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# MONOPSONY

A Fundamental Problem  
in Government Procurement

# **MONOPSONY**

## **A Fundamental Problem in Government Procurement**

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The mission of the Aerospace Research Center is to engage in research, analyses and advanced studies designed to bring perspective to the issues, problems and policies which affect the industry and, due to its broad involvement in our society, affect the nation itself. The objectives of the Center's studies are to improve understanding of complex subject matter, to contribute to the search for more effective government-industry relationships and to expand knowledge of aerospace capabilities that contribute to the social, technological and economic well being of the nation.

## FOREWORD

For many decades the Federal Government has been the principal customer for many of the products and services of the industry represented by the Aerospace Industries Association. That business has been conducted under circumstances very different from those that govern most business transactions under the free market system, for the government is the sole buyer for so much of the specialized output of high-technology suppliers. In this respect, the government is what economists call a "monopsony." As such it has wide-ranging powers to dictate the terms under which companies must bid for, design, develop and deliver the technology systems it seeks.

Notwithstanding the considerable volume of discussion about the government-industry relationship in the aerospace field, there remain limited public awareness and understanding of its unique nature and the resultant implications for government, for industry and for the country. To improve such understanding the Aerospace Research Center commissioned the Orkand Corporation to explore and examine the monopsonistic character of the government as a buyer of goods and services. Added impetus to this study stems from the belief that better public awareness and understanding of that relationship and its implications are especially important at a time when the government is increasingly becoming a buyer in such domestic areas as, for example, mass transit, education, health and environmental protection.

The Association releases this report and its recommendations with the conviction that they represent a very real and constructive contribution to a more informed public discussion of the government-industry relationship and to the effort to make that relationship better serve the interests of the nation, the government and the industries concerned. We welcome comments on the report and on its recommendations.

KARL G. HARR, JR.  
President  
Aerospace Industries Association



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## CHAPTER

# 1

## Introduction

### BACKGROUND

One of the unique—and distressing—aspects of the process by which government acquires major systems is that too often all of the parties involved are unhappy with the results. Congressional and executive agency spokesmen frequently cite examples of schedule slippages, technical failures and cost overruns. Industry in turn points to changing requirements, excessive regulation, inequitable procurement practices and unacceptably low profits. A confused public, generally unsophisticated on the subject, is likely to conclude that government officials and private industry are misallocating and mismanaging scarce public resources.

Given a market structure and acquisition process in which many of the participants fail to meet their objectives, it is tempting to embark on a hunt for particular villains or to seek simplistic solutions to isolated pieces of a complex problem. A more balanced analytical approach, however, must proceed from the recognition that the unsatisfactory results being observed are the outgrowth of the characteristics of high-technology systems, both civil and military, and the government market in which they are sold:

- A product line dominated by the government customer and subject to severe and abrupt shifts in requirements and program levels.
- A product line that is continually pressing the frontier of the technological state-of-the-art and which carries with it unusual levels of technological uncertainty and risk.
- Single programs of high funding levels, high unit value items and relatively small production runs.
- Exceptionally long leadtimes in bringing products and programs to eventual completion.
- Lack of a commercial market for most of the industry's products.
- A procurement process that has developed in a piecemeal fashion without regard to overall impact.

The first of the characteristics—the domination of the market by the government—is critically important to an understanding of the problems in the acquisition of high-technology systems. Domination of a market by a single buyer is termed “monopsony” in economic analysis. Monopsony permits the buyer to establish prices, terms and conditions that are quite different from those that would result from a market structure in which there were many competing buyers and sellers. Because market domination concentrates



such enormous power in the hands of the governmental buyer, it is essential to examine the manner in which this power is employed, the impact of its use and the problems that have been caused.

## STUDY OBJECTIVES

The overall objective of this report is to examine the consequences—for the industry and the nation—of the government's monopsony power in the market for high-technology systems. Somewhat more specifically, the major study objectives are:

- To examine the role of free competition in pricing and resource allocation and the potential impact of market imperfections.
- To assess the nature, degree and impact of government monopsony power.
- To present a recommended action program for the reform of government-dominated markets.

Implicit in this study is the recognition that serious problems, discussed in succeeding chapters of this report, exist in government-dominated markets. Before addressing the primary objectives of this study, therefore, it may be useful to highlight the potential impact of those problems on a wide range of public sector activities.

## IMPLICATIONS FOR THE PUBLIC SECTOR MARKET

Throughout this report, many of the arguments are illustrated by reference to weapons and space systems. This approach is taken because the historical background and empirical data are more fully developed in the markets for weapons and space systems than in other areas, not because these are the only areas of concern.

It should be emphasized at the outset that the government's monopsony power—and the manner in which it is used—has implications that extend considerably beyond the defense and space industries and related sectors. Indeed, it appears that the procurement approach employed by the government in the defense and space markets is, despite the failures experienced, becoming the prototype for systems type procurements throughout the Federal Government.

The significance of this trend is apparent from the fact that Federal Government purchases are nearly ten percent of the gross national product (GNP). They have grown very rapidly, the annual increase in expenditures over the last decade (adjusted for inflation) being nearly three percent. Further, many forecasts project expenditure increases of 25 percent or more (in constant dollars) during the 1970-80 period. Defense is a decreasing percent of the total, but still comprised about three-fourths of the Federal Government purchases in 1972. These figures clearly indicate that the Federal Government expenditures are, and will continue to be, a significant component of the national economy; adverse effects in this component can reach a sizable segment of society.

