evaluation system started in the 1970's; 60 percent are under old standards. The Panel recommends that OPM concentrate governmentwide standards on the working level or professional level positions in an occupation which represents the predominant numbers of positions in that occupation. (They are frequently referred to as "journeyman" positions and involve the full range of duties in the occupation but do not include any supervisory or special responsibilities.) Broad guideline standards should be issued by OPM which agencies would adapt and apply in classifying positions at all other levels in the occupation. Agencies and line managers within agencies could and should be involved in the development of both governmentwide standards, and line managers should also be involved in the adoption and application of those standards in their agencies.

A second problem is organizational. Managers are not held accountable for grade and salary expenditures, while those who are responsible for grades and salaries (position classifiers and OPM) are not held accountable for the work of employees. This comes about because the Classification Act forces managers to organize and carry out their work through positions, which in turn are assigned a grade and pay range. The first phase is carried out by the line managers and executives; the second by position classifiers in agencies and OPM. Managers decide organizational alignment, distribution of functions, delegations of authority, and duties assigned and degrees of responsibility given to individual positions. The role of the classifier is to put the "price tag" on the result which the manager has determined. By giving the line manager greater authority and responsibility for the final step in the classification process, he or she will consider the results from the total process in terms of (1) the requirement to comply with the basic law (the Classification Act), (2) the impact of costs of salary and fringe benefits, (3) issues of equity in their organizations as well as others, (4) the ability to defend the action with higher levels of management, outside review agencies, and individual employees and groups of employees, and (5) possible alternatives. The classifier, in this situation, becomes more of an adviser to line management, frequently to several levels in the organization, in assisting management in taking into account all of the considerations involved and in monitoring the process for agency executives.

". . . OPM should concentrate on standards for the professional level positions. . . ." ". . . agencies would adapt and apply at all other levels. . . ."

A third problem results from efforts by OMB and Congress to control "grade creep" by discouraging increases in the average grade of an organization (the total of all the grades in the organization divided by the number of jobs). Such a control would be useful only when the organization's work program and number of jobs remain static. Changes in program and staffing are frequent and affect the average grade. Therefore this is an unrealistic form of control and another logical candidate for deregulation. The use of the budget process to set dollar limits on personnel costs linked with stronger workforce planning and control can be far more effective means for curbing grade creep which do not have the same constraining effect on supervisor flexibility. Agency executives should be perfectly capable of enforcing compliance with classification standards through supervisory discipline and internal agency evaluation systems. They can also set and enforce budgetary limits as a means of control. OPM continues to disagree, saying that managerial expediency and pressure must be countered by the classification system. Central agencies such as OPM, GAO, and MSPB have an important role also to evaluate programs and to report results of their evaluations to agency heads, to the President, and to Congress.

Recommendations:

- OPM's role should [illegible] standards for the full per[illegible] level positions in occupations and issuing broad guideline standards which agencies would adopt and apply to all other positions in their organizations. Agencies should participate in the development of both these standards and guideline standards.
- Line managers should assume greater responsibility for classification and sound position management; the role of the classifier should be more of an adviser than a control agent.
- OPM should eliminate current methods of classification control, i.e. setting average grades and classifying (certifying) individual positions. Congress and OMB should control classification through overall salary costs and agency heads should exercise organization, position management, and salary controls for their agencies.
- New models of classification systems that meet agency needs should be developed and put in place.

Hiring Quality Personnel

Findings:

- There is a lack of consistent OPM philosophy and practice on delegation of examining authority, and the lack of delegation adversely affects the ability of line managers in their efforts to recruit quality personnel.
- The pipeline for filling professional and administrative career positions essential to effective administration of the executive branch of government has been impaired. No satisfactory temporary or permanent solution is in sight.

Agencies prefer to do their own recruiting and examining for outside hires under delegated authority from OPM, because they find they can do more active recruiting, expedite hiring, increase line management involvement, and achieve better results if they have delegated authority. Yet today, only 30 percent of all outside hires are selected from registers maintained by agencies under delegated authority. OPM has shifted its stance over the years about delegating, recruiting, and examining to agencies, and some current delegations are being withdrawn. OPM contends that such simplifying delegations are not consistent with the law nor the intent of Congress.

The Federal government has been a major employer of college graduates for professional and administrative positions (normally 7000 per year) hired for careers in all agencies. As an example of their importance, IRS uses college graduates as a primary personnel source. Heretofore, an IRS employing office could go directly to OPM for a certificate of eligibles. Now, OPM delegates "Schedule B" hiring authority to agencies only after obtaining specific approval from OPM for each position to be filled. Requests for approval must be submitted through the Assistant Secretary for Administration for the Treasury. Within Treasury, the request goes from a field office to a region, then to the national office in IRS and then to the Assistant Secretary, who would then submit the request to OPM for approval. This whole process is unreasonably complex and slow. It would be simple and preferable to delegate hiring authority to an appropriate agency manager.

"The pipeline for filling professional and administrative career positions . . . has been impaired. No satisfactory temporary or permanent solution is in sight."

In a serious case of delay in delegating authority to hire college graduates, a Department of the Army request to hire 900 college graduates went to OPM in November 1982, but was not approved until March 1983. This made it extremely difficult for the Army to mount a nationwide recruiting drive for the May 1983 graduates.

The delegation of authority to agencies to recruit and hire is helpful, but there are problems over and above delays. The present process was instituted as a result of a consent decree based upon alleged bias of previous examinations; current procedures are supposed to comply with the consent decree provisions. Agencies have not been given guidance on how to comply with consent decree provisions and therefore may not be in compliance. Finally, new employees are unable to achieve career status and cannot be promoted to levels for which they are being developed. The only out is for them to be selected from a civil service register for that higher grade—an action that may be impossible.

Recommendations:

- Change OPM policy to one of maximum delegation of examining authority to agencies, including a liberal definition of "common" positions. Delegations should be without a time limitation and should be withdrawn only if the authority has been abused.
- Assure, by OMB/OPM action, adequate resources for examining.
- As a short-term solution to the consent decree problem, permit agencies to use schedule B under blanket delegated authority, following decree guidelines, and convert employees hired to career status under an Executive Order upon successful completion of a period of employment.

The Performance Appraisal System

Finding:

- Basic responsibility for the new performance appraisal systems has been in the hands of agencies. They have produced systems which in many cases demand excessive time and paperwork and do not have the confidence of the workforce. Agencies should be able to solve such problems.

Effective performance appraisal systems improve communications between the supervisor and the employee about expectations and performance and serve as a basis for decisions on training, promotions, transfers, and in some cases, separations.

Prior to 1978, most Federal supervisors could have avoided appraising performance on a regular basis and many did so. Managers generally do not like to appraise performance and federal managers are no exception. Under the Civil Service Reform Act of 1978, agencies were required to develop new performance appraisal systems for their employees. Further, the appraisals were to relate to the extent of achievement of program objectives. This was a very expensive and time-consuming effort designed to refocus the Federal incentive system from bureaucratic process and assessment of personal traits to the evaluation of how employees are carrying out the missions for which they are being paid by the taxpayers. This major effort still is in progress. Some agencies did their work well; others did not. Most systems went into effect between July 1979 and October 1981; the final evaluation on any of them cannot as yet be made, for industry experience indicates that it takes up to 5 years to fully implement a performance appraisal system.

Agencies have had little initial guidance from OPM and have tackled the effort in many different ways. For example:

- In some agencies, there are three different performance appraisal systems—one each for Senior Executive Service (SES) personnel, Merit Pay employees, and all others.
- Plans for individual employees have varied excessively in quality and lengths.
- Because individual plans are linked to actions which might be appealed, plans can be burdened with paperwork as a defensive mechanism—just in case an employee should appeal.

The only OPM restriction in its regulations was that which precluded forced distribution of ratings. A new OPM proposal to "simplify and standardize performance appraisal systems throughout the government indicates that in the OPM effort to correct certain agency problems, the agencies may have lost an opportunity to install effective systems tailored to meet their particular program needs. While every effort should be made to support OPM initiatives to simplify paperwork, it would not be acceptable for OPM to impose a new performance appraisal system in agencies without managerial and employer acceptance.

Recommendations:

- **Reduce the excessive paperwork in existing agency systems with attention to the number of systems in an agency, the number and detail of critical elements, and the length of individual plans.**
- **Eliminate the requirement that OPM approve agencies' performance appraisal plans; instead OPM should conduct the extensive research and experimentation needed to improve appraisal systems and should place emphasis on issuance of broad guidelines and on program evaluation.**
- **Generally improve and stabilize agency systems, with input from both managers and employees; train managers in the preparation and use of performance standards.**
- **Request OPM to remove restrictions on forced distribution of ratings and hold agency executives accountable for preventing upward skewing of ratings.**
- **Evaluate and recognize managers partly on their effectiveness in personnel management, such as employee development and performance appraisal.**

Merit Pay

Finding:

- Merit pay for supervisors is one of the most controversial personnel problems resulting from implementation of the Civil Service Reform Act. Few argue with the concept of merit pay but the cost, and complexities of administration, the separate and perceived inequitable treatment of supervisors when compared to other employees in the same pay levels, and the meager amount of money involved tend to negate its value as an incentive to better performance.

The law limits use of merit pay to GS-13-15 managers only. All nonmanagerial employees in the same pay range (GS-13-15) and all employees GS-1 through GS-13 continue to receive increases based upon "acceptable" performance and completion of specified waiting periods. Where agencies have dual career ladders, there is a choice of going up via the management route or the purely professional route where the automatic step increase system continues. Top management is concerned about the negative influence merit pay will have on the future career choices of professionals who have the aptitude to become managers.

Employees subject to merit pay are not guaranteed annual comparability increases; one-half their comparability increases go into the merit pay pool which means that the average yearly increase is less than for nonmanagers, contrary to the intent of the civil service reform recommendations. Furthermore, the limitations on the amounts of money available provide meager rewards for the best employees and may preclude "satisfactory" employees from getting their full comparability increases—a point of view which OPM appears to support.

There is no way that a manager or merit pay employee can relate a rating of performance to the specific dollar amount the employee will receive until long after the rating is given. This is due to the fact that the amounts for individual employees are based upon the distribution of ratings in the unit and the funds available—which in 1980 were not known until well after October 24. However, ratings have to be made by October 1.

All these limitations and distinctions are infringements on managers' ability to recognize superior performance with extra compensation—yet another example of the shackling of managerial discretion.

OPM controls on merit pay were imposed after agencies initially developed their systems. These controls discouraged further line management involvement in the development of agencies' programs and precluded the flexibility needed to meet agencies' needs.

"The entire process is so complicated that it is difficult for the manager or employee to understand it, much less accept its results."

The entire process is so complicated that it is difficult for the manager or the merit pay employee to understand it, much less accept the system and its results. These problems point to the need for an intensive interagency review of merit pay under OPM leadership and in consultation with GAO. The objectives should be to solve problems that cause inequities, inefficiencies, and lack of credibility of the system, and there is a need for a careful test and demonstration program to more carefully assess alternative merit pay options. As these objectives are achieved, it will be appropriate to expand the system to levels and types of jobs not now covered.

Recommendations:

- OPM and agencies should change regulations to ensure maximum flexibility in meeting agencies' needs and in making line managers accountable for effective operation of the merit pay system.
- OPM should amend regulations to guarantee comparability increases for merit pay employees if their performance is "satisfactory" or better than "satisfactory."
- Legislation should be sought to authorize agencies to place all GS-13/15 employees under merit pay.
- Funding should be increased for merit pay purposes to a level which assures that amounts paid to employees are sufficient to create real incentives for higher performance. Any merit pay system which is so underfunded that it does not motivate is wasting both effort and money.
- Legislation should be amended to change the merit pay system so that managers and employees will know the effects of a performance rating on merit pay when the rating is given.

Protecting Merit Principles and Protecting Employees

Finding:

- It is possible, though sometimes difficult, for executives and managers to enforce adherence to merit principles, to discourage prohibited personnel practices, to train and direct employees for effective performance, and yet to deal properly with instances of poor performance or conduct.

As is repeatedly emphasized in this report, agency executives and managers must be freed, encouraged, and even trained to practice positive personnel management. They should be held primarily responsible for upholding high standards of employee selection, development, and performance. At the same time they are responsible for assuring that employees are treated fairly, without political or personal favoritism. In cases where executives and managers are deficient in these respects, it was the intent of the CSRA that employees be protected by agency appeals systems and by the processes of the Merit Systems Protection Board and its Special Counsel.

On the other hand, when employees are deficient in their performance, there must be effective tools for managers to seek remedies for these deficiencies. In such cases, the manager is responsible for helping the employee improve or, if that fails, separating the employee. The performance appraisal provisions of the Civil Service Reform Act have resulted in appraisal systems more closely related to agency job requirements. Evaluations completed by MSPB, OPM, and an earlier Academy Panel on Civil Service Reform verify these improvements. Furthermore, agencies involved in this deregulation study indicate successes in improving performance.

By having and using effective performance appraisal plans, an agency may remove a nonproductive employee within 6 months after action is initiated, according to a study in one department. This is a much shorter time than was required prior to CSRA. Unfortunately, there is little data available to indicate the numbers and disposition of formal actions involving nonproductive employees.

