

COMMISSION AUTHORIZED

BEFORE THE
OFFICE OF PERSONNEL MANAGEMENT
WASHINGTON, D.C. 20415

Pay Administration (General), Severance Pay 1989
5 CFR Part 550, RIN 3206-AC41

COMMENTS OF
THE STAFF OF THE BUREAU OF ECONOMICS OF THE
FEDERAL TRADE COMMISSION¹
(submitted July 31, 1989)

I. INTRODUCTION

The staff of the Bureau of Economics of the Federal Trade Commission (FTC) appreciate the opportunity to submit these comments to the Office of Personnel Management (OPM) in support of OPM's proposals to adjust severance pay regulations.² In particular, we support the proposal to provide severance pay benefits to Federal employees involuntarily separated through reductions in force (RIF) who accept employment within ninety days with the private contractor who provides the service previously performed by the RIFed employee.³ We believe that proposal is likely to improve efficiency by smoothing transitions from Federal to private provision of

¹ These comments are the views of the staff of the Bureau of Economics of the Federal Trade Commission. They are not necessarily the views of the Commission or any individual Commissioner. Questions about these comments may be addressed to John C. Hilke, Federal Trade Commission, Bureau of Economics, 6th Street and Pennsylvania Avenue, N.W., Washington, D.C. 20580, telephone: (202) 326-3483.

² The OPM proposals are discussed in Federal Register 54:103 (May 31, 1989) pages 23215-18.

³ Current regulations provide a RIFed worker with severance benefits only if he begins working for the contractor at least 90 days after being RIFed.

commercial services.⁴ OPM's proposals may also help private suppliers compete to supply commercial services to the government.

To further smooth transitions to private contracting, OPM may wish to consider additional changes in its severance pay regulations to provide increased incentives for RIFed workers to accept job offers from the contractor. In considering these options, as well as in reviewing its own proposals, OPM may wish to evaluate the costs and benefits of the proposed changes. Finally, OPM may wish to consider a low cost increment in its record keeping requirements to facilitate improved analysis of the effects of the revised severance pay regulations.

II. EXPERTISE OF THE STAFF OF THE FEDERAL TRADE COMMISSION

The FTC is an independent regulatory agency responsible for fostering competition and safeguarding the interests of consumers.⁵ The staff of the FTC, upon request by federal, state, and local government bodies, regularly analyze regulatory or legislative proposals that may affect competition or the efficiency of the economy. In conjunction with these responsibilities, the staff of the Bureau of Economics are conducting studies of opportunities

⁴ Under the Office of Management and Budget's (OMB) Circular A-76, which establishes the rules of transitions to private contracting, commercial services are transferred from the government to private competitive contracts if the lowest private bid is more than 10% lower than the lowest cost at which the government can produce the service in-house. Commercial services are services commonly provided by several private firms to consumers, other private firms, and governments. See Supplement, OMB Circular A-76 (Revised), U.S. Office of Management and Budget, "Performance of Commercial Activities," August 1983, Part I, pp. 11-15. Also see Executive Order No. 12615 of November 19, 1987, Federal Register 52:225 (November 23, 1987), p. 44853.

⁵ 15 U.S.C. § 41 et seq.

to enhance competition and increase economic efficiency in commercial services supplied to the government.⁶ In addition to these ongoing studies, we have prepared a number of comments and a report which note that private provision of services could represent a potentially attractive alternative to government provision. Our work includes: (1) comments on competition issues related to the U.S. Postal Service's electronic computer originated mail (E-COM) service;⁷ (2) a review of options to privatize the air traffic control system;⁸ (3) comments on the efficiency effects of government regulated utilities competing with private insulation contractors;⁹ and (4) comments on the efficiency and competitive implications of exempting addressed third class mail from the private express (government monopoly) statutes.¹⁰

⁶ Staff's work in antitrust and consumer protection litigation also commonly involves assessing the effects of incentives on economic decisions of individuals and groups of individuals.

⁷ See FTC staff comments on the U.S. Postal Rate Commission's Docket No. R83-1, filed June 1, 1983; Docket No. R83-1, filed June 16, 1983; and Docket No. R84-1, filed December 23, 1983.

⁸ Ogur, J., et al., The Deregulated Airline Industry: A Review of the Evidence, Washington, D.C.: Federal Trade Commission, Bureau of Economics Economic Issues Reports, 1988, Chapter III.