In assessing the role of public sector functions and expenditures Weidenbaum<sup>1</sup> has noted that:

“In a fundamental sense, the dividing line between the public and private sectors is shifting. The federal government is taking on functions that have often been performed elsewhere, at least in the past, and private organizations increasingly are being oriented to serving governmental, rather than private, customers or clients. The development of this new type of public sector is already having an important impact in many specific areas of the economy and of society generally. The many recommendations to extend this close public-private relationship to other areas, such as transportation, welfare, and so forth, make it especially important to evaluate the economic and political implications of these trends.”

Government procurement activity is rapidly spreading into such areas as mass transit, education, health, environmental protection and others. Further, it appears that procurement regulations and practices throughout the Federal Government are being modeled after those of DOD and NASA through the adoption of similar regulations and the transfer of procurement personnel. A primary concern from the viewpoint of this study is that the market problems being experi-

<sup>1</sup>Weidenbaum, Murray, *The Modern Public Sector: New Ways of Doing the Government's Business*, Basic Books, Inc., 1969, p. vii.



enced today by industry are merely a harbinger of the problems that will be encountered as the private sector becomes more committed to markets in which the government's monopsony power prevails.

## **ORGANIZATION OF THE STUDY REPORT**

The following chapter of this report presents a brief summary of the theoretical conditions relevant to different market structures. The concept of pure competition is discussed further and is followed by an analysis of monopolistic and monopsonistic departures from free market conditions. Regulatory considerations and other elements of countervailing power are also discussed.

In Chapter 3, the background information presented in Chapter 2 is utilized to analyze the government as a monopsonist, by discussing (a) the general characteristics of the systems markets; (b) the omnipotence of the government's legal power; and (c) the mobility of the invested resources for alternative uses.

Chapter 4 analyzes the consequences of the government's monopsonistic power. Here, the impacts of such power on industry's profit outlook and other measures of economic performance in relation to the present practices of government procurement are examined. The impacts are discussed at two levels: on private industry and on the nation.

An action program for reform in government-dominated markets is presented in Chapter 5 including the appropriate recommendations drawn from the analyses made in the previous chapters.

## CHAPTER

# 2

# Theoretical Framework for the Analysis of Market Structures

## PURPOSE

This chapter presents a theoretical framework for the analysis of different categories of market structures, i.e., of markets characterized by differing numbers and types of buyers and sellers. In order to provide a baseline for the subsequent analysis, the "ideal" case of pure and perfect competition is presented first. This is followed by a consideration of two major categories of deviation from free market conditions: monopoly and monopsony.

It should be noted that the purpose of this chapter is to establish a frame work for the analysis of monopolistic practices in government procurement. The discussion is, therefore, selective in nature and emphasizes the theoretical concepts that are relevant to the "real world" analysis contained in the following chapters.

## ROLE OF THE MARKET IN A FREE ENTERPRISE ECONOMY

In a free enterprise system (or in the private sector of a mixed economy) the market mechanism plays a central role in the allocation of productive resources and final products. The key functions performed by the market mechanism include:

1. the determination of goods and services that will be produced and the quantity of each;
2. the establishment of prices and conditions of sale for productive resources and final goods and services;
3. the efficient allocation of resources among products and production units given the state of technological information;
4. the division of aggregate output of the economic system among the members of society;
5. the provision of opportunities and incentives for change and growth.

Depending on market structure and behavior, these functions may be performed either well or badly. The following discussion summarizes the expected results under several quite different sets of market conditions.

## THE FREE MARKET: PERFECT COMPETITION

It is both traditional and helpful in an analysis of this nature to first consider an idealized model of a



free market in order to provide a point of reference for the analysis of "real world" conditions in specific markets. Hence, this assessment of different market structures begins with the case of "pure" or "perfect" competition.<sup>2</sup>

### Necessary Conditions for Perfect Competition

From a theoretical viewpoint, a perfectly competitive market is characterized by the following conditions:

1. there are a large number of buyers and sellers each accounting for such a small proportion of total value that no single buyer or seller can materially affect market conditions of demand, supply or price;
2. the product being bought and sold is homogenous;
3. each buyer, acting independently, seeks to maximize the satisfaction of his wants while each seller, acting independently, seeks to maximize net revenue;
4. all buyers and sellers have complete knowledge of the product being sold and the prices at which transactions are taking place;
5. there are no restrictions on the entry of new firms into the industry or on the exit of firms from the industry.

The first four of these conditions pertain to the short-run; the final condition is a long-run requirement.

### Consequences of Perfect Competition

Given the perfectly competitive conditions outlined above, it is possible to predict several significant aspects of the economic behavior that would result.<sup>3</sup> The basic result is that the market price that results from perfect competition is one at which the marginal value to the buyer of an additional unit and the marginal cost of producing that unit are equal. As a consequence, the quantity of each good produced maximizes the sum of the benefits to the buyers and sellers.

<sup>2</sup>Although a technical theoretical distinction can be made between pure and perfect competition, this distinction does not concern us here. The term perfect competition is, therefore, used to cover both cases.

<sup>3</sup>See, for example, Stigler, George J., *The Theory of Price*, MacMillan, 1952, pp. 160-86.

With regard to resource allocation, Stigler<sup>4</sup> has noted that:

"Prices govern the allocation of resources at three levels: among industries, among firms and within firms. High prices for products enable entrepreneurs in these industries to pay high prices for productive services and thus draw resources away from industries whose products are less urgently desired, thus allocating resources among industries. Firms that are more efficient (produce more with given inputs) can pay higher prices for productive services or sell at lower prices to consumers and therefore expand relative to inefficient firms, so resources are allocated among firms. Finally, the entrepreneur seeks the cheapest combination of productive services that will yield a given product, so prices govern the combination of resources within the firm.

A competitive enterprise system allocates resources with maximum efficiency. If resources are used where they obtain the highest rates of remuneration, if they are employed efficiently in these industries, and if they produce the commodities that consumers most desire, output is as large as possible."