The Civil Service Reform Act reduces the possibility of an agency losing a case in minor technicalities. It does not and should not reduce or change the steps in the process or the fact that management must prove that an employee has not lived up to his or her contract for performance reasons.

The employee's rights to continue in his or her job are formally protected by law and regulation. A manager who starts to take formal action against an employee for failure to perform needs technical assistance to make sure the actions adhere to mandated requirements. This will reduce paperwork and unnecessary delay.

Recommendations:

- Train managers to handle effectively problems of employee conduct or performance. Emphasize use of performance appraisals for setting goals related to organizational objectives, giving employees feedback, and delineating expectations for improvement. Require managers, before formal adverse action becomes necessary, to consult with personnel staff on meeting technical requirements.
- Assure that personnel staffs actively support managers who are experiencing problems with employee performance or conduct, make adverse actions as simple as possible, and reduce technical compliance burdens.
- Require OPM and MSPB to develop, maintain, and

distribute data that agencies use to inform managers of the disposition of appeals in adverse action cases.

Equal Employment Opportunity

Finding:

- Executives and managers are frustrated by the overlapping roles of oversight agencies that result in duplicative regulations and requirements. Current regulations and procedures do not relate to the achievement of EEO goals.

One of the merit principles in the Civil Service Reform Act is that "Recruitment should be from qualified individuals from appropriate sources in an endeavor to achieve a work force from all segments of society, and selection and advancement should be determined solely on the basis of relative ability, knowledge, and skills after fair and open competition which assure that all receive equal opportunity." However, this is only one of some 86 different Congressional requirements regarding equal employment. There are numerous special emphasis programs including age discrimination, disabled veterans, upward mobility, and women's programs, each with its own reporting requirement.

"The [EEO] laws and regulations are complex, varied, and fragmented so that agencies are weakened and burdened in their efforts to comply."

The laws and regulations are complex, varied, and fragmented so that agencies are weakened and burdened in their efforts to comply. For example, OPM and EEOC have divided the responsibility for special programs that overlap (OPM is responsible for disabled veterans, EEOC is responsible for handicapped). Agency plans and reports are submitted on different time schedules to OPM and EEOC, even though the objectives of the programs are similar and the same personnel data bases are used. OPM requires collection of data for the Central Personnel Data File, which is the same basic data required by EEOC. However, the system cannot provide appropriate breakouts of data for affirmative action purposes without a major systems redesign.

All these confusing requirements do not motivate managers to constructive action to meet equal employment opportunity goals. Indeed, people tend to pay only lip service to systems that are bogged down in redtape and line managers strive to distance themselves from most of these requirements, thus defeating the very purpose for which they were intended. Furthermore, it is difficult to monitor compliance in such a tangled regulatory situation.

The immensity of the problem is shown by the fact that one agency's multiyear affirmative action plan was 4 feet high when stacked up. The yearly update was eight 3-inch notebooks. The possibility of improvement is exemplified by the fact that another agency, the Department of Education, uses a simple form that managers submit on a monthly basis, which serves as a self-evaluation tool that summarizes the personnel actions or opportunities taken that month, and shows what the managers did with those opportunities.

A governmentwide problem is that no innovative authority exists to depart from normal methods of competitive examination in an organization where underrepresentation clearly exists.

Recommendations:

- Begin an interagency examination by OMB, EEOC, OPM, and Justice of laws, regulations, and reporting requirements with the objective of:
  —recommending, consolidating, and codifying existing laws and repealing of unnecessary requirements;
  —simplifying affirmative action reporting requirements by incorporating affirmative action data into the Central Personnel Data File; and
  —coordinating roles and responsibilities of oversight agencies where they cannot be consolidated.
- Meanwhile initiate collaborative work by agencies with EEOC to initially reduce reporting requirements (as Education and NASA have done) until the recommendation above is implemented.
- Evaluate managers' performance partly on their use of opportunities to take affirmative action. Place less emphasis on individual affirmative action plans.
- Start development by OPM and operating agencies of innovative programs to achieve improved representativeness of the Federal service. This could include but not be limited to alternative examination procedures where underrepresentation exists. This could be tried under the research and demonstration provisions of the Civil Service Reform Act.

"A governmentwide problem is that no innovative authority exists to depart from normal methods of competitive examination in an organization where underrepresentation exists."

"Redtape" Reforms

Finding:

- The present system of personnel regulations is excessive in length, complexity, and compartmentalization and ill-adapted to use by managers.

The Federal Personnel Manual (FPM) derives authority from Title V of the United States Code. As the requirements of the Code cascade to the Federal Personnel Manual, its 552 pages become 8,814 pages in the FPM. Since agency regulations must parallel the FPM and supplement it in terms of procedure or policy within the agency, two things happen:

- Agency directives become an extension of the FPM and frequently can't be understood without referring to the FPM.
- The compartmentalization of the system and the contents of the regulations make them tools of personnel specialists but undecipherable to executives and managers.

The system is even becoming more complex because proposed regulations are now issued in:

- The Code of Federal Regulations.
- The Federal Personnel Bulletin or the Federal Personnel Letter, which serve as a means of issuing instructions or information on a temporary basis.
- The Federal Personnel Manual, which serves as the vehicle for translating the instruction into a permanent Issuance.
- The Federal Personnel Manual Supplement, which is used to expand on the FPM by providing additional guidance or procedures on a specific subject.

A recent check with OPM indicates that 9 additional chapters and 22 additional subchapters of the FPM are currently in process.

The review resulted in the following number of recommendations for changes in regulations in the FPM:

Rescind all or part of the regulation	2
Increase delegations of authority	25
Delete procedures required	15
Eliminate reporting requirements	10
Reduce prior approvals required	9
Make other changes	16
	77

These recommendations are spelled out in the staff report which supplements this Panel report. Each of the 77 recommended changes will help deregulate the personnel management system of the Federal government. Despite the magnitude of the changes proposed, the Panel believes that the broader changes in OPM recommended in this report would give great impetus to a much deeper and more effective deregulation of the FPM than those proposed here.

Recommendations:

- **Develop and issue OPM criteria for regulations with particular concern for delegations of authority, reports approvals, procedures, and program evaluation.**
- **Require agencies with subordinate organizations to reexamine their criteria in the same areas—particularly delegations of authority.**
- **Encourage agencies to experiment with issuing essential parts of their manuals in language managers can understand without being bound by the format or the compartmentalization of the FPM.**

Delegation of Authority

Finding:

- Executives and line managers feel that delegations in personnel management are inadequate to meet their needs. The result is frustration, time lost, and losses in acquiring and retaining quality people necessary to accomplish mission because the decision authority is held by someone far away from the action and usually not accountable for program results.

If a manager does not have the delegated authority to act, it means that he or she must either request someone else to act or obtain prior approval for his proposed action.

As indicated above, the Panel found in the review of the Federal Personnel Manual that there were:

- 25 types of actions in which agencies should be delegated authority to act and
- 9 types of actions where prior approvals from OPM could be eliminated. (See Table 2.)

". . . almost all actions require prior approval of OPM in Washington, and in many cases under current procedure, by the [OPM] Director."

The significance of this is that almost all the actions require prior approval of OPM in Washington, and in many cases under current procedure, by the Director. Agencies tend to follow the practice of central agencies in administering their personnel systems and the problem becomes compounded. The time delays and paper involved alone are mind-boggling, let alone the hampering of managers in taking action.

Recommendations:

- **Expand delegations to agencies from OPM; eliminate delegations with time limitations; withdraw delegations only if there is abuse.**
- **Encourage agencies to expand delegations to sub-**

TABLE 2

Delegations That Could Be Made/Prior Approvals That Could Be Eliminated

Type of action	Delegation of authority	Prior approvals	Total
Hiring	4	2	6
Details of employees	1	—	1
Performance appraisal	1	2	3
Promotion	2	1	3
Incentive awards	—	1	1
Classification	3	—	3
Pay	2	—	2
Merit pay	1	—	1
Life insurance	1	—	1
Health benefits	1	—	1
Retirement	5	1	6
Training	1	—	1
EEO	—	1	1
Security	1	—	1
Financial disclosure	—	1	1
Examining motor vehicle operators	2	—	2
	25	9	34

Automation

Finding:

- Personnel action processing and information systems in most agencies are not automated. Processes are time-consuming, yet executives and line managers do not have the data they need on a timely basis to make decisions. The current emphasis in personnel information systems is to meet OPM's requirements first. The personnel officer's requirements are second. The manager's requirements come in a poor third.

There are two types of personnel information and records which the manager needs. The first is the personnel action that confirms the hiring, promoting, assigning, or separating of an employee. It can be viewed as the contract between the employer and the employee and is prepared in the personnel office. The second is information about all employees available to all supervisors to help in personnel actions or utilization of the workforce. Failure to complete the personnel action (the contract) in a correct manner and on timely basis can result in loss of the manager's time as well as that of others involved, incorrect actions, and loss of quality personnel. Failure to have adequate information on which to make decisions can also result in loss of time, delayed actions, and bad decisions. It is possible to automate the processing of personnel actions and the necessary personnel information to meet the manager's needs.

The Panel has learned that the Central Personnel Data File required by OPM for all employees meets OPM's requirements for statistical reports and other purposes but does not reduce agency reporting requirements (e.g., EEO reports are separate). Nor does the data file lend itself to analysis of such problems as adverse actions, nor in its current form, assist managers in making decisions.

Few agencies are making full use of computers in processing personnel actions. For example, only Energy, Air Force, and Transportation have fairly sophisticated systems, which quickly and correctly process personnel actions.

The Department of Energy is one of the most advanced in having a data base that will provide executives and line managers at all levels in the organization with the information they need to make decisions on managing their human resources. Most agencies are far behind or not even in the ball park. The Reform '88 Project proposes to develop the basis for a single, governmentwide payroll-personnel information system design, and OPM appears to support this initiative, assuming that further analysis is undertaken.

Recommendations:

- Develop a basic integrated payroll/personnel system framework but permit agencies to make adaptations to satisfy their special requirements which meet managers' needs.
- Encourage use or adaptations of systems (such as Energy's) which meets centralized needs but assures that the system is responsive to the needs of other management levels in the organization.
- Adapt, where possible, systems or parts of systems currently in place in agencies rather than each agency "reinventing the wheel."

CHAPTER SIX

Adapting to Rapid Changes in Information Resource Management

A revolution is happening once again in terms of computers and their impact, and the Federal government is struggling to adjust to new realities.

In the 1950's and 1960's computer technology carried the Federal government along with other users into an era of large powerful mainframe systems which were capable of handling volumes of data and numbers of transactions far beyond previous capability. These mainframes were very expensive and led, in many agencies, to establishment of large centralized computer organizations staffed by highly skilled systems design people, software design experts, and computer programmers and operators.

These centralized organizations became the most feasible mode of management to adopt because of the data-handling power of that generation of computers, and it led to several management courses of action. Data processing tended to be pulled into the central system to optimize the utilization of the expensive equipment and to use the technical staff skills most effectively. Agency program managers or staff directors had to concede some degree of direct control of their own information processing in order to help achieve maximum operational efficiency and cost effectiveness of these central computer service organizations. Also, because of their great expense and the need for planning adequate capability for the future, the front-end computer acquisition decision became very important, and extremely complex and detailed procedures were established to attempt to guarantee that these acquisitions were prudent and cost effective. By the mid-1960's the Congress had charged OMB and GSA with strong, centralized, governmentwide authorities over ADP policy and systems standards and mandated review of agency plans and system performance. Central authority for all contracting was placed in GSA.

During the 1960's and 1970's, the agencies' automatic data processing underwent rapid and continuous enlargement with widespread extensions of their uses and capacities. Included were high-volume operations, such as social security check processing, IRS processing of income tax returns, Treasury receipts and disbursements—and literally billions of other transactions each year. Without computers many parts of the government simply could not function. At the same time, computer usage began to expand in other ways. Scientific and engineering research and development have been fundamentally changed. Computers are increasingly being built into the operating systems of spacecraft, military ships, tanks and planes, and air traffic control installations. Computers have also come to play an important role in management itself. Planning, statistical analysis, program control, financial operations, payroll processing, procurement controls, auditing and inspection, law enforcement, and even normal office operations increasingly rely on automated data processing.

"New opportunities are being created which the Federal government cannot afford to miss, but there are also new challenges to some of the managerial processes and controls so painstakingly developed in the 1960's."

In the 1980's, the pace of change in the technology of computers and electronic data transmission continues to grow in quantum leaps. New opportunities are being created which the Federal government cannot afford to miss, but there are also new challenges to some of the managerial processes and controls so painstakingly developed in the 1960's. In the arenas of program management and administration, there are important opportunities to upgrade the capability of managers, to enhance planning and analytical scope, and to cut the costs and speed up the results of the government's huge volume of administrative and financial transactions.

The Impact of New ADP Technology

At an extraordinarily rapid pace, the new technology is putting fast, powerful computers into small, relatively inexpensive packages, with separate memory modules, enhanced capability to link directly to remote locations through telecommunications networks, and a whole new wave of standard, prepackaged software for a wide range of uses. These technology advances are already creating pressures to change the management uses of computers in the following major ways:

- Individual managers recognize that they can now have their own computer capability—and there are compelling reasons to do so. The computer will increasingly be "built in" as part of local, integrated program management control systems. For example, a contract manager will want to use his computer not only to store and retrieve data, but to control costs, prepare budgets, link together headquarters and field offices, provide real time data transmission, and evaluate contractor performance. These attractive management opportunities are going to create pressures all over the Federal government to acquire new microcomputers and minicomputers.