⁹ See "Comments of the Federal Trade Commission to the Department of Energy Pursuant to Section 216(g) of the National Energy Conservation Policy Act," 42 U.S.C. Section 8217(g), provided November 15, 1985, and "Statement of T. Muris, Director of the FTC Bureau of Competition, on Competition by Utilities in Energy Conservation and Home Appliance Markets," before the Senate Committee on Small Business, November 3, 1983.

¹⁰ See the FTC Bureau of Economics staff comments to the Postal Rate Commission, Docket No. C89-1, filed February 28, 1989.

III. OPM'S SEVERANCE BENEFITS PROPOSALS

OPM's proposed changes in the Federal government's severance pay regulations seek to improve the efficiency of transferring the provision of commercial services from government to private contractors by facilitating the movement of Federal employees to the private contractors. Experience indicates that considerable cost savings can be realized when competitive contracting is introduced.¹¹ Agencies with extensive contracting experience report that contractors often can increase efficiency by reorganizing and adopting more efficient management techniques while employing some of the workers that the Federal government employed to do the same work. However, OPM reports that the net benefits of increasing competition and efficiency through contracting-out have been diminished, at least during the initial transition period, by difficulties some contractors have encountered in hiring RIFed employees.¹² OPM believes that current severance pay

¹¹ See Musell, M., Contracting Out: Potential for Reducing Federal Costs, Washington, D.C.: Congressional Budget Office, 1987. In reviewing data for 180 privatization assessments at the Department of Defense covering 1984 to 1986, Musell found that 65% of the contemplated transfers actually took place with average cost savings after a year of 35%. In the remaining 35%, internal management improvements were sufficient to continue government provision, with average cost savings of over 20%. Cost and quality evaluations over a 90-day period were not included by Musell, hence this study cannot be used to quantify the transition effects considered by OPM in its proposals.

Musell estimated that considerable potential for additional Federal cost savings remained because approximately 1.4 million Federal workers perform jobs that are classified as commercial services.

¹² Federal Register Notice, p. 23215. OMB's Circular A-76 requires that the government make efforts to hire displaced workers and that "the contractor will give Federal employees, displaced as a result of conversion to contract performance, the right of first refusal for employment openings on the contract for positions for which they are qualified." However, the Department of Defense reported in 1984 that only three percent of Federal

regulations substantially contribute to this problem by creating a disincentive for RIFed employees to accept employment with the private contractor.

Under current regulations, Federal employees who accept employment with the contractor within 90 days of being RIFed receive no severance benefits.¹³ This provision creates a disincentive for these employees to accept jobs with the contractor before 90 days have passed, making them more difficult for contractors to hire during the transition period. Ironically, a worker's incentive to wait 90 days before accepting employment increases with the length of service and (presumably) experience.¹⁴ OPM proposes to encourage experienced workers to accept job offers from the contractor by eliminating the 90 day requirement, thus granting severance benefits to those who accept employment with the contractor sooner than 90 days after the RIF.

employees involuntarily separated due to private contracting went to work for private contractors while 94% retired or transferred to other government jobs. The 1985 report of the General Accounting Office (GAO) indicated that in its random sample of conversions, 86% retired or obtained other government employment while only 7% accepted jobs with contractors. See U.S. General Accounting Office, Information from Previous Reports on Various Aspects of Contracting Out under OMB Circular A-76, Washington, D.C.: GAO, 1985. Also see Stolzenberg, R., and S. Berry, A Pilot Study of the Impact of OMB Circular A-76 on Motor Vehicle Maintenance Cost and Quality in the U.S. Air Force (Study R-3131-MIL), Santa Barbara, California: Rand Corporation, 1985. Similar findings have been reported concerning contracting out in local governments. See Dudek & Co., Privatization and Public Employees: The Impact of City and County Contracting Out on Government Workers, Washington, D.C.: National Commission on Employment Policy, 1988.

¹³ Under Section 550.704, other workers ineligible for severance benefits include those who are eligible for retirement and those who refuse a reasonable offer of employment from the Federal government.

¹⁴ Severance benefits increase with the length of government service and with age.

We agree with OPM that the current regulations probably increase the costs of private contractors and thereby reduce the quantity of services converted to competitive contracting. During the initial 90 day transition period, the contractor may have to spend additional money for training or pay a wage premium because some RIFed employees can be expected to decline employment offers. Those higher costs will increase contractors' bids in general, and, in some instances, the increases may prevent competitive contracting.¹⁵ An additional social cost arises because the current regulations may encourage RIFed employees to remain idle or to accept less productive work during the 90 day interim. Those outcomes involve nonrecoverable losses of productivity.

