STATE OF CALIFORNIA GEORGE DEUKMEJIAN, *Governor*

COMMISSION ON CALIFORNIA STATE GOVERNMENT ORGANIZATION AND ECONOMY
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November 18, 1983

Honorable George Deukmejian
Governor of California

Honorable David A. Roberti
President pro Tempore of the Senate
and Members of the Senate

Honorable Willie L. Brown, Jr.
Speaker of the Assembly
and Members of the Assembly

Honorable James Nielsen
Senate Minority Floor Leader

Honorable Robert W. Naylor
Assembly Minority Floor Leader

Dear Governor and Members of the Legislature:

In response to a request from Assembly Majority Leader Mike Roos, the Commission on California State Government Organization and Economy, also known as the "Little Hoover Commission," and the Assembly Committee on Governmental Organization conducted a joint hearing on August 3, 1983 to assess the performance of Los Angeles County's program for contracting out government services under the authority of the ordinance which implemented Proposition A. The hearing was based in part on an April 1983 report by the Los Angeles County Grand Jury* which analyzed the County's contracting pursuant to Proposition A. Although the report supports contracting as an effective management strategy, the Grand Jury concluded that weaknesses in Los Angeles County's direction and management of the program have resulted in overstated claims of dollar savings. The Grand Jury also identified a number of other problems which could be corrected through the adoption of various recommendations.

Proposition A, adopted in 1978, permits the County to award cost effective contracts to private firms for the provision of a broad range of services which have historically been performed only by County employees. One consequence of these contracts is that they can be used to reduce the County work force and thereby reduce the cost of government operations. Thus, the results of this multi-million dollar, four-year-old program are of considerable interest to legislators, other State officials, County managers and employees, organized labor, private entrepreneurs, and all taxpayers.

Contracting out is an effective method to reduce the cost of government operations. In Los Angeles County, this program has saved millions of dollars. However, contracting out services previously

*Los Angeles County Program for Contracting Out of Services Under Provisions of Proposition A: April 1983.

conducted by government employees has certain inherent problems some of which were reported by the County Grand Jury. Although Los Angeles County has initiated several new procedures in response to the Grand Jury report to strengthen the process of contract analysis, development, and management, it has not yet fully resolved the dilemma of how to achieve maximum savings from contracting while minimizing the impact on affected employees. Specifically, our hearing and analysis of related documents determined the following:

- The County continues to overstate the savings it claims from Proposition A - related contracting. Although the County claims nearly $23 million of cumulative savings from the contracting program, we concur with the Grand Jury's findings that less than $10.8 million is attributable to Proposition A contracts through September 1982. The County has overstated the savings because it has included savings from non-Proposition A contracts and applied inappropriate analytical and audit techniques in calculating the savings.

- Future savings from new or renewed Proposition A contracts are uncertain due to potential reductions in the County's budget, possible increases in training costs, diminished competition between prospective vendors, and questionable vendor compliance with contract standards.

- Contracting out of County services has had a somewhat negative effect on employees because of job losses and job insecurity, diminished salaries and benefits, and limited retraining opportunities. The benefits of contracting have been achieved at a disproportionate cost to minority employees.

We believe that contracting out of governmental services offers opportunities to substantially reduce operating costs. However, government agencies at all levels should approach such a program with caution because anticipated savings may be achieved at a considerable cost to the public work force and might contain other unidentified risk factors. In order to document our assessment of the performance of Los Angeles County's Proposition A contracting to date, and to facilitate continuing discussion and review of salient policies and issues, specific findings from our joint hearing are presented below in greater detail.

The Savings Which the County Formerly Claimed from Proposition A Contracts Were Overstated, and the Actual Savings Remain Uncertain

The Los Angeles County Grand Jury report focuses on purported savings from contracts developed pursuant to Proposition A because the development of these contracts marked a significant and controversial change of policy. For the first time, it permitted the County to legally contract out services traditionally provided by County workers when it found that this course of action would be cost effective. Thus, these contracts have the potential to change the size and composition of the County work force.

In managing its contract development program, the County has estimated the cost savings resulting from Proposition A contracts, but has also included savings resulting from contracts originating under a different statutory authority. Specifically, the County has included 47 contracts awarded between October 1979 and March 1983 under an authority other than Proposition A with 209 actual Proposition A contracts. As a result, the County record and public statements concerning the Contract Development Program have heretofore implied that estimated savings were all attributable to Proposition A when in fact they were not.