"Individual managers recognize that they can now have their own computer capability . . . and there are compelling reasons to do so."

- This same movement will tend to cast serious doubt on the future role of many of the large central computer "service" centers which have been built up in agencies over the last 10 to 15 years. Managers will tend to pull their data out of central data banks, which will reduce their load factors and utilization rates.
- Many current computers are obsolete. Others which are still efficient will rapidly be made economically obsolete by the new generation of technology. This will radically change the patterns of equipment replacement; it may not be relevant to consider replacing the obsolete equipment in the large central service organizations, for example. Avoiding these major expenses would offset much of the cost of the many smaller micro- and minicomputers which the government is expected to acquire.
- Major changes in software development are also happening. New standard software packages will go far in meeting the needs of individual managers and will reduce the demand for skilled in-house Federal systems design and software development people. This has important implications for future personnel policy in this career field. Where large central operational systems are retained, their effectiveness and continued economic justification may be extended through upgrading of their software rather than through acquisition of new hardware.
- Finally, we will be experiencing changes in the basic criteria which are used to evaluate ADP effectiveness. In large central computer service organizations, it is proper to evaluate them on such criteria as high centralization of customer coverage, maximum time utilization of equipment, and maximum cost effectiveness. But, with the new pattern of decentralized micro- and minicomputers in the hands of the customers, such tests may no longer be appropriate. For example, if a program manager can show clear advantages of greater program effectiveness and cost control through a separate computer built into his/her management system, this may have far greater cost effectiveness for the government, even if computer usage rates are not optimum.

Thus, the technology revolution is creating pressure for a related management revolution. The NAPA Panel emphasizes that these management changes are already happening and that they can and should be of great benefit to the government. Said another way, the Federal government should, as a matter of policy, actively and vigorously seek to take maximum feasible advantage of the opportunities provided by this technological revolution. Not to do so would be a serious failure of management leadership and would entail indefensible added costs to the government.

The technology revolution has great economic and budget impact, because, like it or not, older and otherwise satisfactory systems simply become obsolete, overly expensive, and inefficient compared to newer capabilities, and unless this obsolescence is eliminated, taxpayers would be deprived of economies which they have every right to expect Federal managers to achieve.

Information Systems Planning

The Congress has been aware of this revolution and has already taken steps to guide and facilitate the movement of the Executive Branch in this direction. In 1980, Congress passed the modestly entitled Paperwork Reduction Act (P.L. 96-511). One of its titles moves the Federal establishment into the new world of *information resources management*, which recognizes that information has become a valuable resource in managing the government's affairs and that the management of that resource must be more directly and effectively done. The Paperwork Reduction Act represents an extension and advance in thinking over and beyond the older guiding legislation (known as the Brooks Act, after Congressman Jack Brooks of Texas, Chairman of the House Government Operations Committee), which deals primarily with equipment acquisition. In the Paperwork Reduction Act, Chairman Brooks, Representative Horton, and other legislative sponsors mandated the creation of an Office of Information and Regulatory Affairs in OMB and directed agency heads to appoint information resource managers (IRM's) in their agencies. It also gave to the GSA Administrator powerful central control over this IRM structure, as an addition to existing direct authority over all computer acquisitions. In fact, it is the GSA Administrator who delegates authority to agency IRM's for all aspects of ADP information management, and these officials are responsible to the Administrator for all activities defined under the statute. Moreover, this delegation of authority may be withheld or withdrawn if OMB's evaluations or GSA's own reviews of agency IRM plans and procedures persuade the GSA

Administrator that an agency is not adequately managing the information resource.

If the Congress has already established a basis of guiding legislation and the technology is already motivating change, what else must be done? What still stands in the way of swift and successful seizure of those technological opportunities? There appear to be two broad answers:

- *Within agencies*, only a very few of the most perceptive and knowledgeable leaders are really aware of how swiftly change is being forced on their organizations. Steps must be taken to educate both career and political leadership, to obtain their active support, to rethink program potentials, and to move very vigorously to redesign and modernize ADP and electronic communications systems.

In response to this new technological wave, program managers and staff directors must act first and fastest. These people must rethink the uses of information management capability as a means of enhancing their total management and decisionmaking. Management systems will require redesign to eliminate wasteful manual paper procedures, build in more powerful analytical capabilities, make many data flows electronic rather than paper-oriented, and integrate rapid communications channels with decisionmaking approvals.

"In response to this new technological wave, program managers and staff directors must act first and fastest."

This rethinking is a condition precedent to the government's ability to move up to the higher level of managerial effectiveness which the technology permits. It is also a condition precedent to the intelligent selection of exactly what kinds of computer and electronic data transmission capabilities will be needed for the future, and how these capabilities will be staffed and managed within each agency. It is the kind of strategic thinking which only program managers can do and which cannot be delegated to information specialists, or computer hardware or software experts.

This rethinking must become the basis of the information resources management plans which the agency IRM is charged with developing, and it is not until these plans are well developed that agencies will be in a sound position to seek effective clearances by the central agencies or delegations of acquisition authority where necessary.

- *The Federal central agencies*—OMB, GSA, Commerce, and OPM—must become advocates and facilitators of agency action. The government urgently needs coordinated central leadership if it is to orchestrate more effectively the new concepts of information resources management. As new technology brings thousands of individual supervisors and managers into a far more important role, the leadership of these central agencies will need to shift from an emphasis on prior approvals of individual agency actions to one of maximum feasible delegations within a framework of standards and policies. Governmentwide oversight, evaluation, and reporting will still be a necessary role, along with authority to demand reasonable compliance or to withdraw delegations where necessary.

Adapting to Change in Agencies

Nobody yet fully understands exactly what improvements are going to be feasible in the next few years. The best private sector companies are making heavy investments of time, talent, and money to assess and exploit their opportunities and seize them. The Federal government appears far more tentative and uncertain and with few exceptions, has yet to put the same vigor and commitment into its own strategies.

At the heart of this potential for change, however, is the perception that the future will call not for large centrally defined and driven solutions, in most instances, but for a broad general reaction by the thousands of program and staff units in government for which information is vital. This does not mean that there will no longer be a need for comprehensive central planning and strategy, agency-level direction and control, or even some large central information service organizations and staffs. It does mean, however, that agencies will have to rethink past strategies which emphasized central control and operation and will have to create a new environment where decentralization and local management flexibility become not only possible but probable.

Few agencies seem fully prepared to achieve these objectives. Many agency executives, both career and political, are ill prepared by background and experience to understand and cope with these complexities and are intimidated by them. Budget examiners, contracting officers, and personnel experts will tend to cling to current administrative systems which are protective and familiar, unless helped to do their own systems updates. There is general and serious concern, for example, that the new technological opportunities will create budget demands which are indigestible in today's stringent budget environment; and there is a collateral concern that agencies caught up in a wave of new opportunities will "run amok" and acquire more new computers, office automation equipment, or communications capability than they can effectively use.

"Many agency executives, both career and political, are ill prepared by background and experience to understand and cope with these complexities and are intimidated by them."

Even today's agency ADP experts, who know most about the new technology, can create their own organizational inertia. Many have, for years, been managers of large central service organizations with expensive central processing units, and they have had to work hard to load up these facilities to optimize their utilization and cost effectiveness. Many agencies have large (and expensive) central staff resources of programmers, systems design experts, software designers, and computer operators. Others have developed networks of support contractors to provide this expertise. Small but powerful minicomputers and microcomputers, which can be effectively operated on a decentralized basis, challenge the future need for large centralized computer service organizations and demand a rethinking of this management approach.

These elements of agency management do not necessarily oppose change or make it impossible, but few agencies are structured to facilitate change. In their book *In Search of Excellence*,[1] Peters and Waterman speak of a "bias for action" as one of the principal criteria for achieving organizational excellence. The Panel believes that the time is ripe for creating a positive bias for action in the arena of information resources management. Almost every element of each agency can and should participate, but it must be the line managers and heads of staff offices which become the real driving force for defining change and making it happen.

The Panel strongly believes that Federal agency heads and top managers must make information resource management modernization a top agency priority and must invest personal effort to educate themselves as to the significant potentials for cost savings and operational improvements their agencies can achieve.

Recommendations:

- Agency heads should direct a full-scale rethinking of total agency information resource capability, including the following:

—A clear directive to their managers to accept full accountability for their own information resource responsibilities.

—More freedom to individual managers to take advantage of the flexibility, memory, and access capabilities of modern information systems.

—A reassessment of the use of central ADP service organizations vs. justifiable decentralization of ADP capability to line and staff organizations, including field organizations.

—Identification of obsolete computer and people systems capability and the development of plans to modernize such equipment and upgrade the critical managerial and technical skill base.

—Evaluations to determine policies regarding agency computer capability and integration needs while still permitting maximum feasible flexibility to individual managers.

[1] *In Search of Excellence*. Thomas J. Peters and Robert H. Waterman, Jr. Harper and Row, Publishers. New York, N.Y. 1982.

The Role of Central Management Agencies in a Decentralized System

Decentralized administrative authority and responsibility makes for more economical use of the limited resources of the central management agencies who can perform the most useful oversight without getting involved with the mass of details that are meaningful only to those most intimately acquainted with particular agency operations. Central leadership can be most useful in developing broad policies and in providing general rather than specific control over administration.

OMB already has responsibility under the Paperwork Reduction Act of 1980 and OMB Circular A-71 for providing governmentwide leadership and guidance by:

- issuing automatic data processing management policies and criteria,
- evaluating agency ADP management systems against those policies and criteria, and
- providing governmentwide project leadership for solving specific governmentwide ADP problems.

The Panel believes that this remains a good statement of leadership responsibility and that this form of leadership from a central management office is essential if the government is to continue making progress in improving the management of its information processing technology. In carrying out its responsibilities, OMB has made a conscious decision that primary responsibility for ADP management improvements must rest with agency heads and their information resource managers. OMB's primary emphasis has been on developing incentives that will encourage improved management rather than trying to rely on traditional directives and regulations. These actions are consistent with the need for decentralized ADP management.

GSA is expected to be the operational manager of the government's ADP to include determining the agencies' needs for ADP as well as acting as their central procurement agent. This responsibility is based on the assumption that GSA can effectively control and manage over 18,000 medium- and large-scale computers located in over 4,000 sites around the world. However, there will be an additional strong tide of new, less controllable acquisitions in the near future. GSA is expected to carry out these responsibilities through either case-by-case delegations of procurement authority or by reviewing and approving annual procurement plans and proposals. It is simply unrealistic to believe that in the future GSA will ever be able to cover this enormous range of responsibility, nor is it likely that the Congress would approve the staffing levels which would be needed to do this work effectively. The functioning of the information resources management structure unfortunately has the high potential of becoming another layer of bureaucracy which would simply slow down what must be very swift future decisions about ADP planning and acquisition.

GSA also has responsibility for assisting OMB in evaluating agency ADP management systems. The Panel

CHAPTER SEVEN

The Management of Administrative Services

Introduction

Four of the management systems which were selected for study are classed as administrative support—

- Providing and maintaining the buildings which Federal workers occupy ("real property").
- Providing employees with furniture, equipment, and other supplies and materials ("personal property").
- Meeting Federal needs for printing.
- Providing travel services and paying travel expenses.

If these administrative services, which directly affect almost every manager and employee in the Federal government, are poorly provided, the adverse consequences are felt throughout the Federal government's own internal operations.

In all four of these service activities, however, the principal problems seem to deal not with service to individual employees but rather with the major service delivery systems which the Federal government has established to provide each service.

For many decades, the Joint Congressional Committee on Printing, and the Government Printing Office have exerted strong centralized control over Executive Branch printing. Then in 1949, the General Services Administration was created as an independent central agency to direct or manage a number of common administrative services including real and personal property and travel. There is a longstanding and never-quite-resolved conflict between these central organizations and the departments and agencies of the Executive Branch, many of which resist (and perhaps resent) the pull of central authority. They feel that as an alternative, they should be given their own authority, believing that they could take care of their own needs more effectively.

In addition, there are alternatives having to do with whether aspects of these services should be provided by Federal employees (either in GPO and GSA or in the line agencies themselves) or by the private sector through government contract. The contract alternative is further complicated by a debate as to whether such contracting should be done through the central agencies or by each agency directly on its own behalf.