Before examining the profit patterns that emerge under perfect competition it is useful to introduce the concepts of "short-run" and "long-run" behavior. The number of firms in an industry, the size of the firms and the rate of output of given firms all can be changed over time. The short-run is generally defined as the period within which the rate of supply from given plants can be changed but the number and size of firms is fixed. In the long-run, firms may enter or leave the market and increase or decrease the number of plants.

It is generally argued that under perfect competition, profits will be driven down to a "normal" rate set by the best alternative use for entrepreneurial resources. "Pure" profits, i.e., profits in excess of the normal level, will result only in the short-run since their existence will cause other firms to enter the industry thereby reducing prices and profits.

The elimination of pure profits should, however, be regarded as a tendency rather than as an absolute oc-

<sup>4</sup>*Ibid.* pp. 8-9.



currence. Depending on the industry (and even in the absence of entry barriers) the time differences between the long- and the short-run may be significant. Similarly, profits arising from innovation may persist for some time. Further, the successful innovator can continuously seek new profits from further innovations.

It should be emphasized that the conditions of perfect competition are not encountered in our present day economy to any significant degree. The perfect competition model, does, however, provide a benchmark for assessing the characteristics—and outcomes—of more realistic market structures.

## MONOPOLY AND MONOPOLISTIC COMPETITION

Having examined the conditions and consequences of the perfectly competitive market, it is useful to shift attention to market structures that are more frequently encountered in the real world. These include the monopolistic market and the more general case of monopolistic competition.

### Conditions of Monopoly and Monopolistic Competition

The variables which help us to determine the structure and characteristics of “real world” markets are:

1. the number of buyers;
2. the number of sellers;
3. the amount of knowledge that each participant in the market possesses;
4. their plans and objectives;
5. the degree of homogeneity of the product;
6. the extent of legal, institutional and economic barriers to the entry of new firms or the exit of existing firms;
7. the mobility and divisibility of productive services.

A market is said to be monopolistic if there is a single seller of the product supplying a large number of buyers. This condition will exist where there are significant legal, institutional or economic barriers to the entry of new firms. (These may include patents, the franchises granted to mass transit and telephone companies, etc.) In addition, for purposes of theoretical analysis, it is assumed that both buyers and seller possess full knowledge of market conditions.

The case of monopolistic competition, which is a

fairly accurate representation of significant portions of our modern economy, is one in which the products produced by different sellers are a close but not perfect substitute for each other, i.e., the product is differentiated. It is also assumed that there are legal and other obstacles (patents, trademarks, advertising, etc.) that prevent any seller from producing and selling a product that is in all respects identical with that being offered by any other seller. Given product differentiation (and despite the fact that there may be a reasonably large number of sellers) one or more sellers have a perceptible influence on price. The case in which there are relatively few sellers is termed oligopoly (which may exist with or without product differentiation).

There are, of course, a large number of additional market structures that can be defined. The cases identified above are, however, the ones most relevant to the objectives of this report.

### Consequences of Monopoly

The demand curve faced by a monopolist has the same general properties as the industry demand curve for a perfectly competitive market, i.e., the monopolist is the industry. A major difference between a monopolist and a perfect competitor is that the monopolist's price decreases as he increases his sales. A perfect competitor accepts price as given and maximizes profit by varying his level of output and productivity.

On the other hand, a monopolist may maximize profit with respect to variations of either output or price; he cannot, of course, set both price and quantity since his price (or output) is uniquely determined by the demand curve he faces once he has selected an output (or price) level. It does not matter whether he chooses price or output as his control variable. It can be shown that if he maximizes his profit, his output and price would be determined at the point where his marginal revenue and marginal cost are equal, just as in the case of a perfect competitor. However, the monopolist can increase his profit by expanding (or contracting) his output, as long as the addition to his revenue exceeds (or is less than) the marginal addition to his cost. As a result, in general, his output level will be lower and his price will be higher than would be the case if he followed the pattern of a perfect competitor. In this sense, we may say that a monopolist is less efficient than a perfect competitor.



Suppose the assumptions used in the above analysis of monopoly are modified. More specifically, the conditions to be considered are those when (a) there are several markets for his product; or (b) there are potential buyers who are not aware of his product or do not know it can satisfy their desires.

Assumption (a) is the case of discriminating monopoly. Price discrimination is feasible only if his buyers are unable to purchase his product in one market and re-sell in another. A good example can be found in the utility industry. The resale of such commodities as electricity, gas and water, which require physical transportation between seller and buyer, is extremely difficult, and, if price were unregulated, price discrimination would be widely practiced.

If a monopolist chooses to practice price discrimination, his profit is the difference between his total revenue from all of his separate markets and the total cost of producing for all the markets. If his marginal revenue in each market is equal to or more than the marginal cost of the output as a whole, he is maximizing his profit. Otherwise he could increase total revenue without affecting total cost by shifting sales from low marginal return markets to higher ones. As was the case in the above model of monopoly, his output will be lower and price higher than they would be under perfect competition.

Under assumption (b), if the monopolist knows or suspects that he can increase sales by advertising and better packaging, etc., the demand curve he faces is not a datum but a variable he can partly control. In fact he may combine these efforts with market discrimination as discussed under assumption (a). Advertising will, of course, increase costs but increased sales will compensate for the initial reduction in net profit. In combination with the market discrimination technique, the net result may be increased output, but still the monopolist's output will be lower and his price higher than in the case of perfect competition.

Although it is generally true that prices and profits are higher under monopoly conditions than under free competition it does not follow that profits will always be excessive or, indeed, even positive. Under certain demand conditions, the monopolist may be placed in a situation where average revenue is below, or only slightly above, the average cost. Further, it may be difficult or impossible for him to utilize his resources in a more profitable product line because of technical or market specialization.