OPM's request for comments does not mention additional costs likely to be associated with the proposed changes. We discuss two such costs. First, some workers who accept job offers from the contractor will respond to the proposed changes by choosing to start work immediately rather than waiting 90 days. Government costs increase because the government is required to make severance payments earlier. However, this additional cost would be minimal, equalling the present value of the interest that could have been earned had the severance payments been delayed 90 days. Second, the proposed changes may cause some additional RIFed employees to qualify for severance benefits. For example, some employees who, under current

¹⁵ Transfer of a service to competitive contracting is only indicated if cost savings are more than 10% higher than the lowest feasible cost of providing the service in-house. The lowest feasible in-house cost includes cost reductions from internal management reforms. Musell, op. cit.

regulations, would choose to seek and obtain other positions in the original agency (and therefore not qualify for severance pay) may now prefer to accept employment with the contractor and thereby qualify for severance pay. OPM may wish to conduct an additional evaluation of the effects of its proposals by balancing expected increased costs of severance benefits against increased efficiency in transitions to contracting.¹⁶ Any additional costs or benefits of reducing the number of workers transferred within the original agency should also be considered.

In sum, we agree with OPM that the proposed changes in the severance pay regulations are likely to alleviate some transition inefficiencies by diminishing current disincentives to accept job offers from contractors during the transition phase.

IV. ADDITIONAL OPTIONS

In addition to the current proposals, OPM may wish to consider four modifications to the regulations that we believe could further smooth transitions to competitive contracting. All of these options increase incentives for RIFed employees to accept job offers from the contractor who will be responsible for providing the service. In the first of these options, we believe that incentives can be increased at little or no additional cost. The other options could involve payment of severance benefits to additional

¹⁶ Part of this evaluation may also depend on the effects of the proposed changes on the climate of cooperation among OPM, OMB, individual agencies and representatives of Federal workers concerning the A-76 program. In general, changes with positive compensation effects on RIFed employees should make the A-76 program more attractive to workers.

RIFed employees and OPM may wish to assess and balance the added costs against the potential efficiency benefits. We also believe that evaluation of the effects of the changes discussed below, as well as OPM's original proposals, could be enhanced by keeping slightly more refined records of employment of RIFed employees by contractors.

(1) Increased Incentives Not to Reject Employment with the Contractor:

Rejection of a reasonable offer from the original government agency results in denial of severance benefits under OPM's current and proposed regulations. Thus, the proposed regulations provide a penalty for RIFed employees who reject a reasonable offer from the original government agency. However, the proposed regulations do not provide a similar disincentive for RIFed employees to reject a reasonable offer from the contractor.

OPM may wish to consider regulations to provide parallel denial of severance benefits when a RIFed employee rejects a reasonable offer from either the government or the contractor.¹⁷ This should increase incentives to accept a job offer from the contractor and should, therefore, increase the

¹⁷ To implement this suggestion, OPM would have to define a "reasonable employment offer from the contractor." This could include pay, benefits, commuting area, job security and other job characteristics. The provisions required of reasonable private offers could parallel or differ from the definition of a reasonable offer from the government contained in Section 550.703 (definitions). Simple and clear regulations defining reasonable private employment offers may be important to avoid litigation concerning the sufficiency of contractors' offers. As proposed by OPM, a reasonable government offer must provide pay no more than two grade levels below the employee's current grade level.

contractor's ability to provide a smooth transition. This option should not involve increased government severance costs.¹⁸

(2) Grant Severance Pay to Those Who Accept a Job with the Contractor Even If They Have Refused a Reasonable Offer from the Government: Under current rules, Section 550.704(b)(2), a RIFed employee who has refused a reasonable offer from the government receives no severance benefits even if he or she accepts employment with the contractor. This feature of the current regulations, which would not be changed by the proposed rules, appears to be inconsistent with the stated purpose of OPM's proposals by biasing RIFed employees toward accepting an offer from the original agency. OPM may wish to consider granting severance benefits to RIFed employees who accept employment with the contractor, but would be disqualified for severance pay under current and proposed rules because they refused a "reasonable offer" of government employment.

¹⁸ OPM could apply this approach to all Federal employees or only to government employees hired after these new regulations go into effect. Prospective employees would have information about the new regulations and would be expected to include this consideration in making a decision to accept Federal employment. Incumbent employees would not have had this information at the time they were making employment decisions. Although, incumbent employees accepted Federal employment knowing the unilateral and often negative nature of changes in pay and benefits in Federal employment, the more often the government makes such negative unilateral changes, the more likely it is that prospective employees will take that into account in their decision making. This effect may make it more difficult for the government to hire and retain a workforce in the future. Thus, any action by the government in this instance that negatively alters the terms of employment could have some, albeit small, negative impact on the government's ability to hire in the future.