In fact, what seems to have emerged is not a single clear-cut management choice between these alternatives but a vague and confusing situation in which alternatives are used in an unpatterned way based not on logic, but on history, legislative mandate, or individual agency circumstances. The balance of this chapter attempts to sort through practices which differ substantially among agencies and identify general improvements which most agencies feel would enhance general systems effectiveness. In most cases, the general role of GSA, and the degree to which it engages in direct operations rather than leaving such operations to the agencies, is clearly a predominant theme. Most of the operating problems dealt with in this report have existed for many years and are not specific to GSA's current leadership. In fact, it is clear that the current GSA Administrator is making a major and highly commendable effort to set GSA's own house in order and is attacking many of these long-standing problems in a vigorous and business-like manner. These GSA efforts, however, are once again highlighting the fact that many problems of process and procedure stem from failure to deal effectively with the more fundamental issues of delegation and decentralization of operational authority to the 100-plus agencies in the Executive Branch. In its own assessment, the NAPA Panel has held to several general guidelines:

- In keeping with the strong overall theme of this report, the Panel has sought for ways to achieve maximum feasible delegation of operations from the central agencies to the line departments.
- Because many of these administrative services involve the kinds of operations which can also be provided by the private sector, competitive opportunities to test private sector contracting or the more effective use of the contract mechanism have been identified.
- The Panel believes that GSA's relationships with line departments and agencies have been very bad

"Most of the operating problems dealt with in this report have existed for many years and are not specific to GSA's current leadership."

and have impaired efforts for management reform. This problem cuts in both directions, but the Panel is encouraged by GSA's recent efforts to find ways to place these relationships on a more cooperative and productive footing.

Suggestions were made for creation of several advisory councils of agency representatives to help improve working relationships between GSA and other agencies. A better idea might be to ask the Assistant Secretaries for Management Group to serve as an overall advisory body to GSA, since this group has a broad management perspective rather than a narrow technical one and represents the senior officials most concerned with administrative services matters in their own agencies. The ASMG could also help by establishing subcommittees or working groups to help GSA on selected issues or in specific service areas. In any event, GSA can benefit greatly by a more consistent policy of seeking out agency concerns and getting agency comments on proposed regulations prior to issuance, when GSA's position can still be affected.

Federal Buildings Management

The Federal government is one of the largest owners and users of buildings in the world. Federal civilian employment in 1980 was just over 2 million people, excluding the Postal Service. Of these, about 1.2 million people work in space which is directly under the control of their own agency—the two largest holders being the Defense Department and the Veterans Administration. The balance of about 880,000 workers are in facilities controlled by the General Services Administration.

"The NAPA Panel found once again that the objectives defined for the Federal Buildings Program are not being realized. . . ."

The Congress established the General Services Administration in 1949. Soon after, Reorganization Plan No. 18 of 1950 withdrew from other agencies and transferred to GSA the authority to lease real property, assign or reassign space, and maintain or have custody of office buildings. GSA was envisioned as an independent central agency which would guide the government toward the more effective provision of a number of common administrative services. In the case of real property, the GSA Administrator was authorized and expected to delegate operating authority back to the agencies and to retain authority to issue and enforce policies and regulations within which the agencies would operate.

In 1975, GSA instituted its Federal Buildings Program to make governmentwide use of all facilities more prudent and cost effective. Because of the program's cost and its importance to the rest of the government, it has been subjected to repeated special studies and GAO audits. The NAPA Panel found once again that the objectives defined for the Federal Buildings Program are not being realized, and that each of the four major elements of the program is generating serious complaints from Federal agencies who are served by GSA or who must administer their own facilities under rules which GSA establishes.

Real Property Acquisition

The first element of the Buildings Program is real property acquisition, and it is the generator of the highest level of complaints about conflicting and unhelpful policies, a lengthy and cumbersome leasing process, and inadequate GSA resources. There are also complaints of frequent uncompromising attitudes on the part of GSA officials who fail to understand or show much sympathy for agency missions and operations. Whether well founded or not, there is clearly a strongly unfavorable client attitude toward GSA which has become an important factor in the weakness of GSA's government leadership role in this and other programs.

A key complaint of agency officials is that GSA does not meet their requests for space on a timely basis and that unwarranted delays have critically inhibited programs. GSA itself examined this issue in 1980, after the Federal Buildings Program has been in effect for 5 years. GSA found that the average delay in its own pipeline had gone from 125 days in 1977 to 240 days by the end of 1980. One agency, checking in late 1980, found that its actions ranged from 367 days to 801 days in the process. GSA itself recognizes this problem and has stepped up its internal efforts to reduce time in process. The leasing program has now been placed under a tracking and control system designed to achieve occupancy within a 200-day average where construction is not involved. GSA states that its backlog of uncompleted lease projects has dropped nearly 50 percent since 1980. In addition, a badly needed lease acquisition handbook is now in preparation.

Some of this delay must be attributed to the fact that 80 or more evaluations or determinations must be made in each case. A large number of these are mandated by law, including the following:

- Rural Development Act
- Central Business District Policy (E.O. 12072)
- Federal Urban-Land Use Act
- Cooperative Use Act
- Randolph-Sheppard Act
- OSHA (Safety Survey)
- Economy Act
- Architectural Barrier Act
- Equal Employment Opportunity Act
- Small Business Subcontracting Requirements

GSA points out that rental limitations imposed by the Economy Act and those giving preference to central business districts have now been suspended. These determinations add an average mean time of 71 processing days. Further, space acquisitions involving net rental or alteration costs of $500,000 or more also require the preparation of a prospectus which must be approved by Congress as required by the Public Buildings Act of 1959. *This*

Users Charge (SLUC) rate based on the cost of renting space in equivalent commercial buildings—not on GSA's costs for providing services, nor on the services actually provided. Under the previous system, agencies received government-owned space rent-free and paid for leased space only until GSA could provide for it within its own budget.

As initially conceived, the Federal Buildings Fund (FBF) had the following stated objectives:

- to provide better services to renting agencies,
- to make it easier to identify the actual cost for an agency's buildings,
- to create a fund to provide for the construction of new Federal buildings, and
- to provide agencies with an incentive to achieve good space utilization.

But after almost 10 years of operation under the FBF concept, agencies feel that none of these objectives has in fact been fully achieved and that major and persistent problems have developed in implementation of the law, in both GSA and the line departments and agencies.

The Federal Building Fund process is seriously flawed. It has failed to create a source of funds for new Federal construction or replacement of inadequate older buildings; and yet its statutory existence has precluded use of the alternative of direct authorization and appropriations for public buildings. Funds collected from agencies, ostensibly for financing this construction fund, have instead been used to pay off the notes on nearly 100 purchase contract buildings and to continue the nearly 5,000 leases administered by GSA. This practice may have helped to ease the budget pressures on these costs, but not in the manner which the Congress intended. This problem is not solely GSA's, since it involves OMB and the Congress in setting these funding levels. Part of this distortion has been precipitated by the fact that, each year since the institution of the FBF, GSA has had imposed on it a freeze in the levels of appropriation for leasing and alterations. Thus, even where the funds have been available, the appropriations freeze has prevented them from being used.

"The Federal Building Fund process is seriously flawed. It has failed to create a source of funds for new Federal construction or replacment of inadequate older buildings. . . ."

GSA and the agencies are dependent on the ability of the SLUC system to generate the funds needed to sustain adequate levels of custodial, alteration and maintenance services provided by GSA, especially in government owned buildings. When this SLUC procedure fails to generate sufficient funds, or when available funds do not flow properly so that they satisfy legitimate need, agencies have been put in situations where they have had to go through additional paperwork for separate work orders to satisfy these unmet needs. In addition to this added paperwork burden, some agencies assert that there appears to be no adequate process for negotiating credit under the SLUC charge process and that, in the worst case, an agency would actually pay twice for a given service. GSA continues to insist that agencies "by their own choosing" may supplement standard levels of service.

The GSA field offices which actually provide for the maintenance and operation of buildings are considered by agencies not to have adequate resources for their current role. These field offices must respond to agency requests for reimbursable services as well as to a voluminous reporting system imposed by their own regional offices. Cleaning services which GSA should provide "consistent with the private industry" have, in the view of the agencies, never been a reality; and in efforts to reduce cost, GSA has cut back on the provision of guard service. However, GSA believes that it is narrowing the gap in its cleaning costs and that its current average of $1.21 per square foot is much more in line with commercial averages. GSA also points out that, in an overall sense, crimes on Federal property are down and recovery of stolen property is up.

However, agencies continue to pay SLUC charges based on GSA's providing a full level of services. In addition, agencies must contract for guard service to fulfill that need. Again, the agency pays twice.

Recommendations:

The NAPA Panel believes that the FBF in its present form has not succeeded in solving the problems of numerous inefficiencies and ineffective service. However, it does not appear either practicable or desirable to do away with the basic FBF approach. To improve the situation, the NAPA Panel recommends that:

- GSA seek legislation to make the FBF a true revolving fund to assure that funds are available to provide the services paid for by the agencies and that the FBF be removed from the annual appropriations process.
- GSA policies and regulations should provide more authorizations to agencies to seek truly competitive services; if GSA is unable to provide adequate competitive services, or if the agency could acquire them at lower cost elsewhere, the agency should be allowed to take the alternative route.

Building Space Utilization

The newest element of GSA's overall buildings management program deals with the more effective use of workspace. GSA is implementing Executive Order 12411, which establishes a new objective of not more than 135 square feet per person as an average for office space in the Federal government. The policy places primary responsibility for meeting these objectives on the agencies themselves within GSA guidelines.

As a means for getting high level policy attention and backing for the objective, it is clearly successful. But it has not been well received at the working level. The key issue, as in so many other GSA related situations, is the concern that GSA is pushing an economy measure which inadequately takes into account real agency needs, and does so in a way which adds further procedural complexity without really helping anybody. GSA reported to the Cabinet Council that private sector average space utilization ranged from 110 to 150 square feet per person. Yet the Building Owners and Managers Association International reports that the national average in 1981 was 230 square feet per person. A 1983 study by the Congressional Budget Office reported that "overall, the space use for Federal buildings compares favorably with that reported by owners and managers of private office buildings." Agencies vary markedly in their missions, responsibilities, organization and level of operational activity. In addition, the buildings themselves differ in their architecture, age and degree of flexibility. In these circumstances, it is not surprising that agencies see any single uniform government-wide space utilization standard as inherently arbitrary. In their comments to the NAPA study team, agency representatives raised a whole range of concerns which make it clear that GSA has failed to issue fully explanatory guidelines for this program—people view it with suspicion, do not understand the impact or groundrules for the program, and consequently are prepared to believe the worst.

Many of these concerns involve with questions of definitions, timing, relationship with agency plans and budgets and the allowance of deviations from the mandated uniform target number. All of these questions could have been answered in advance, but were not. Once again, GSA appears to have underemphasized its role as a service organization, and mandated standards in the name of governmentwide economy without adequate consideration of the impact on agencies.

The development of agency space management plans offers an important opportunity not only to prepare for improved space utilization (recognizing the constant changes in program plans and requirements), but also for GSA and the agencies to develop more mutual understanding and a cooperative relationship to replace the current adversarial condition in the space management field. However, certain provisions of the GSA regulation which prescribe implementation procedures requires modification if the basic intent of improved use of office space is to be achieved.

Recommendations:

- The Panel recommends that GSA facilitate the achievement of the purposes of its Temporary Regulation and take into account the differences in agency missions and requirements by making the following changes:
  - —Exclude from the GSA definition of office space and from calculations of the utilization rate such support spaces as machine and word processing areas, conference rooms, auditoriums, libraries, reception areas, holding areas for program clientele, private security corridors and circulation space.
  - —Utilize the GSA-required agency/space utilization plan as a basis for cooperative and flexible negotiation between GSA and each agency.
  - —Authorize agency heads to approve exceptions from the 135 square foot space limitation with written justification to GSA documenting the program need or overall cost savings on which their decisions were based.
  - —In cases of dispute between GSA and an agency, require the preparation of a cost-benefit analysis to determine the course of action which can be expected to return optimum benefits over at least a 5 year period.
  - —Allow for the gradual long-term achievement of the 135 square foot average rate to avoid costly and unnecessary expenditures for internal moves and alterations.
  - —Study experience of agencies which have achieved significant improvement in space utilization; provide seminars to communicate to all agencies successful improvement processes.
  - —Provide an appeal mechanism to the GSA Administrator or Deputy.

Federal Personal Property Management

The Federal government with its direct payroll of four million civilian and military employees is the world's largest buyer and user of "business-type" supplies and equipment. The government has a multibillion dollar investment in inventories; each year it spends millions more in buying new equipment and capital items and each year also disposes of large quantities of no longer required materials. The fundamentals of Federal property management can be simply stated—to "get, use, and dispose of" materials required for operation of the government, ranging from paper clips, to medicine, vehicles, or computers. Management of this property entails standardization and cataloging, receipt, storage and warehousing, allocation, distribution, control, protection, overhaul and maintenance, and disposition. In its broadest terms the management of these vast assets engages over 100,000 employees.

When it enacted the Federal Property and Administrative Services Act in 1949, the Congress intended to provide the Federal government with an economical and efficient system for managing government property. The Administrator of GSA was given broad authority in the Federal property area with the authority to redelegate all but policy functions.

There have been repeated expressions of dissatisfaction with the results of these management efforts. The second Hoover Commission (1954–55) was critical of GSA's results; in 1965 the Congress was sufficiently dissatisfied to exempt DOD, Coast Guard, and NASA from GSA controls; GAO studies have repeatedly been critical of GSA management; a 1977 Administrative Services Reorevery other aspect of government purchases including the use of new electronic printing devices and print related-technologies. This is a classic case of intensely bureaucratic, detailed micromanagement. Also, as stated in a 1981 GAO report:

> "The current structure . . . does not conform to prudent business practices . . . nor to the requirement that there be a separation of powers between the Executive and Legislative Branches—nor does it afford the Executive Branch sufficient flexibility in satisfying its own printing needs."