## Consequences of Monopolistic Competition

Given the primary condition of monopolistic competition, involving a differentiated product, each seller will face a separate demand curve which shows the quantity of his product that buyers would purchase at each price given their preferences, planned expenditures and prices charged by other sellers. Since the seller is only one of a number of sellers, and since their products can, to a greater or lesser degree, be substituted for his, the seller is concerned with the actions of competitive firms.

For the purpose of this report, it is useful to emphasize the case of differentiated oligopoly in which a few firms compete by means of differentiated products (as, for example, in the automobile industry). In these markets, each seller believes that any change in his selling price, output, quality, advertising or any other variable under his control is likely to trigger retaliation from other sellers in the industry.

The analysis of the economic consequences of monopolistic competition is extremely complex and depends on a number of conditions including the number and relative sizes of sellers, the degree of product differentiation and the perceptions and objectives of the sellers. Formal analyses of particular cases show that under certain conditions there will be strong incentives for total collusion to occur, with economic consequences similar to those of monopoly. Under other extreme conditions market behavior will approximate that under perfect competition. An intermediate case, often termed price leadership, is one in which the dominant (usually largest) firm establishes a pricing structure that is followed, to a greater or lesser degree, by other firms in the industry, i.e., there is a form of implicit collusion.

In general terms, and over a wide range of cases, the economic consequences arising from monopolistic competition will be somewhere between outcomes of perfect competition and those of monopoly. The element of product differentiation permits sellers to establish somewhat higher prices (and hence lower output levels) than those that would result from perfect competition. Conversely, the existence of other sellers producing goods that are reasonable if not perfect substitutes ensures that prices will be lower and output higher than in the case of monopoly.

With regard to profits, if there are no absolute legal limitations on the entry of new firms, the rate of entry of new rivals is the basic limitation on profit levels. Where the entry capital requirements are not



huge in absolute terms and the economies of scale are relatively small, the individual seller will not, in the long-term, be able to maintain prices much above the level of marginal costs. If capital requirements are large the entry of rivals is serious only when price is considerably in excess of marginal costs, i.e., when profits are considerably greater.

## MONOPSONY

Having discussed monopoly, a deviation from perfect competition in which sellers dominate the market, we turn now to a consideration of monopsony, a deviation from perfect competition in which the market is dominated by a single buyer. The following discussion focuses on the theoretical framework of monopsony; specific aspects of the government's role as a monopsonist are discussed in later chapters of this report.

### Conditions for Monopsony

Monopsony refers to a market in which there is only a single buyer, i.e., producers cannot find alternative buyers of their product. Somewhat more specifically, the conditions of pure monopsony are:

1. there is a single buyer, who dominates a given market, facing many sellers;
2. the product being bought and sold is homogenous;
3. the buyer seeks to maximize the satisfaction of his wants while each seller, acting independently, seeks to maximize net revenue;
4. the buyer is fully conversant with the cost and supply characteristics of the entire industry.

In a real world situation, of course, all of these conditions need not be fulfilled. There may, for example, be several sellers rather than many and the product of each may be a close substitute for the others rather than entirely homogenous. Under these conditions the outcomes anticipated by monopsony theory will generally result, with only minor modification.

An extreme case is one in which there is only a single buyer and a single seller in a given market, a situation referred to as bilateral monopoly. This situation is rarely encountered in the real world, however,

because the existence of substitute products weakens the position of the "single" seller. It may, for example, appear that the producer of a given cargo ship for military use is in a bilateral monopoly position. In fact, however, the government can (with some time delay) either secure cargo ships of alternative design, establish second sources for production of the initial design or employ alternative modes for transporting cargo, e.g., aircraft.

### Consequences of Monopsony

Relatively little attention has been directed to the theoretical analysis of monopsony or to the application of monopsony theory to real world problems. Further, available models tend to focus on labor markets and on other cases in which the monopsonist is in the market to obtain the resources needed for desired production output.

The following discussion emphasizes the elements of monopsony theory that are most applicable to government procurement. It should, therefore, be noted at the outset that the demand in the public sector is established on the basis of national objectives, public policy and perceived needs rather than being determined purely by price. Hence, the demand elements in this market are less sensitive to price changes than would be true in markets for the various factors of production, such as for labor.

The basic behavior and consequences of the monopsonistic market have been summarized by Spiro<sup>5</sup> as follows:

"The concept of monopsony assumes the inability of suppliers to one customer to find alternate buyers of their products. Otherwise they would not offer their products to the buyer at their incurred marginal costs. In turn, this implies the ability of the customer to enforce terms and conditions for his supplies which need not cover the total costs incurred by his supplier, because the opportunity cost for suppliers is, by definition, zero. In effect, therefore, buyers can command, at least in the short run, prices which are below even the

<sup>5</sup>Spiro, Herbert T., *Optional Organization of the Military Hardware Industry*, University of California-Los Angeles, 1972, p. 16.



marginal cost of the suppliers. The supplier's motivation in meeting these harsh terms is survival. Since his opportunity cost is zero, the supplier is willing to deliver in the short run until he perceives that in the long run he will not be able to meet his marginal costs."

Stated somewhat differently, the government can, in the short run, at least, utilize its market power to establish prices that force the suppliers to operate at a loss, i.e., prices that are below the seller's total cost or, in some cases, marginal cost. The monopsonist can, in fact, dictate such prices, as long as there is excess capacity in the industry, through recourse to the competitive pressure generated by the unused capacity of other firms. (Administrative mechanisms may obscure this process; nonetheless, such practices as disallowing certain types of costs are, in reality, price reductions.)

The above analysis illustrates the ability of the monopsonist to force prices to unreasonably low levels in the short run. The willingness of firms to accept such short term price conditions is reinforced by two longer term considerations: the limited transferability of resources and the prospect of future benefits.