The Grand Jury report questioned County reports which implied that all of the reported savings under the Contract Development Program were attributable to the contracting authority granted by Proposition A. Specifically, the Grand Jury reported, and we concur, that no more than $10.8 million of the $23 million of claimed savings from the Contracts Development Program was strictly attributable to contracting out of county services under the authority of Proposition A.

Nevertheless, the County's Chief Administrative Office has been generally insensitive to the need for specific reporting of Proposition A contract statistics. In a March 15, 1983 letter to the Chairperson of the Grand Jury Subcommittee studying the results of Proposition A contracting, the Chief Administrative Officer explained an "oversight" in a report wording related to contracting authority and stated that "in order to avoid any future misinterpretations, the use of the term 'Proposition A' is being discontinued immediately in all reporting documents." Similarly, in his prepared statement presented at our August 3 hearing, the Chief Administrative Officer reported on the total estimated savings from all contracts rather than discussing Proposition A - related savings alone.

The County Auditor-Controller, on the other hand, has recognized the need for a classification system to separate Proposition A contracts from all others. In a June 1983 memorandum, the Auditor-Controller stated that the County should develop formalized criteria for classifying contracts. Such criteria would enable the County to clearly distinguish Proposition A from non-Proposition A cost savings.

Additionally, the County's estimated savings are somewhat exaggerated according to both the Grand Jury and the County Auditor-Controller due to certain technical and methodological errors in their calculation. In the past, the County has lacked a sufficient centralized contract review and approval process. Having developed only general guidelines concerning contract development, various departments have been given wide latitude in evaluating cost effectiveness. Consequently, errors have occurred. The most significant County error identified in the Grand Jury report, and corroborated by the Auditor-Controller, was the overstatement of estimated savings from contracting out of services when County costs were incorrectly based on budgeted rather than actual County positions required to perform the contracted service. Other problems have included inadequate accounting for the costs of feasibility studies, insufficient contract monitoring, differences in service levels between the County and the contractor, and inaccurate projections of inflationary increases in County costs.

In a June 1983 memorandum, the County Auditor-Controller reported on his review of Proposition A contract savings for the period from October 1979 through March 1983. He found $12.7 million of "audited savings" from 209 contracts which he determined to have been awarded pursuant to Proposition A.

Although the Auditor-Controller's assessment of savings from contracting out county services is certainly more adequate than former published claims based on imprecise methods, his study may be seriously limited because it evidently generalizes from poorly documented information. In certain instances, the Auditor-Controller's study apparently assumes the accuracy of savings reported by some departments although corroborative data are absent. Additionally, his report does not contain sufficient detail to permit an independent reviewer to critically examine conclusions which appear to be hedged or contradicted by qualified statements within his study.

Although the Grand Jury reported that virtually all the departments it contacted lacked the backup calculations and data necessary to verify their claimed savings, this was not an obstacle to the Auditor-Controller's conclusions concerning program savings. In a July 25 letter to the Little Hoover Commission, he stated that "documentation was available in the various departments" to facilitate his audit of the savings which the County had previously claimed. However, in an attachment to his June 6 memorandum, the Auditor-Controller stated that, "in cases where documentation was not available or was incomplete, we reconstructed the cost analyses and resultant savings."

However, in at least one instance where documentation was inadequate to either substantiate or disconfirm earlier reported savings, the Auditor-Controller inappropriately verified these as "audited savings." Specifically, the Auditor-Controller noted that the Department of Community Development did not present documentation to support claims of $283,000 in projected savings from three contracts which it developed. Nevertheless, this qualification did not prevent him from including this entire amount in his report as "audited savings."

Additionally, the Auditor-Controller determined that two Proposition A contracts were not cost effective. Besides these contracts, he added that in a number of situations it was not possible to verify whether reported contract savings had occurred and, therefore, it was possible that some of these contracts were not cost effective.

Anticipated Savings from New or Renewed Proposition A Contracts Might Not be Realized

Reported savings from Proposition A contracting were based primarily on an historic strategy of reassigning County employees from affected jobs to other budgeted positions which needed to be filled to provide County services. To the extent that current or future reductions in the County budget may require a curtailment of services or service levels provided by the County, they would preempt savings which might otherwise have been achieved by contracting for the provision of the affected services at reduced rates. Additionally, budget reductions would reduce the number and kinds of vacant positions available to receive employees reassigned from jobs affected by contracting. This could result in a significant increase in County training costs and a commensurate reduction in program savings if the County adheres to a policy of attempting to mitigate the adverse impact of contracting on its employees. Similarly, diminished rates of attrition or retirement could make personnel reassignments more difficult and increase training costs.