The case of the Government Printing Office is even more anomolous. GPO was established in 1860 as an arm of the Congress, as a means to satisfy its own large printing requirements and to eliminate profiteering, kickbacks and other abuses. Today, the JCP mandates that Federal printing requirements above a certain size must be procured through GPO. While GPO has a large printing plant in Washington, and six others around the country, most of the printing workload is put out on contract through 13 GPO contracting offices.

Almost all Congressional printing continues to be done by GPO, and it is usually given preferential treatment. Some agencies, notably the Defense Department, have been permitted to have their own printing facilities operated under JCP regulations, and in some cases to contract directly with the private printing industry. But as of 1980, GPO still processed more than $600 million ($81 million for Congress) of the total of $1.16 billion of direct printing costs.

Thus, GPO's operational control over Executive Branch printing, especially of larger, more sophisticated jobs, has become very great. How well GPO does has real impact on agency performance.

GPO handles printing in two ways: it may, depending on its internal workload, print in its own plants; or, if it is fully scheduled or has an order it is not technically equipped to handle, it may place the work out on contract with private printing companies.

". . . GPO's operational control over Executive Branch printing . . . has become very great."

GPO's in-house operations: GPO's reputation is that it uses Executive Branch agency printing orders first to fill up its in-house capability. When this occurs, the printing appears almost always to exceed agency cost expectations, sometimes by as much as 100 percent. GPO routinely requests additional production time in order to accommodate its in-house schedule. Agencies thus feel that they receive inordinately slow and uncertain service at prices which often exceed contractor printing prices.

GPO contracting operations: Even after GPO has exercised its privilege of loading up its in-house work schedule, about 75 percent of the printing work goes out to industry through contracts which GPO totally controls. Even after an agency has processed its own work requirements, they must be reprocessed by GPO, which normally requires 4 to 6 weeks. Agencies must deal through a GPO contracting office as a "third party" and are not allowed direct contact with the contractor nor any direct control over the work performed. GPO can and does overrule an agency on printing requirements. Quality of work is often a serious point of conflict, where agencies are forced to accept what they regard as work of inferior quality, but which GPO accepts as usable product. Agencies complain that attempting to obtain reprinting through written complaints to GPO is time-consuming and frustrating.

"The current JCP-GPO organization for control of Executive Branch printing is archaic and out of date."

The current JCP-GPO organization for control of Executive Branch printing is archaic and out of date, but events are moving so swiftly in the technology of printing that it would be shortsighted to seek only to repair the flaws of the current system. New methods of reproduction such as micropublishing, reprographics, laser and electronic printing, and data transmission technology are blurring the traditional view of printing as "ink-on-paper." In some cases, traditional printing is simply one step in an integrated information management system which includes computers, electronic transmission of data, and remote computer-driven printing. *There is a critical risk that tight bureaucratic control over the printing part of such integrated information systems will severely inhibit the government's ability to take advantage of this technological revolution.* More than ever before, the critical need will be for managers all over government to have the authority to make decisions regarding printing which serve program demands.

The Congress too is struggling to make it possible for the government to master the new technology. While the JCP is reportedly moving to enlarge its controls over printing by whatever technology, the Paperwork Act of 1980 has already launched the Federal government into integrated "information resources management" with information resource managers mandated in each agency, and governmentwide direction and guidance of the program assigned to OMB and GSA. As stated in a House committee report, this policy "focuses efforts to manage and control information through its entire life cycle, from the time the requirement for the information is first expressed, through the ultimate disposition of the data. . . ."[1]

"The Executive Branch should be given direct control over its own printing responsibilities."

The JCP clearly is conscious of this technological wave and is evaluating its own role in it. The Public Printer has undertaken a series of steps to improve GPO's per-

[1] "Report on the Paperwork Reduction Act of 1980;" House Committee on Government Operations (1980), citing testimony of a DOD witness.

formance and strengthen its management. But the NAPA Panel concludes that the present structure for the management of Federal printing is inadequate, resistant to rapid change, and fundamentally wrong in its approach. What is needed is a whole new system for the Executive Branch, having the following characteristics:

- The Executive Branch should be given direct control over its own printing responsibilities. A comprehensive plan for accomplishment of this objective should be developed, recognizing traditional separation of powers doctrine, and clearly preserving the power of Congress to exercise oversight over printing comparable to its oversight powers elsewhere.
- The Executive Branch must be authorized to create an organization and management system which exerts adequate control over printing as an integral part of its total information resources management system and which assures continuation of efficient, cost-effective printing standards and regulations.

Recommendations:
The NAPA Panel makes the following specific recommendations:

- The Congressional Joint Committee on Printing should:
  —At an early date, revise the Government Printing and Binding Regulations to permit Federal executive branch agencies to contract directly with private printers under guidelines to be established by the Executive Branch.
  —Develop broad basic policy for, and maintain associated oversight of, Federal government printing.
  —Integrate its printing policy and oversight activities with other related Congressional activities, specifically the government operations committees, regarding the information resources management field, so as to assure consistent and practicable Congressional policy in these related fields with a minimum of duplication and overlap.
- The Joint Committee on Printing, the General Accounting Office, and the Office of Management and Budget should establish a joint project to develop broad plans for efficient and effective systems for printing for the Federal legislative and executives branches, recognizing the independence and rights of each branch, and making optimum use of existing facilities.
- The establishment of a Government Printing Corporation as printing operations and service entity should be given consideration as an option.
- The Office of Management and Budget, in cooperation with the General Services Administration, and under the aegis of the Cabinet Council on Management and Administration, should focus a major effort on the development of a structure and process for the management of Federal Executive Branch printing:
  —The structure should emphasize the responsibility of the heads of departments and agencies for the provision of printing essential to their agency's mission and programs.
  —The process adopted should incorporate recognized business management principles including management information on costs of production adequate to permit assessments of alternatives for meeting printing needs.
  —This effort should also establish and maintain a continuing activity to learn and share the experiences of private sector printing and information management practices.

Travel Management

As the Federal government has grown in scope and expanded its contracting, grant making, and regulatory responsibilities, a comparable increase has occurred in the cost of travel for Federal employees. That cost now exceeds $4 billion annually. These travel costs are highly vulnerable in the budget process and always receive more than their share of both political and managerial attention. There is a constant conflict between efforts to control total travel expenditures and the need to meet program needs. Almost every Federal activity has legitimate and often critical reasons to travel: military personnel are reassigned, contract managers must visit contractor plants, auditors and inspectors must collect data, laws must be enforced, and so on. Thus, the most important decisions about travel are those made by thousands of supervisors and managers who must direct travel in order to manage their programs. Whether travel costs are well or poorly managed is very dependent on the quality of these individual management decisions.

Over time a complex set of statutes, regulations, and administrative procedures has grown up defining a central system for travel management; and since 1979, OMB has directed a coordinated Interagency Travel Management Project which has made significant advances in tackling some of the principal travel management problems. That project effort has highlighted these concerns:

- Budget cuts in travel are not effectively related back to their programmatic consequences; this has often produced a visible saving of travel dollars, but at a high cost of unfortunate and unwarranted cutbacks in necessary program oversight and direction.
- The travel processing system is designed to "guard" the funds and is burdened with red tape as a result. Federal travelers obliged to take official trips pay a penalty in paperwork.
- Often, travelers are not fully reimbursed for the expense of official trips, because limitations on travel expenses have not kept up with inflationary reality.
- Assistance to travelers has been neglected.
- Total paperwork in agencies is a managerial prob-

APPENDIX A

Staff of the Project

Project Staff

Director	Don I. Wortman
Dep. Director/Senior Consultant on Budget Process	William Bozman
Senior Consultant on Personnel Management	George Maharay
Senior Consultant on General Administration	John McGruder
Senior Consultant on Information Resources Management	Robert Taylor (GAO)
Senior Consultant on Procurement	John Christensen (Dept. of Education)
Senior Consultant on Legislative Branch	Elmer Henderson
Executive Assistant	Sammie Bear
Administrative Assistant	Theodora Mosesso
Secretary	Nina Lynn Bylan
Secretary	Karen Hayasaka

Final Report Staff

Author and Advisor to Panel	Charles Bingman (DOT)
Editorial Advisor	Hannah Fein

Part Time and Special Assignments Staff:

E.J. "Andy" Anderson
Jo-Anne Basile (Dept. of Education)
John Campion
Don G. James* (NASA)
Rick Kirkendall* (NASA)
John M. Rodgers (FAA)
David T. Stanley
Cherie Takemoto* (HHS)
Toy-Ping Tiara (NOAA)
Thad T. Uehling (FAA)

APPENDIX B

Council of Federal Officials

CHAIR: Robert L. Fairman, Assistant Secretary for Administration	Department of Transportation
Cora Beebe, Assistant Secretary for Administration	Department of the Treasury
David O. Cooke, Deputy Assistant Secretary for Administration	Department of Defense
John J. Franke, Jr., Assistant Secretary for Administration	Department of Agriculture
Charles L. Heatherly, Deputy Under Secretary for Management	Department of Education
William Heffelfinger, subsequently, Martha O. Hesse, Assistant Secretary for Management and Administration	Department of Energy
Richard R. Hite, Principal Deputy Assistant Secretary for Policy, Budget and Administration	Department of the Interior
John P. Horton, subsequently, Howard M. Messner, Assistant Administrator for Administration	Environmental Protection Agency
Thomas S. McFee, Assistant Secretary for Personnel Administration	Department of Health and Human Services
Dr. Walter Olstad, subsequently, John W. Boyd, Associate Administrator for Management	National Aeronautics and Space Administration
Dominick Onorato, Associate Deputy Administrator for Information Resources Management	Veterans Administration
R.T. Rollis, Jr., Assistant to the Administrator for Management	Agency for International Development
Kevin D. Rooney, Assistant Attorney General for Administration	Department of Justice
Dale Sopper, subsequently, John J. O'Shaughnessy, Assistant Secretary for Management and Administration	Department of Health and Human Services
Thomas Tracy, Assistant Secretary for Administration, subsequently, Robert E. Lamb, Acting Assistant Secretary	Department of State
Arlene Triplett, Assistant Secretary for Administration	Department of Commerce
Alfred Zuck, Assistant Secretary for Administration and Management, subsequently, Daniel J. Lacey, Executive Assistant to the Assistant Secretary	Department of Labor

the ultimate elimination of 80 percent or more of our regulations for the routine contracting in the Federal Government. Too much of our traditional tinkering with the procurement system, as we see it, is penny-wise and pound-foolish. We simply must seek major changes that really make a difference.

One note of caution. It requires highly competent personnel to take advantage of streamlined administrative processes. Bare bones systems permitting substantial flexibility tend to lead to abuse in the hands of unqualified contracting officers or managers. The panel concluded:

To be effective, however, most departments and agencies, as well as the Executive Office of the President, must give far higher priority to managerial experience in the recruiting and appointing of political and career leadership to posts with responsibility for operating multimillion dollar programs and supervising many thousands of employees. Otherwise, no amount of administrative reform will make much difference.

We believe it is essential that higher priority be given to professionalizing our procurement personnel. This includes further building of the Federal Acquisition Institute, proper classification of positions, more emphasis on recruiting and selecting qualified individuals, more training and intern programs, and a more careful process for appointing qualified contracting officers.

In conclusion, Mr. Chairman, the Academy panel believes that most Federal administrative systems, including procurement, are overregulated, overburdened, and stultifying. The price paid by the taxpayers for this state of affairs is quite significant in view of the fact that between a fifth and a quarter of our Federal budget is spent through contractual arrangements. It tends to impose inefficiency on an industry that needs every encouragement and incentive to enhance productivity.

Thank you for this opportunity to testify.

[The prepared statement of Mr. Ink follows:]

PREPARED STATEMENT OF DWIGHT INK

Mr. Chairman:

I am pleased to have the opportunity to appear before this Committee. I understand that there is some interest in the recent study by a Panel of the National Academy of Public Administration on the overburdened federal administrative systems. This study did not deal directly with economic issues and I am not an economist. However, there are several facets of the findings of the Panel I chaired which may be relevant since procurement is one of the administrative systems we addressed.

The effectiveness of federal procurement systems is very significant when one realizes that taxpayer funds spent through contracts increased from $57.5 billion in 1972 to $159 billion in 1982, close to one fourth of the total federal budget. And given the current thrust toward more contracting out of federal agencies' activities under A-76, the impact of procurement practices on the delivery of goods and services to the government takes on added dimensions.

I would like to comment briefly on four principal findings of the Academy Panel, which cause us to believe that federal procurement as well as other administrative processes are in difficulty.

First, the controls over federal management systems in general are too centralized, both within agencies and in the central agencies, i.e., OMB, OPM, and GSA. Managerial failures tend to be met not by correcting the management problems but by new legislation or regulation placing new restrictions or requirements on all agencies regardless of whether all agencies have experienced problems. While justification exists for a number of common requirements which agencies place upon contracting, for example, overcentralization limits the flexibility of the line manager in both the administering agency and the contractor in adapting the legitimate needs of a wide variety of different contractual arrangements. Research and development contracts have to be administered much differently than do production type contracts. Service contracts present still different circumstances as do individual consulting arrangements. The cost factor, for example, is easily measured in production contracts, but how does one place a meaningful price on the ideas one contracts for in a consulting arrangement?