In principle, firms will, in the longer run, respond to monopsonistic price levels by leaving the industry, i.e., transferring their resources to other uses and thereby reducing capacity in the industry. In certain industries, however, the resources involved are so specialized that the cost of exit is quite high. As is shown in Chapter 3, this is particularly true in government-dominated markets where technical, managerial and marketing resources have been tailored to fit the needs of a single unique customer. Hence, there is a tendency to remain in the industry, even at greatly reduced profits, as long as financial survival is possible.

The second long-run consideration, the prospect of future benefits, reflects the fact that firms will act to maximize long-term profits, providing that they can survive in the short term. In the context of government procurement, this desire for long-term profit maximization explains the willingness of firms to undertake relatively unprofitable contracts with the hope of being in a favored position to receive large follow-on awards. As will be shown in Chapter 4, it explains the "buy-in" practice, which has, unfairly, been blamed on industry rather than being recognized as a natural consequence of the prevailing market structure.

Based on the above theory, one might conclude that the government's use of its monopsony power would reduce short-term costs to the government, but introduce serious questions with regard to the long-run strength of the industry. In fact, the question of the long-term viability of certain government oriented industries is a very real one. Further, and somewhat ironically, there is, as is discussed in Chapter 4, considerable doubt as to whether the government— or nation—is realizing any short-term benefits.

## REGULATORY CONSIDERATIONS

To complete the discussion of various market structures, it is necessary to consider briefly the extent to which the regulatory powers of government have been utilized to correct imbalances in market power.

In the case of monopolistic power, there has, since the late nineteenth century, been a continuing pattern of government intervention to prevent the abuse of monopoly power. Although specific antitrust objectives have shifted over time, the overall approach has been one of using the force of law to influence both the structure and performance of industry. With regard to structure, the thrust of antitrust policy has been to prevent or reduce, where possible, any trends toward increased concentration in industries where such concentration would imply monopoly power. With regard to behavior, antitrust legislation has outlawed such practices as collusion and price discrimination that tend to create or increase monopolistic power.

General antitrust policy has been supplemented by specific and detailed regulation of industries in which the existence of monopoly is either economically desirable or the result of government policy, e.g., utilities, mass transit, railroads, etc. In these cases, the purpose of regulation is to ensure that prices and profits are reasonable but not excessive.

With regard to undue power on the buyer's side of the market, however, there is no parallel record of policy and action to curb potential abuses. The omission is, of course, hardly surprising, since the government itself provides the prime example of monopsony power. What is surprising is that so little has been done to recognize and limit the potential misuse of government's monopsony power. Hopefully, the analysis and recommendations contained in the remainder of this report will provide a starting point for the reform of government-dominated markets.

## CHAPTER

# 3

## The Government as a Monopsonist

### PURPOSE

The previous chapter outlined the conditions for monopsonistic control of a market and the expected consequences of such control. This chapter demonstrates that the government is, in fact, a monopsonist in certain of its major procurement areas including the acquisition of high-technology, large scale systems. The analysis shows that, because of its volume of purchases and the uniqueness of large systems efforts, the government represents the only significant buyer in markets that are characterized by several highly competitive sellers. Further, the government, by virtue of its procedural and regulatory powers, can obtain virtually complete information concerning the supply and cost structure of the industry. Finally, these procedural and regulatory powers are used to support the government's monopsony power and to reinforce the basic economic domination that it enjoys.

The analysis contained in this chapter is structured in terms of three complementary sources of economic power:

1. the ability to dominate the market through volume of purchases and the uniqueness of products and services;
2. market domination through procedural and regulatory powers beyond those of private parties;
3. the inability of government-oriented firms to transfer resources to other markets, i.e., to get out of government-dominated markets.

To a certain extent this chapter draws its illustrative examples from markets in which governmental monopsony power is already well established. Of great importance, however, is the danger that this power (and its abuses) will permeate other markets as the magnitude and composition of federal expenditures change.

### MARKET DOMINATION THROUGH VOLUME OF PURCHASES

#### Overall Trends in Federal Government Expenditures

As noted in the first chapter of this report, Federal Government purchases are over ten percent of the GNP. Projections developed by the Bureau of Labor Statistics indicate an increase of 27 percent (in constant dollars) during the 1970-80 period.



**TABLE 1**  
**SALES OF THE AEROSPACE INDUSTRY**  
(\$ Million)

Year Ending December 31	Total Sales	Aerospace Products and Services					Non- aerospace products and services
		Department of Defense	NASA and Other	Total Gov't	Non- Gov't	Percent Gov't.	
1948	\$ 1,493	\$ 1,182	---	\$ 1,182	\$ 177	87%	\$ 134
1949	2,232	1,802	---	1,802	230	89	200
1950	3,116	2,598	---	2,598	238	92	280
1951	6,264	5,353	---	5,353	347	94	564
1952	10,130	8,568	---	8,568	650	93	912
1953	12,459	10,604	---	10,604	734	94	1,121
1954	12,807	10,832	---	10,832	822	93	1,153
1955	12,411	10,508	---	10,508	786	93	1,117
1956	13,946	11,525	---	11,525	1,166	91	1,255
1957	15,858	12,833	---	12,833	1,598	89	1,427
1958	16,065	13,246	\$ 1	13,247	1,372	91	1,446
1959	16,640	13,171	130	13,301	1,841	88	1,498
1960	17,326	13,196	363	13,559	2,208	86	1,559
1961	17,997	13,871	630	14,501	1,876	89	1,620
1962	19,162	14,331	1,334	15,665	1,772	90	1,725
1963	20,134	14,191	2,628	16,819	1,485	92	1,830
1964	20,594	13,218	3,635	16,853	2,020	89	1,721
1965	20,670	11,396	4,490	15,886	2,816	85	1,968
1966	24,610	13,284	5,026	18,310	3,663	83	2,637
1967	27,267	15,855	4,201	20,056	4,632	81	2,579
1968	28,959	16,573	3,920	20,493	5,917	78	2,549
1969	26,126	15,771	3,314	19,085	4,342	81	2,699
1970	24,930	14,643	3,000	17,643	4,643	79	2,644
1971	22,182	12,584	2,777	15,361	4,302	78	2,519

Source: Aerospace Industries Association, Aerospace Facts and Figures, 1973/74.