This alternative could increase the government's total severance pay costs because employees who refuse a government offer and accept the contractor's offer would become eligible for severance benefits. In considering this option, OPM may wish to weigh the benefits of smoother transitions and additional competitive contracting against the costs of additional severance benefits.¹⁹

(3) Additional Incentives for Retirement Age Employees to Accept Employment with the Contractor: The proposed regulations continue to prevent payment of severance benefits to employees who are eligible for an immediate Federal annuity -- for example, workers of retirement age.²⁰ This provision may discourage the most experienced workers from transferring to the contractor. If attracting experienced workers during the transition period is as important in making a smooth transition as OPM suggests, OPM may wish to consider eliminating this exclusion of retirement age workers from severance benefits when they transfer to the contractor. Doing so could provide an increased incentive for experienced employees to accept employment offers from the contractor. In considering this option, OPM may wish to balance possible efficiency gains in transitions against the potential increase in severance payment costs.²¹

¹⁹ This option could also provide benefits (or costs) by reducing bumping and intra-agency reassignments of RIFed personnel. Bumping refers to the right of an employee facing a RIF to displace another worker with a lower grade and length of service within the same occupational class.

²⁰ Section 550.704(b)(5).

²¹ This option may require legislative approval.

(4) Eligibility of Employees Hired by the Contractor before the General Notice of a RIF: The proposed regulations classify an employee as involuntarily separated, and therefore eligible for severance benefits, as long as the employee resigns after receiving official notice of the transition (RIF).²² However, this official notice may be received some time after the contract to transfer the service to the private sector has been let. In those situations in which the contractor believes that recruiting soon-to-be RIFed workers at the earliest possible date would be helpful in making a smooth transition, OPM may wish to consider authorizing severance pay to employees who resign to go to work for the contractor before the issue date of the official RIF notice.²³ In most cases the notice to employees probably provides sufficient lead time for the contractor to organize for the transition, but in some cases the contractor might be able to provide a more efficient and smoother transition if current employees did not lose severance benefits if they were hired after the contract is signed but prior to the official RIF notice.²⁴

²² Federal Register 54:103 (May 31, 1989) at page 23217.

²³ Since this option involves paying severance benefits earlier than would otherwise be the case, the contractor could reasonably be required to repay the government for the interest cost of earlier payment of severance benefits.

²⁴ The contractor could provide a bonus or other incentive to compensate for the loss of severance benefits, but this would increase the contractor's costs by more than it saves the government. The savings to the government of postponing payment of severance benefits until after the RIF notice is at most a few weeks worth of interest on the severance benefits. The cost to the contractor to overcome the employees' incentive to wait until the RIF notice is issued is equal to the entire present value of severance benefits, since the employee loses all severance benefits if he or she resigns before the RIF notice is issued (under OPM's current regulations).

Record Keeping: OPM may wish to ask agencies to record (1) when RIFed employees (who agree to work for the contractor) make the transfer and (2) whether such RIFed employees continue to be employed by the contractor during the following year. Such information could facilitate OPM's evaluation of the effects of the new regulations as well as to increase information about the effects of contracting-out on the employment experiences of RIFed employees. The current proposed data requirements do not address either of these questions and these data should be routinely maintained and readily available from the payroll records of contractors.

V. CONCLUSION

OPM has identified an aspect of its severance pay regulations that appears to increase the costs of transferring commercial services from government to competitive contracting. In light of the large potential cost savings provided by such transfers, we commend OPM for taking steps to alleviate the problem. We believe that OPM's proposals may substantially improve transitions to competitive contracting.

OPM may wish to consider some additional measures that could help smooth transitions by further encouraging experienced, qualified workers to accept job offers from the contractor who provides the service previously provided by the government employees. OPM reports that contractors are able to provide better and more efficient service during transitions when they are able to hire these workers. We believe that revising the concept

of a "reasonable offer" to include offers of reasonably comparable pay from contractors could provide such additional encouragement. We also believe that permitting retirement age employees to transfer without loss of severance benefits could improve transitions. In considering both its own proposals and those discussed in these comments, OPM may wish to assess the proposals' costs and benefits and give preference to those in which expected benefits exceed the expected costs. OPM may also wish to enhance its ability to measure the effects of the proposed changes by requiring agencies to track retention rates for RIFed employees who accept positions with the contractor.