Multibillion dollar weapons acquisitions require a highly sophisticated procurement system with more than a few regulations. However, the vast majority of federal procurement actions are much less complex and these are greatly overburdened with excess requirements.

The more complicated the procurement procedures, the more process overwhelms substance. Procurement officers tend to be reduced to procurement technicians. Line managers become somewhat divorced from their decision making responsibilities because they are unwilling to invest the time required to deal with excessive complexities. Procurement officers often face greater difficulty in maintaining a close and effective working relationship with the line manager who may either strive to end run the whole process, or simply throw up his/her hands and leave the field to the technicians. All of this further complicates life for the contractor.

Second, federal management systems are too negative. They focus on the attempt to preclude bad management practices more than they foster good management. They tend to be too regulatory. They deal far more with process than substance. Over time we have accumulated myriad procedural requirements, each one by itself not very noticeable, but the accumulative negative impact on managers and contractors of the totality of these requirements is great. The bulk of our procurement regulations promote a stultifying caution rather than speed and efficiency.

Third, the Panel drew attention to the fact that excessive checks and balances can become counterproductive. Checks and balances are a fundamental characteristic of our form of government. The question clearly is not whether they are needed, but how many constraints can be brought to bear before they hurt more than they help. The Panel believed that the accumulation of these checks have become excessive and have tended to be resorted to as the answer to better management rather than the more appropriate corrections needed to strengthen management. In fact, the Panel concluded that highly cumbersome systems with inordinate checkpoints "generate counterefforts to end run or circumvent them, or worse, to manipulate them," thus increasing vulnerability to the very abuses they were intended to curb.

A substantial portion of the Legislative and Executive oversight machinery pushes federal operations in precisely the wrong direction, namely toward more expensive and more time consuming administrative processes which frustrate the citizen who is to be served by the federal programs and equally frustrate the public servant striving to administer the programs.

Fourth, federal management systems are too expensive. Red tape in these systems require too much servicing and maintenance, resulting in too much overhead. For example, procurement regulations in DOD, GSA and NASA total over 6,000 pages, and many agencies have their own manuals.

It is a sad fact that the federal government does not have the capacity to measure the overhead cost of this red tape. I would emphasize that this overhead includes both governmental and private sector costs, a fact rarely recognized. Because we are unable to measure these costs, we lack anything comparable to the private sector warning light when overhead costs are increased by administrative process delays. At times delays dramatically increase costs, e.g., construction costs for a defense system increasing because of inordinate delays in administrative and decision making processes while even low level inflation contributes to so-called project overruns.

Little recognition is given to this problem and the blame is typically misplaced on the "bureaucrat" who is typically the most frustrated of all.

Even less recognition is given to the costs of the prospective contractor trying to maintain its team needed to provide goods or services to the government while the government ponderously meanders among its tedious web of red tape.

In the end these costs sap the vitality of substantial segments of our private enterprise system and burden the taxpayer with unnecessary tax dollars. It is scarcely the way to have a lean and efficient government-industry partnership that can compete effectively in tommorrow's international marketplace.

Another frustrating area for both federal managers and contractors over the years has been OMB Circular A-76 which defines the steps which must be taken to determine whether a given federal function or activity is best performed by an in-house civil service staff or contracted out to the private sector.

The long and tortuous process of cost analysis generated by A-76 has created serious problems for managers. Delays of a year or more were brought to the attention of our Panel including one case in which an estimated $250,000 in study costs over a two-year period were involved in trying to save $165,000 per year.

OFPP and a number of agencies are now taking some positive steps to move away from a highly mechanistic approach which made A-76 simply an imprecise accounting technique with endless debate over cost elements. The A-76 studies and decisions are beginning to be more properly looked upon more broadly as a potentially effective cost reduction and management improvement program.

In summarizing its principal findings, the Academy Panel concluded that the negative impact of federal internal red tape on the capacity of managers to manage has reached serious proportions. The federal management systems are overregulated, overburdened, and stultifying. The Panel reported that:

> The true cost of administrative redtape is impossible to express in dollars and cents. First is the obvious slowing of governmental action. There is the resultant pressure for more staff to keep up with the workload. More and more oversight regulations and mechanisms are put in place to monitor the processes. Professional managers and their employees become frustrated, and the career service has greater difficulty in attracting and retaining able men and women. Accountability for programs and expenditures becomes diffused. The impact of the voter is weakened by this confused accountability and the public is the ultimate loser in this process.

It is time now to move forward to a new phase of streamlining our procurement system.

We are fortunate to have very effective leadership of the Office of Federal Procurement Policy, that of Mr. Don Sowle. We applaud the work of Mr. Sowle and his staff the past three years in their efforts to move toward a more sensible, less complex, procurement system. Their work provides a good foundation for additional actions.

The Panel concluded that one of the best opportunities for future reforms of procurement is authority to try new systems and practices on a pilot basis. We had recommended somewhat stronger authority for such testing than that which was passed by the Congress, but the legislation nonetheless provides opportunities for which I would hope the Congress would provide support. This new authority provides a chance to construct important building blocks for true reform.

I would urge that the Congress and/or the Executive Branch arrange for a detailed analysis comparing step by step the non-defense procurement processes of government agencies, public corporations and the private sector. I am talking about a flow chart level of detail. The public accountability of government requires some protections not needed in the private sector, but I am confident that such a comparative study would reveal very significant opportunities for cutting costs and time, perhaps utilizing the new authority for research and demonstration before widespread application of the lessons learned. Too much of our traditional tinkering with the procurement system is penny wise and pound foolish. We must seek some major changes that can really make a difference.

One note of caution. It requires highly competent personnel to take advantage of streamlined administrative processes. Bare bones systems permitting substantial flexibility tend to lead to abuse in the hands of unqualified contracting officers or managers. The Panel concluded: "To be effective, however, most departments and agencies, as well as the Executive Office of the President, must give far higher priority to managerial experience in the recruiting and appointing of political and career leadership to posts with responsibility for operating multi-million dollar programs and supervising many thousands of employees. Otherwise, no amount of administration reform will make much difference."

It is essential that more priority be given to professionalizing our procurement personnel. This includes further building of the Federal Acquisition Institute, proper classification of positions, more emphasis on recruiting and selecting qualified individuals, more training and intern programs, and a more careful process for appointing qualified contracting officers.

It is my personal judgment that we could improve the quality of most procurement actions, and avoid considerable cost to government and industry by eliminating roughly 80%-90% of our regulations and investing a small portion of these savings in the development of a highly trained corps of skilled federal contract administrators. Our level of competition also should increase through the use of streamlined procedures. Programs could move more rapidly and effectively. More firms would be interested in competing for the government's business. I would suggest that smaller businesses are the least able to bear the burden of procurement red tape, and should in most instances benefit most.

In conclusion, the Academy Panel believes that most federal administrative systems, including procurement, are overregulated, overburdened and stultifying. The price paid by the taxpayers for this state of affairs is quite significant in view of the fact that between a fifth and a quarter of our federal budget is spent through contractual arrangements.

Thank you again for this opportunity to address what I believe to be an important issue in federal management. Unfortunately, the man who headed the procurement position of our National Academy study, Tom Morris, could not be here today. Although I lack his technical procurement expertise, I would be happy to respond to questions from the perspective of a long-time public manager.

Senator JEPSEN. Thank you, Mr. Ink.

I now recognize Mr. Donald Rappaport, national director of Smaller Business Services, Price Waterhouse.

You may proceed. Your testimony as written will be entered into the record as if read, and you may proceed in any manner you desire.

STATEMENT OF DONALD RAPPAPORT, NATIONAL DIRECTOR, SMALLER BUSINESS SERVICES, PRICE WATERHOUSE

Mr. RAPPAPORT. Thank you, Mr. Chairman.

I appreciate this opportunity to share my views on meeting the capital needs of small service companies with the Joint Economic Committee. Let me summarize my written statement, the subtitle of which might well be "Small Service Companies are Beautiful, but * * *."

As the director of our national efforts to serve smaller companies, I am keenly aware that adequate access to affordable capital is a leading concern of my firm's smaller clients. Small firms remain heavily dependent on short-term borrowing and especially vulnerable to a credit crunch. Generation of sufficient cash flow is their major preoccupation.

The financing concerns of small service firms are particularly acute. The present tax system does relatively little to alleviate their concerns. In general, small service firms are unable to take advantage of the tax benefits available to capital-intensive, large, and established firms.

Service firms tend to be labor-intensive. They tend to be small. Those with under 500 employees account for perhaps 80 percent of the service sector's output. And many are new. Of 397,000 enterprises started between 1980 and 1982, about 36 percent were in service businesses.

The contribution from service businesses is reflected in long-term increases in their share of production value added and share of employment. Services have experienced the greatest relative increase in sector share of production value added. The addition of 1.1 million service-sector jobs more than accommodated the 981,000 net increase in total U.S. employment between 1980 and 1982. As a result of this sector's growth, about half of all private-sector jobs are now in service businesses, and service employment now exceeds manufacturing employment.

Apart from gross amounts of income and jobs, what do service businesses provide? Service industries foster tremendous labor mobility and have been the main avenue for absorbing women, youth, minority, immigrant, and displaced workers. The sector also provides a wide array of support that facilitates the availability of products from the goods-producing sector, encourages the development of physical assets, promotes ever more efficient production operations, preserves our large stock of durable goods, helps exert human mastery over our physical environment, improves control over financial resources, contributes positively to our international balance of payments, satisfies desires for current consumption, and creates and preserves human capital. The notion that the service sector is somehow inferior and nonproductive is simply wrong.

The service sector's accomplishments and contributions have come in spite of the tax system, which extends to the service sector a disproportionately small share of tax expenditures support. The Congressional Budget Office applies the term "tax expenditures" to revenue losses that arise from provisions of the tax code extending selective or special tax relief to groups of taxpayers. This relief may be in the form of deductions, preferential rates, credits, or tax deferments.

When the share of total tax expenditures support received is compared with the share of total production value added by each industrial sector, we find that services come in last in tax expenditures support relative to production value added.

In particular, service businesses receive a relatively small share of the tax expenditures support associated with capital investment. To illustrate: Although the production value added by the manufacturing sector amounts to only 84 percent of the production value added by services, manufacturing's capital investments win it three times as much tax support from the accelerated cost recovery system and investment tax credits.

Small service businesses get significant tax support because of their size—specifically, reduced tax rates on the first $100,000 of corporate income. But other size-related tax opportunities, less often mentioned, are available to large, diversified businesses. They are able to offset any losses from new product development against income from profitable operations, and thus reduce their overall taxable income.

Moreover, many service businesses are new and still engaged in the process of becoming profitable. Thus, they cannot use the tax benefits theoretically available to them. Although losses can be carried forward to profitable years in the future, this is of no immediate use to the cash-hungry service business trying to establish itself.

For service industries to realize their exceptional promise more fully, they need additional capital. Several proposed tax system changes, designed to increase access by small service firms to additional internal funds, to equity capital, and to affordable debt capital deserve consideration. These are: A refundable general jobs tax credit, provisions for the immediate writeoff of equity investments in qualified small businesses, and provisions for the pass-through of interest deductions from businesses that cannot use the deductions to their lenders who can.

First let us take the jobs credit. A broader jobs tax credit may or may not be the best way to promote fuller employment. It would, however, provide tax benefits to service businesses more comparable to those now available to capital-intensive industries.

An alternative, the elimination of the accelerated cost recovery system and investment tax credits, coupled with proportional reductions in corporate tax rates, could achieve the same end. But this approach would presumably arouse stiff political opposition. A general jobs tax credit, which would need to be fairly generous to balance the ACRS and ITC benefits available to capital-intensive industries, is perhaps more feasible.

Because many companies lack the taxable income to permit immediate use of a jobs tax credit, experts suggest that a truly useful jobs tax credit would have to involve refunding a portion of employer FICA taxes.

Let me now turn to external equity capital. While equity capital is extremely attractive to all small businesses—service firms included—because it entails no debt service burdens, entrepreneurs are understandably reluctant to yield control over their businesses by selling a majority share of the firm's equity to outsiders. For outsiders, however, a minority stake in a small business is an unenviable investment; it offers neither liquidity nor control.

A number of proposals to resolve this dilemma have been made. The most promising involve direct write-offs by the investor of noncontrolling equity investments in qualified small businesses. There is a bill sponsored by Senator Paul Tsongas and a House version of it, the Goldstein bill.

The direct write-off approach is already used by the British. Their business expansion scheme allows an individual to deduct the cost, up to about $57,000 annually, of shares issued by qualified companies. According to the Chancellor of the Exchequer, the write-offs are:

> A further move towards removing the bias in the tax system against the personal shareholder, and a further measure to encourage wider share ownership. . . . The scheme will assist many more small and medium companies to realise their undoubted potential growth.

Small businesses—service firms included—find it difficult to obtain affordable debt capital. Since May 1982, the prime—versus small-borrower spread has fluctuated between 3 and 5 interest percentage points. To add injury to insult, small businesses still in their loss phase derive little if any benefit from the tax deductibility of their high interest expense.