A recent study<sup>6</sup> by the Brookings Institution shows total federal outlays of \$244.3 billion in FY1973 and projected outlays of \$300.0 billion and \$335.0 billion in FY1975 and 1977 respectively. Further, of the total increase of \$90.7 billion projected from 1973 to 1977, \$67.2 billion will be accounted for by domestic outlays.

<sup>6</sup>Schultze et al, *Setting National Priorities, The 1973 Budget*, The Brookings Institution, 1972, p. 415. (For comparison, the actual FY73 Budget submittal was for \$249.8 billion for total federal outlays)

Other projections of government expenditures serve to highlight the dramatic changes in outlays in a number of major program areas related to high-technology systems.

- Natural resource expenditures, including new materials development, new processes and techniques, recreational and environmental improvements and solid waste disposal, show a projected increase from \$2.7 billion in 1970 to \$17.2 billion in 1980.

**TABLE 2**  
**PERCENTAGE DISTRIBUTION OF AEROSPACE INDUSTRY SALES**

Percent of Annual Sales

Customer	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971
DOD	76	77	75	71	64	55	54	58	57	60	59	57
NASA and Others	2	4	7	13	18	22	20	15	13	13	12	13
Commercial Aerospace	13	10	9	7	10	14	15	17	20	17	19	19
Non-Aerospace	9	9	9	9	8	9	11	10	10	10	10	11
TOTAL	100	100	100	100	100	100	100	100	100	100	100	100
Commercial Aerospace plus Non-Aerospace	22	19	18	16	18	23	26	27	30	27	29	30

Source: Computed from Table 1.

- Commerce and transportation, including mass transit, short-haul rapid transit, airport and airways development and associated environmental systems, show a projected increase from \$4.1 billion in 1970 to \$7.8 billion in 1980.
- Housing and community development, including urban renewal, innovative housing technology and community facilities, show a projected increase from \$1.0 billion in 1970 to \$4.1 billion in 1980.
- Education, including training products and systems and simulation equipment, shows a projected increase from \$1.0 billion in 1970 to \$2.5 billion in 1980.
- Health and sanitation, including automated hospital systems and new medical and surgical products, show a projected increase from \$1.5 billion in 1970 to \$4.0 billion in 1980.

The above is intended to indicate the general direction of changes in federal expenditures, particularly expenditures on domestic programs. Although the impact of government expenditures on specific markets cannot be assessed at this time, it is clear that the magnitude of federal expenditures in such areas as

transportation, housing, medical care, education and environmental protection poses important questions regarding the spread of the government's monopsony power over a wide range of market areas. For this reason, it is important to examine the nature of the government's market power in areas in which that power has been established long enough to permit a reasonably thorough assessment of its impact.

#### **Aerospace Market Purchases: An Illustrative Example**

As noted earlier in this report, the aerospace industry, because of its long history of influence by its government buyer, provides a valuable example of the nature and consequences of monopsony power. Tables 1 and 2 summarize aerospace industry sales by type of customers during the period of 1948-71. The percent of sales of aerospace products and services to the government ranges from a high of 94 percent in 1953 to a low of 78 percent in 1971. Starting in the 1960's, government expenditures on aerospace products and services ranged from 20-30 percent of total national defense and space exploration expenditures. The

**TABLE 3**  
**FEDERAL OUTLAYS FOR SELECTED FUNCTIONS**  
**AND FOR AEROSPACE PRODUCTS AND SERVICES**  
 Fiscal Years, 1948 to Date  
 (\$ Millions)

Year Ending June 30	Total National Defense	Total NASA	Federal Outlays for Aerospace Products and Services	Aerospace as Percent of Total National Defense and NASA
1948	\$11,983	N.A.	\$ 891	7.4%
1949	13,988	N.A.	1,474	10.5
1950	13,009	N.A.	2,130	16.4
1951	22,444	N.A.	2,878	12.8
1952	45,963	N.A.	6,075	13.2
1953	50,442	\$ 79	9,204	18.2
1954	46,986	90	11,194	23.8
1955	40,695	74	10,470	25.7
1956	40,723	71	10,544	25.8
1957	43,368	76	12,506	28.8
1958	44,234	89	13,160	29.7
1959	46,483	145	13,330	28.6
1960	45,691	401	13,269	28.8
1961	47,494	744	13,866	28.7
1962	51,103	1,257	15,295	29.2
1963	52,755	2,552	16,214	29.3
1964	54,181	4,171	17,940	30.7
1965	50,163	5,093	15,697	28.4
1966	57,718	5,933	17,771	27.9
1967	70,095	5,426	20,193	26.7
1968	80,516	4,724	21,353	25.1
1969	81,240	4,251	20,472	23.9
1970	80,295	3,753	18,747	22.3
1971	77,661	3,382	17,335	21.4
1972	78,336	3,421	17,061	20.9
1973 <sup>E</sup>	76,435	3,061	16,156	20.3
1974 <sup>E</sup>	81,074	3,135	16,410	19.5

Note: "National Defense" includes the military budget of the Department of Defense and Atomic Energy Commission. "Total NASA" includes research and development activities, administrative operations and construction of facilities of NASA. NASA construction is not included in "Total Aerospace Products and Services."