Although the County has instituted some procedures to reduce the likelihood of becoming "contractor dependent" for the continuation of contracted services, there are indications that this is a potential problem which could erode apparent long-term savings from contracting. For example, we received testimony that the savings rate on contract renewals was 42 percent less than on first-time contracts.

We also learned that there have been various charges of vendor noncompliance with contract standards, resulting in false economies and, in some cases, public endangerment. While some of these contracts were awarded according to authorities other than Proposition A and might not have identical requirements such as cost effectiveness, the County acknowledged that it nullified two Proposition A contracts because of inadequate vendor performance. Although contracts which include cancellation or penalty provisions for inadequate performance can reduce the risks associated with contracting, they must be carefully monitored to assure vendor compliance with all quantitative and qualitative standards. As the County gains more experience in monitoring these contracts, it might find more instances of projected savings which prove to be misleading because of marginal or unacceptable vendor performance.

Proposition A Contracting Has Negatively Impacted Some County Employees

Perhaps as many as 1,000 employees (the County reports budgeted rather than actual positions because it does not know the latter figure) have been displaced from their former County jobs because of Proposition A contracting. Available aggregate statistics reported by the County suggest that some employees are placed with the contract vendors prior to the contract awards, some are laid off, and most are reassigned to other County jobs which have been budgeted but are vacant.

Employees who are placed with contract vendors generally suffer reductions in their wages and benefits. For example, a survey by the Los Angeles Times found that County custodial employees earn \$5.52 to \$6.88 per hour, have health, dental and life insurance plans, 10 days vacation after one year and 12 days of sick leave. Of four companies that have custodial contracts with the County, only one, which pays one dollar per hour less than the County, has nearly comparable benefits. The others provide far less in both wages and benefits. In one case, the vendor pays its employees a salary of \$3.35 to \$4.50 per hour and provides them no benefits at all.

Although the County reports that only 82 permanent employees were laid off because their work was contracted out (and half of these were later rehired), we learned that approximately 100 additional employees classified as "temporary" or "recurrent" might also have lost their jobs because of contracting. The contracting program has been characterized as "rascist" because blacks and hispanics account for an estimated 47 percent of the County's work force, but comprise 95 percent of the 82 official layoffs. No ethnic breakdown is available for the affected temporary or recurrent employees.

The Grand Jury report observed that the County has no affirmative action guidelines to assure that some of the private contracts go to minority or female-owned businesses. This is particularly significant because the report speculates that minorities will continue to be heavily impacted by future contracting.

Finally, labor union officials have challenged the adequacy of the County's commitment to mitigate the impact of contracting by training employees for reassignment to other County jobs. They have charged that the County has been slow to spend funds committed after June 1982 for retraining employees. Based on the cumulative number of reassigned County employees and total expenditures to date of less than $200,000, the County appears to have a very modest commitment to retraining affected employees.

Conclusions and Recommendations

Contracting out governmental services offers an opportunity to substantially reduce the operating costs of certain activities. However, State and local government agencies should be aware that projected savings may be achieved at a cost to the public work force. Additionally, contracting out services may contain certain risks which may eventually reduce the overall savings achieved by the program.

To more accurately assess the costs and benefits of Los Angeles County's contracting program, we recommend the following:

1. Contract provisions should be amended to include measurable standards for assessing contractor performance. These standards should reflect the acceptable minimum service level.

2. The current contracting program in Los Angeles County should be reevaluated in 12 months and 24 months to determine net savings in operating costs and to assess problems. Specifically, the evaluation should

   - separately identify savings for Proposition A contracts and other contracts

   - analyze contract renewals to determine how much the cost of contracts increase and why (e.g. inflation, change in services provided, less competition in contracting process)

   - determine how many employees -- part-time as well as full-time -- have been laid off, reassigned, demoted, and placed with private contractors

   - evaluate the effects on minority public employees

   - evaluate contractor performance trends

- determine the effectiveness of County affirmative action programs to encourage minority contractor's participation in the contracting out program.

3. The current County program for retraining employees should be reviewed to determine sufficiency of funds budgeted, the timeliness of training, and the effectiveness of training content.

Although our public hearing and this letter report address a local government matter, the general experience is particularly relevant to the Legislature and Administration for two reasons. First, the State provides Los Angeles County with funds to assist in supporting various programs and must therefore be assured that the County manages its programs efficiently and effectively. Second, the State in the future may itself consider contracting out certain services currently provided by public employees in order to reduce overall operating costs. Therefore, we believe the State would benefit by observation of Los Angeles County's contract development program.

Respectfully submitted,

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