This situation has prompted proposals for an interest deduction pass-through provision. To the extent that a small business borrower chooses, by virtue of operating losses and favorable loan terms, not to deduct interest expenses, the lender would be allowed to deduct that portion of interest revenue from taxable income. This would provide a higher after-tax return to the lender. I believe this provision would promote small business lending at lower rates, thus eliminating some of the disadvantages of newness and of smallness.

In conclusion, observers differ on what role the tax system should have beyond raising necessary Government revenues. Some feel it should be used as a mechanism for promoting socially or economically desirable ends. Others insist that the tax system should be essentially neutral and allow the market to determine investment free from tax distortions. The proposals discussed here are consistent with either philosophy, for it is clear that our vital service sector is denied benefits comparable to those available to capital-intensive, large, and established businesses under the present tax system.

While these proposals would result in some immediate loss of revenue, they would produce additional revenues over time from taxation of increased business and personal incomes. The net effect is obviously of critical concern in this time of enormous budget deficits. These judgments, however, are best left to tax economists.

My principal concern is with meeting the capital needs of the service sector. I believe that a general jobs tax credit, write-offs for equity investments in qualified small businesses, and targeted interest deduction pass-throughs could provide more internal funds, equity capital, and affordable debt capital to small service firms. These enterprises have already provided enormous economic and social benefits to the nation. Measures to help them better realize their exceptional promise deserve serious consideration.

Thank you.

[The prepared statement of Mr. Rappaport follows:]

Prepared Statement of Donald Rappaport

During my thirty-odd years with Price Waterhouse, I have worked with a wide variety of firms--manufacturing and service businesses, both large and small. As the firm's National Director of Smaller Business Services, I am continually apprised of the concerns of our smaller clients.

Adequate access to affordable capital is a leading concern. Small firms remain heavily dependent on short-term borrowing and especially vulnerable to a "credit crunch." Generation of sufficient cash flow--rather than growth--is the major preoccupation as long as real interest rates stay high. A slowdown in the real rate of business growth could put a severe liquidity squeeze on many small firms.

The financing concerns of small service firms, which make an enormous contribution to our economy and society, are particularly acute. The present tax system does relatively little to alleviate their concerns. In general, small service firms are unable to take advantage of the tax benefits available to capital-intensive, large, and established firms. Several tax system changes--designed to increase access by small service firms to equity capital, affordable debt capital, and additional internal funds--warrant consideration.

Service Industries: What They Are and What They Do

What is a service business? Definitions vary. I take this category to include personal services, business services (advertising; consumer credit reporting and collection; mailing, reproduction, and stenographic; facilities support; personnel supply; computer and data processing; etc.), auto and miscellaneous repair, hotels and lodging, amusement and recreation, health services, legal services, education, social services, membership organizations, engineering and architecture, accounting and auditing services, professional consulting and research. These firms tend to be labor-intensive rather than capital-intensive, as you would expect. They tend to be small: businesses with under 500 employees account for perhaps 80 percent of the service sector's output. And many are new: of 397,000 enterprises started between 1980 and 1982, only 6 percent were in manufacturing while about 36 percent were in service businesses.

The value provided by these businesses is reflected in long-term increases in their share of gross product originating (GPO)[1] and share of employment. As table 1 indicates, services experienced the greatest relative increase between 1958 and 1977 in sectoral shares of GPO.

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1. GPO represents that part of GNP generated by private business using resources resident within the country. GPO measures the value each sector adds to production; this value is returned in the form of income to the factors of production.

workers. The sector also provides a wide array of logistical support that facilitates the availability of products from the goods-producing sector; encourages the development of physical assets; promotes ever more efficient production operations; preserves the large stock of durable goods built up since the 1950s; helps exert human mastery over our physical environment; improves control over financial resources; contributes positively to our international balance of payments; satisfies desires for current consumption and facilitates desired lifestyles; and creates and preserves human capital. The notion that the service sector is somehow inferior and nonproductive is simply wrong.

The Present Tax System

The service sector's accomplishments and contributions have come *in spite of* the tax system, which extends to the service sector a disproportionately small share of tax expenditures support. The Congressional Budget Office (CBO) applies the term "tax expenditures" to revenue losses that arise from provisions of the tax code extending selective or special tax relief to groups of taxpayers. CBO classifies as a tax expenditure any tax code provision that is a special exemption from a tax rule and is intended to provide a subsidy. Tax expenditures take the form of reductions in taxable income through exclusions, exemptions, or deductions; preferential rates for a portion of income; credits against tax liabilities; and tax deferments. When the share of total tax expenditures support received is compared with the share of total production value added by each industrial sector, as shown in table 3, we find that services (the data also includes trade businesses) come in last in tax expenditures support relative to production value added, as measured by gross product originating.

Table 3. Sector Shares of Tax Expenditures Support and Production Value Added

Industrial Sector	Share of Tax Expenditures Support (%)[1]	Share of Gross Product Originating (%)	Support Relative to GPO
Mining	12.5	3.0	417%
Transportation, Communications & Utilities	17.8	10.7	166%
Manufacturing	36.7	29.1	126%
Construction	3.9	5.4	72%
Finance, Insurance & Real Estate	11.4	17.3	66%
Services & Trades	17.8	34.5	52%

Source: Congressional Budget Office, Federal Support of U.S. Business, January 1984, pp. 41, 44-51 and 58; SBA, Annual Report on Small Business, 1984, p. 118.
1.Totals 100.1 because of rounding.

What is going on? Service businesses--because they tend use available tax benefits before becoming profitable.

Jobs Tax Credit

Jobs tax credits to promote employment have been available since 1971, when the WIN (Work Incentive) credit was enacted. A broad jobs tax credit, which imposed few limitations on its availability and use, was adopted in 1977. It provided a 4 percent credit against increases in FICA wages over a base period. Declining unemployment prompted restrictions in 1978 and 1981 intended to focus employment incentives on groups with high unemployment rates or special employment needs. Under present law, the Targeted Jobs Tax Credit (TJTC) is only available to firms that hire individuals from a specified economically disadvantaged group. The TJTC has been criticized as not particularly useful because it is considered too limited and complex. Rep. Hank Brown (R-CO) has responded with draft legislation that would provide a jobs tax credit to businesses when they hire a worker who has been on unemployment insurance at least 26 weeks. The credit would be limited to the lesser of $100,000 or 50 percent of the aggregate of the qualified first-year unemployment wages paid by the employer. Additionally, the credit could only be applied to the aggregate unemployment insurance wages which exceed those wages paid in the prior year.

Reinstitution of a general jobs tax credit has received wide support from those concerned with the working capital position of small, growing companies. Discussions suggest that the credit should provide incentives for small businesses to invest in human assets; for small businesses to increase the number of employees on a long-term rather than on a seasonal or temporary basis; and for businesses to provide necessary training. (An interest in increased training has led Senator Nunn (D-GA), alternatively, to propose a 25 percent credit against increased training expenditures.) It is also urged that the jobs tax credit be easy to use and well publicized. Because many companies lack the income to permit immediate use of already available tax benefits, experts suggest that a truly useful jobs tax credit would have to involve refunding a portion of employer FICA taxes.

A broader jobs tax credit may or may not be the best way to promote fuller employment. It would, however, provide tax benefits to service businesses more comparable to those now available to capital-intensive industries. An alternative--elimination of ACRS and investment tax credits coupled with proportional reductions in corporate tax rates--could achieve the same end, but this approach would presumably arouse stiff political opposition. A general jobs tax credit--which would need be fairly generous to balance the ACRS and ITC benefits available to capital-intensive industries--is perhaps more feasible.

businesses have customarily paid banks between one and two percentage points over the prime interest rate available for loans to large businesses, this spread has lately worsened from the small business perspective. Since May 1982, the prime/small spread has fluctuated between three and five percentage points. Moreover, small business loans sometimes are simply not available. In response, bankers claim that the recent high number of small business bankruptcies demands a higher risk premium and that it costs more to analyze and monitor the financial position of small borrowers. A recent Wall Street Journal article summed matters up differently, however: "It appears that deregulation of banking has increased competition among lenders to get the business of big companies. Banks increasingly are offering discounts to lure these borrowers, but they don't need to make similar efforts to bring in small-business borrowers." To add injury to insult, small businesses still in their loss phase derive little if any benefit from the tax deductibility of their high interest expenses.

This situation has prompted proposals for an interest deduction pass-through provision. To the extent that a small business borrower chooses--by virtue of operating losses and favorable loan terms--not to deduct interest expense, the lender would be allowed to deduct that portion of interest revenue from taxable income. This would provide a higher after-tax return to the lender. I believe this provision would promote small business lending at lower rates, thus eliminating some of the disadvantages of newness and smallness, and providing more affordable debt capital to the services sector.

Conclusions

Observers differ on what role the tax system should have beyond raising necessary government revenues. Some feel it should be used as a mechanism for promoting socially desirable ends. Others insist that the tax system should be essentially neutral, and allow the market to determine investment free from tax distortions. The proposals discussed here are consistent with either philosophy, for it is clear that our increasingly valuable service sector is denied benefits comparable to those available to capital-intensive, large, and established businesses under the present tax system.

As for revenue effects, while they would result in some short-term loss of revenue from service and other small businesses, these proposals would presumably produce some additional revenue from taxation of increased business and personal incomes. The net effect is obviously of critical concern in this time of enormous budget deficits. These judgments, however, are best left to tax experts.

My principal concern is with meeting the capital needs of the service sector. I believe that a general jobs tax

Mr. HOSTETLER. I certainly do not claim to have any expertise on the issue, but I think it can be helpful and I would rank it around a 6 or a 5.

Senator JEPSEN. All right, Mr. Ink.

Mr. INK. I pass.

Senator JEPSEN. Mr. Rappaport.

Mr. RAPPAPORT. I would say about a 7. I agree with Mr. Simonetti.

Senator JEPSEN. The domestic content legislation.

Mr. Simonetti.

Mr. SIMONETTI. Here I would have to put that at the lower end of the scale, on I guess a biased view that domestic content has a tendency to be restrictive, too protective, and counterproductive. Thus, I would rate that on a lower scale, below 5.

Senator JEPSEN. Mr. Hostetler.

Mr. HOSTETLER. I would also agree that I think the domestic content legislation would lead to retaliation and to restrictions in the system and would be counterproductive, so I would give that a lower ranking.

Senator JEPSEN. Zero or 2 or 1?

Mr. HOSTETLER. I would say 1.

Senator JEPSEN. And yours would be below 5, Mr. Simonetti?

Mr. SIMONETTI. Well, I would rank it very close to what Mr. Hostetler said.

Senator JEPSEN. Mr. Ink.

Mr. INK. As a panel member, I pass, but my personal view would certainly give it a low rating of about 1.

Senator JEPSEN. Mr. Rappaport.

Mr. RAPPAPORT. I am opposed to domestic content legislation.

Senator JEPSEN. Zero.

Service export subsidies.

Mr. SIMONETTI. Here, I guess to give you a quick answer, I think I would rate it somewhere around a 7 if we can be specific as to what we mean by export subsidies. And I will comment on that later if time permits. But with respect to some specific support, for example, extending services income to the Domestic-International Sales Corporation scheme, I would rate that very high as a 7 or 8. I might have a different view with respect to the specifics of another subsidy.

Senator JEPSEN. Mr. Hostetler.

Mr. HOSTETLER. I myself would feel that that general category might be broadened out. I would give it a high ranking of 8 or even 9, but I think we need to consider a variety of ways where we, through financing techniques, can assure that domestic services are able to compete fairly overseas. And this would be one such technique.

Senator JEPSEN. Mr. Ink, do you have a comment?

Mr. INK. I pass.

Senator JEPSEN. Mr. Rappaport.

Mr. RAPPAPORT. I would probably give it the highest rating, because I think that this would most directly help smaller companies, especially in the area of capital formation, which we have just discussed. I think subsidies in that area would be extremely helpful.

Senator JEPSEN. Would anyone want to give an example of a subsidy that you think could be helpful?

We will start with you, Mr. Rappaport.

Mr. Rappaport. Well, I think low-cost financing would be the principal subsidy that I would hope we could look for. I think it is very difficult for small companies to finance activities overseas because of the problems in collection, the longer time it takes to collect receivables and so on. In that area, I think we could have a real impact.

Senator Jepsen. Is this the biggest shortcoming, our "capital gap" problem?

Mr. Rappaport. Yes; the shortcoming of working capital is the major problem we have.

Senator Jepsen. And short-term working capital especially for export?

Mr. Rappaport. Especially for export, because of the time it takes between spending cash on the goods and services which are purchased and recovering that cash back into the business.

Senator Jepsen. That was not one of the three items or suggestions you explored, but you would rate that very high, a subsidy?

Mr. Rappaport. Yes. In my prepared statement, I was really talking about tax policy.

Senator Jepsen. Do you have an example of a subsidy, Mr. Ink?

Mr. Ink. I would just comment that the problem Mr. Rappaport has addressed is one that I have encountered time after time in this area. I think it is a very valid concern.

Senator Jepsen. Mr. Hostetler.

Mr. Hostetler. I have nothing to add.

Senator Jepsen. Mr. Simonetti.

Mr. Simonetti. Mr. Chairman, let me explore more fully the concept I discussed. Without trying to impede in any way the legislation that is going through the Congress today with respect to a Foreign Sales Corporation which would replace the DISC, I used this merely as an illustration to suggest the dichotomy that we have between goods and services. DISC was created as a tax deferral technique. We understand that. It is part of a help in the international marketplace.