N.A.—Not available.

<sup>E</sup>Estimate.

Source: AIA, *op. cit.*, p. 23.



**TABLE 4**  
**DISTRIBUTION OF DOD PRIME CONTRACTS — 1967 - 1971**

	DOD Total	Top 10 Firms	Top 15 Firms
FY 1967	\$39.2 billion	\$11.6 billion - (30%)	\$14.0 billion - (36%)
FY 1968	38.8 "	11.6 " (30%)	14.3 " (37%)
FY 1969	25.2 "	10.7 " (42%)	13.1 " (52%)
FY 1970	31.3 "	9.1 " (29%)	11.3 " (36%)
FY 1971	29.8 "	10.3 " (35%)	12.7 " (43%)
FY 1972	33.4 "	11.8 " (35%)	14.2 " (43%)

Source: AIA, *op. cit.*, p. 109

absolute amount and percent of the government expenditures on aerospace products and services have declined rapidly in recent years (Table 3). This sales pattern makes the industry very sensitive to changes in the government demand.

It is apparent that the industry has been slowly, but noticeably, trying to reduce its dependence on the government expenditures. Since 1965, the percent of sales to government has gone down from 85 percent to 78 percent in 1971. Both the absolute amount and percentage of sales of non-government buyers and sales of non-aerospace products and services are growing. However, largely because of its heavy involvement in the government process in the past, the industry has a number of unique problems when it faces a cut in government expenditures and attempts to diversify.

Firms in the aerospace and defense industries are fairly large corporations, with significant vertical integration of resources. Since only a relatively small number of companies are capable of meeting the specialized needs of government and, therefore, receive major portions of government contracts, the aerospace and defense industries are highly concentrated.

In order to examine the extent of involvement with government contracts and the concentration of the firms in DOD and NASA markets, the values of total DOD and NASA prime contracts and the distribution of contracts among the top ten and 15 firms during the period from FY1967 through 1971 are shown in Tables 4 and 5. The top ten firms in DOD contracts received more than 30 percent of the DOD total and the top 15 from one-third to one-half, while

the top ten and 15 firms in NASA contracts received about two-thirds and three-fourths respectively of the NASA total during 1967 through 1971. Further, the majority of the top ten and 15 firms in DOD contracts are also the top ten and 15 in NASA contracts. It should also be noted that the top firms are not only prime contractors, but also major subcontractors for weapons and space systems.<sup>7</sup>

Despite the fact that governmental purchases of aerospace products are massive, its needs for the products and services of the aerospace industry are not governed by usual market behavior (e.g., a higher demand at a lower price) but rather by external uncertainties and government policies. For this reason, the demand for aerospace products tends to vary less in response to price change, but may shift from one product line to another. Further, the total quantity demanded for all aerospace products is highly unstable, due primarily to budgetary and priority re-assessment.

The above analysis demonstrates quite unambiguously the extraordinary influence of the government in the aerospace market. Entire companies or major divisions of companies are devoted to meeting the needs of a single buyer. As a result, the government can determine the entry and exit of firms, influence their growth or decline and bring about the adoption of specific business practices and policies. This enormous market power is reinforced by the regulatory and procedural powers discussed below.

<sup>7</sup>See, for example, pp. 55-57 in AIA, *op. cit.* (Table 3), for the distribution of systems contractor and component manufacturers.



TABLE 5

## DISTRIBUTION OF NASA PRIME CONTRACTS — 1967 - 1971

	NASA Total	Top 10 Firms	Top 15 Firms
FY 1967	\$ 3.9 billion	\$ 2.7 billion - (69%)	\$ 3.0 billion - (77%)
FY 1968	3.4 "	2.4 " (71%)	2.6 " (76%)
FY 1969	3.0 "	2.0 " (67%)	2.3 " (77%)
FY 1970	2.8 "	1.8 " (64%)	2.0 " (71%)
FY 1971	2.3 "	1.3 " (57%)	1.5 " (65%)
FY 1972	2.1 "	1.3 " (62%)	1.4 " (67%)

Source: AIA, *op. cit.*, p. 110

## MARKET DOMINATION THROUGH PROCEDURAL AND REGULATORY POWER<sup>8</sup>

### Background

The regulatory and procedural powers that the government can bring to bear in markets in which it is the dominant buyer are specified in its procurement regulations and in a mass of related documents. The enormous economic and social impact of these powers, reinforced by the size of outlays for government procurements, is felt by the firms that are parties to government contracts, their employees and investors, firms in related industries and the public at large. It is useful, therefore, to examine the nature of these regulatory and procedural powers, criticisms that have been made regarding the procurement regulations and certain problems that result from the exercise of the government's powers.

The procurement regulations implement the two basic statutes governing procurement by federal agencies—the Armed Services Procurement Act of 1947 and the Federal Property and Administrative Service Act of 1949. These basic procurement statutes, however, state only the broad policies governing the manner in which federal agencies will contract. Filling the details of these policies and establishing procedures for implementation is the function of the procurement regulations. This

function of issuing contract rules in the form of regulations has been delegated to the head of each of the executive departments. Pursuant to these grants of authority in the two basic statutes, the Secretary of Defense issued the Armed Services Procurement Regulation (ASPR) and the Administrator of General Services has issued the Federal Procurement Regulations (FPR).

The procurement regulations are in turn implemented, supplemented and expanded by thousands of DOD documents, many of which have the force and effect of law when cited in a contract.