However, services income generally is not included, either in DISC, except as it applies incidental to goods transactions. The reason services income was excluded when DISC was first introduced was that it was largely viewed as a revenue drain. But we find when we are revisiting this issue today under a new rubric, the same issue comes up, that in order to be considered, it must be a revenue-neutral provision. And I find that difficult to understand. You understand we have problems of the deficit, but here again we are creating the distinction between the goods sector and the services sector.

So I would consider the inclusion of services income into the new FSC if it were prudent from a revenue point of view. If we could find other places to reduce the deficit, this would be one place in which we could provide greater equity between the goods sector and the services sector.

Senator Jepsen. The current reciprocity act has been passed by the Senate. A similar bill passed earlier. It will be taken up after the tax bill. Are you suggesting that maybe we ought to consider this at the same time as part of, and included in, the tax bill?

Mr. Simonetti. Well, as an individual I would, but unfortunately, since we have, in the business community, segregated ourselves between those who are promoting the goods sector and those promoting effective management system to really implement that in a meaningful way.

In 1979, we got the management system. As Mr. Ink has said, that seems to be increasingly improving. Unfortunately, the basic thrust of the policy has been watered down and changed, so now, for example, the Federal policy simply accepts competition between Government and the private sector and emphasizes very complex cost comparisons.

I would simply refer to an attachment to my own testimony where Burt Hall, from the General Accounting Office, has a brief comment called "Cost Confused." Essentially the thrust of Hall's analysis is that we need to move away from very complex cost-comparison methodology and return to a basic policy that states basic reliance on the private system whenever reasonable prices are available.

And that seems to me to be why it is so important that Congress try to cut through this complexity and state very clearly what the national policy should be.

Senator JEPSEN. Do any of you in your studies or experience find some undercurrent resistance toward that from organized Federal employees?

Mr. HOSTETLER. There is very strong resistance to that, and I think there are some ways in which perhaps the productivity issue can be used to help persuade Federal employees that this is ultimately in their interest as well as in the interest of the Government in the way we use Federal resources.

Second, OMB and the Office of Federal Procurement Policy have recently tried to refine the process by which Federal employees who may be displaced are assured of opportunities to continue in Government service or with contractors who get jobs that are converted from in-house service to private service.

I think that is a sensitive issue, but I think it is one that should be addressed in a straightforward way, and I see some evidence that it is happening.

Mr. INK. I agree with that. I would simply add one comment, that over the years, the concept, I think, has been handicapped in some respects because in a number of instances, the contracting-out has not been accompanied by any serious thought with respect to how these contracts are to be administered without the capacity to effectively administer the contracts. And a host of problems have risen out of that, some of them generated by the contractor, some by the Government agencies.

Senator JEPSEN. The other morning, I had the privilege of hosting Mr. Grace of the Grace Commission report. Mr. Ink, you chaired the Special Panel on Revitalizing Federal Management. There was a rather voluminous report on improving Government management.

Was there any comparison in your findings on Government management with the Grace Commission report? Are there any similarities or any agreements? Would you just comment generally on that? I would like to compare notes and I have a fair opportunity to do so here with you being chairman of the panel.

Mr. INK. Our work was largely done before the Grace Commission material was available to us, Mr. Chairman, so we did not have the opportunity that we had hoped for of the kind of comparison we would have liked to have undertaken. As you know, the Grace Commission had a tremendous volume of activity and the report was delayed somewhat.

We had some strong similarities with respect to our overall assessment of the Federal systems being, as I said earlier, overburdened, overregulated, too costly. We had strong similarities with respect to the need for simplification, and I think we both in different words were saying that we were talking about major changes, not minor changes, not tinkering with the system. Although it might take some time to reach the full magnitude of the changes desired, those changes did need to be very, very substantial.

We probably placed more stress than the Grace Commission—although some of the Grace Commission task forces, I think, pretty much agreed with our conclusions—that the problem that we face is much more the bureaucratic systems than it is the bureaucrat. We took the position that the bureaucrat was as much the victim of the bureaucratic systems as the public or as industry. We stressed that, I think, a good deal more than the Grace Commission did.

We both concluded that the Federal leadership in the Federal Government for better management needs to be strengthened. The Presidential leadership needs to be strengthened through an Office of Federal Management in the Executive Office of the President. We disagreed very substantially on the nature of that office. We felt it should be broken out of the Office of Management and Budget because the budget overwhelms the whole process, whereas the Grace Commission urged the strengthening of the Office of Management and Budget.

Senator JEPSEN. Mr. Simonetti, you testified that the right of establishment of ownership is one of the most serious foreign barriers to U.S. service exports. In what way do these barriers restrict expansion of the U.S. service firms in host countries, and what can we do about it?

Mr. SIMONETTI. Starting with what do we do about it, it is one of constant negotiation, it seems to me.

On the right of establishment, based upon both the respondents' views and some personal perceptions, I find that if you are dealing with some developing countries, you have a set of conditions that exist that are protective of the developing country's industries. So we found that the right of establishment—I am sorry, sir

Senator JEPSEN. Just a one-liner. Define "right of establishment," and then continue.

Mr. SIMONETTI. "Right of establishment" means the opportunity to do business within the country, either through an independent investment or through a working relationship with a host country's company. For example, our own firm, Price Waterhouse, practices around the world as a professional service company. There are some places in the world in which, for example, we may not even use the name "Price Waterhouse" because of local conditions which restrict the use of our name and require local ownership. And that is an example of an approach typically in countries where a particular service area might be protected.

Banks, to some extent, find the same could be true in selected countries. For example, the respondents to our survey noted that in Australia, in particular, there were some peculiar problems relative to the right of establishment in the banking community. And, of course, Congress is reviewing the conditions under which banks

It is very important, I think, that two things are done in approaching this kind of review: one, that the base be a factual base. And in 1969, we undertook actual flow charts of each one of the some 500 various grant-in-aid programs, flow-charted it out. We took these, among others, to the leadership of the interest groups that were very concerned about retaining these objectives. And we said, "Here's the horror story. Clearly, this can't keep going on. We are paying a price, a price that the recipients are really not aware of." And we went through the whole litany of that. And we found that a number of these groups were surprisingly supportive and cooperative with finding ways to simplify the process.

I believe the same thing can be done here, but the groups who are most concerned about the motivation of such reviews have to be involved.

Senator JEPSEN. I thank you for your comments.

I have about 6 minutes to go to vote. It is exactly noon and everything is coming together, and it is time to adjourn.

Does anybody have a statement they would like to make in closing for the record? [No response.]

I thank you very much for your participation today.

The committee will now stand adjourned.

(Whereupon, at 12 noon, the committee adjourned, subject to the call of the Chair.)

[The following statement was subsequently supplied for the record:]

STATEMENT OF HARRY L. FREEMAN, SENIOR VICE PRESIDENT, AMERICAN EXPRESS, ON BEHALF OF THE COALITION OF SERVICE INDUSTRIES

The Coalition of Service Industries appreciates the opportunity to submit testimony to the Joint Economic Committee on international trade in services. We commend the Committee for scheduling a series of hearings devoted exclusively to gathering information on the service economy. It is through hearings such as these that we will be able to focus attention on this often overlooked component of U.S. trade and industry.

The Coalition of Service Industries (CSI) was formed in January 1982, to promote public awareness of and interest in the service industries segment of our economy. Our membership is comprised of thirty of the nation's largest providers and exporters of services, representing a wide range of service industries including banking, insurance, investment, shipping, advertising, retailing, telecommunications and construction. A list of our member companies is attached to this testimony.

In recent years it has become clear that the U.S. economy is a service economy and that trade in services has become the most dynamic aspect of U.S. trade. Services now account for fully 67% of total GNP and 70% of all U.S. jobs are derived from the production, delivery and sale of services. Over the last twenty years services exports have grown in huge proportions. Between 1977 and 1981 alone, the export of U.S. services grew by over 76%.

Today, unfortunately, those "good old days" of rising services surpluses are gone. Since 1981 our services trade surplus has shrunk by 25 percent, from an estimated $39 billion in 1981 to an estimated $30 billion last year.

There are many reasons for this decline. At the heart of the matter, however, lie two converging trends. First, increasing foreign competition in services trade is rapidly reducing U.S. market share. According to the U.S. Trade Representative's office, the U.S. share of world trade in services shrank from 25 percent in 1972 to 20 percent in 1981. Increasingly, U.S. services exporters face keen competition in the fields we have traditionally dominated such as telecommunications, finance, construction engineering and transportation.

In our view, foreign competition is something America's services companies must learn to live with. The fact is anyone wishing to compete in world markets must be "tough and lean", and we are confident American services firms can meet and beat the foreign competition. However, if our task is clear, the playing field on which we struggle is frequently obscured by gaps or inequities in our own laws.

For example, no one really knows how well or how poorly American companies are facing up to foreign competition. The limited overseas performance statistics collected by the U.S.

government on U.S. services companies provide only a fraction of the total picture. In effect, we have set off on a difficult journey, over unknown terrain, with only a fragment of a map.

The second trend contributing to the decline in our services trade surplus consists of growing foreign protectionism against U.S. services exports. Today increasing numbers of nations seek to protect their emerging service sectors from foreign competition through a myriad of non-tariff barriers. Examples of these may be found:

- In Argentina, where American accounting firms are limited in the number and type of audits they can perform.

- In Italy, where no foreign advertising agency is allowed to offer services and all TV commercials produced outside of the country are forbidden.

- In Germany, where foreign banks are prohibited from offering or providing services, only representative offices are allowed in the country.

And the list goes on. The point is, U.S. services companies are severely handicapped in their efforts to deal with these trends both by the fact that U.S. trade law is biased in favor of goods and by the fact that services are excluded from the international body of trade law known as the GATT.

Not having recourse to international trade laws embodied in the GATT strikes us as unfortunate. In November of 1982 at the GATT Ministerial, the U.S. led the fight to launch GATT negotiations on trade in services. That effort was only partially successful. Rather than launching a GATT work program on services, the ministers called for member countries to conduct their own National Studies on Services. Since then, many of the countries which initially opposed the U.S. initiative have, upon investigation, discovered their own stake in services trade. The EEC, for example, has announced that services account for over 30 percent of its total exports. As a result the U.S. has been joined by the EEC and several other countries in an effort to integrate services into the GATT.

On the other hand, not having recourse to the trade laws and remedies of the United States -- as other exporters do -- strikes us as unacceptable, incomprehensible and -- fortunately remediable.

Since 1983, legislation has been pending in this Congress which would grant services exports parity with goods in U.S. trade law. This bill, variously known as S. 144, or the International Trade and Investment Act, has been passed by the

Senate three times. Recently, it was attached to the House-sponsored Miscellaneous Tariff bill H.R. 3398 which is now awaiting action on the Senate Floor. Still it hasn't gotten over the goal line. Similar bills are also awaiting action in the House.

In brief, this important legislation would accomplish three goals of great importance to the competitive position of U.S. services exporters.

1. It would grant services full parity with goods under U.S. trade law, particularly with regard to Section 301 of the Trade Act. This would enable U.S. trade officials to pursue bilateral as well as multilateral agreements to liberalize trade in services.

2. It would create a Congressional mandate authorizing the President to carry out negotiations leading to the incorporation of services into the GATT.

3. It would establish a clear priority for the improved and expanded collection and analysis of service industry performance data by the U.S. government agencies.

While passage of this legislation will not eliminate all the problems which service industries encounter in their international trade activities, it will certainly provide some essential tools for enhancing their ability to compete. In addition, it will place our trading partners on notice that we are committed to liberalizing world marketplace for services. The Coalition believes that the growing U.S. trade deficit makes enactment of this legislation more crucial than ever. Only by taking progressive and forward-looking action now will we be able to prevent the service industries from suffering the fate of some of our basic industries.

COALITION OF SERVICE INDUSTRIES, INC.

LIST OF MEMBER COMPANIES

AMERICAN EXPRESS COMPANY

AMERICAN INTERNATIONAL GROUP, INC.

AMERICAN MEDICAL INTERNATIONAL, INC.

AMERICAN TELEPHONE & TELEGRAPH COMPANY

AT&T INTERNATIONAL, INC.

ARA SERVICES, INC.

ARCHER DANIELS MIDLAND COMPANY

BBD&O INTERNATIONAL, INC.

BECHTEL POWER CORPORATION

BENEFICIAL MANAGEMENT CORPORATION

CBS, INC.

CHASE MANHATTAN BANK, N.A.

CIGNA CORPORATION

CITIBANK, N.A.

THE CONTINENTAL CORPORATION

COOPERS & LYBRAND

DELOITTE, HASKINS & SELLS

FLUOR CORPORATION

INTERNATIONAL BUSINESS MACHINES CORPORATION

THE INTERPUBLIC GROUP OF COMPANIES, INC.

JOHNSON & HIGGINS

MANPOWER, INC.

MARSH & McLENNAN, INC.

MERRILL LYNCH & COMPANY, INC.

PEAT, MARWICK, MITCHELL & COMPANY

PHIBRO-SOLOMON, INC.

SEA-LAND INDUSTRIES, INC.

SEARS, ROEBUCK AND COMPANY

YOUNG AND RUBICAM, INC.

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