Among the provisions in the ASPR and the FPR are: formal advertising, negotiated procurement, termination of contracts, contract cost principles, right to audit contractor records, changes, disputes, patent and technical data rights, the government's right to inspect work in progress and the correction of deficiencies. Of particular importance are the sections of ASPR and FPR which contain clauses that must be inserted in government contracts. These provisions have a significant effect on the substantive rights of government contractors and their employees despite the fact that many of the provisions are not found in commercial dealings. Because of the virtually universal applicability of these provisions in government contracts, it is imperative that prospective contractors be aware of their peculiarities.

Criticism of the procurement regulations ranges from issues of procedural fairness to the inequities of specific clauses. In the following discussion those criticisms that deal with basic policy issues that are relevant to the government's role as a monopsonist

<sup>8</sup>The following discussion draws heavily upon the material found in Grossbaum, John J., *Procedural Fairness in Public Contracts: The Procurement Regulations*, Virginia Law Review, March 1971.



will be emphasized. The economic impact of certain specific procurement regulations is discussed in the following chapter.

### Procurement as a "Housekeeping" Function<sup>9</sup>

Certain of the problems of procurement regulations have arisen from the tendency to view government procurement as "housekeeping;" this view has been largely shared by the Supreme Court, Congress, and other public agencies. The traditional view of the Court has been that the Federal Government may set down guidelines, for the purpose of its housekeeping, by which its agents are to proceed in procurement of goods and services. Although government procurement may at one time have been a simple housekeeping task of minor national consequence, this is no longer true. Today the procurement process affects the quality of American life on a vast scale. Significant increases in R&D contracting during the last two decades highlight the growing complexity of federal procurement. Contracting is no longer limited to the construction of buildings, roads and government arsenals, or to the purchase of office supplies. Nevertheless, the persistent view of procurement regulation as a housekeeping function has led to the adoption of regulatory and procedural provisions without adequate safeguards to protect the interests of all the parties involved.

### Contract by Regulation

Grossbaum<sup>10</sup> has observed that:

"Like an insurance policy, the government contract is one of adhesion, only more so. Structurally, the 'General Provisions,' often called the 'boilerplate,' and the 'Schedule' are the essence of the government contract. The Schedule is tailor-made for each transaction and represents the substance of the deal. But the boilerplate, usually more extensive than the Schedule, enjoys a special significance because it consists mainly of clauses required by statute or regulation to be included in public contracts. Since the boilerplate has the

same binding effect on the rights and obligations of the parties as does the Schedule, the bulk of the provisions of a government contract tend to be prescribed by law and regulation. Because deviations from the requirements of the regulations involve a tedious procedure, generally undertaken only on a case-by-case basis, such deviations are the exception rather than the rule. This situation lends credence to the view that for the most part, the Government contracts by regulations."

"Contract by regulation" has the effect of establishing economic relationships that differ from those that would result from a free market. It was noted, for example, that some provisions of the federal procurement regulations have little or no counterpart in private commerce. They are the provisions relating to the right to unilateral changes, disputes, terminations for convenience of the government, examination of records, denial of costs, etc.

As one example, the standard "changes" clause is included in nearly every government contract in order to give the government a major degree of flexibility over contract performance. Under the "changes" clause, the government has power to order certain unilateral changes within the scope of the contract. The salient point of the clause is that the contractor, even though he is compensated for such changes, cannot reject a change order and that he must proceed with performance of the contract as changed.

The concept of "termination for convenience" modifies the common law of contracts by denying expected profits and thus precludes recovery of anticipated profits when the government cancels a contract without fault on the part of the contractor.

It is apparent that these clauses have a tremendous impact on the individual right of contractors. To the extent that many of these same clauses are required to be inserted into subcontracts, these rules can affect those who are not even in privity with the government. The basic procurement laws, however, are silent as to the government's power to make unilateral changes, or to cancel contracts. These provisions were developed as part of the process in filling in the details of government contracting not specifically addressed in the basic procurement statutes and reflect the judgment of the rulemakers. Nevertheless, many of these rules have the force of law.

<sup>9</sup>Grossbaum, *op. cit.*, pp. 172-77.

<sup>10</sup>Grossbaum, *op. cit.*, pp. 182-83.



## Overreaching, Overreaction and Unmanageability

Grossbaum<sup>11</sup> has also observed that among the more significant criticisms of the procurement regulations are that they are overreaching, that they result from overreaction and that they are unmanageable.

The overreaching charge implies that the regulations often are arbitrary; that they strike an unduly hard bargain on behalf of the government, frequently by shifting risks from the government to the contractor. Examples of this include the limitations on government liabilities arising from terminations, changes and defects in the specifications it issues and the limitations on government obligations clauses, used in many major procurements.

The overreaction criticism focuses on the fact that procurement regulations are often revised hastily to seek a cure to a specific incident or as a result of judicial decisions that go against the government. With respect to the latter, it has been observed that in many cases such adverse court decisions correct inequities in the procurement process and that some additional restraint on the part of regulation writers would be healthy.

The unmanageability of the procurement regulations is the result of their size, complexity and lack of clarity. The overall thrust is that of a set of regulations issued solely for the benefit of the government with little regard to the potential impact on industry.

## The Interaction of Market and Regulatory Powers

As can be seen from the above discussion, the market power of the government is supported by regulatory and procedural powers that are generally unavailable to private parties. These combined powers can, in turn, be used to impose contractual regulations on industry that depart significantly from the bargain that would result in a market in which relative power was more closely balanced. What appears to many critics to be missing is adequate recognition that the government as a monopsonist owes an obligation to the private sector to use its power fairly and reasonably.

## TRANSFERABILITY OF RESOURCES

As noted earlier, the government's regulatory power and volume of purchases enable it to exercise monop-

sony power in a variety of markets. The final element that solidifies that power, however, is the limited ability of firms in government-dominated markets to "leave the market," i.e., transfer their resources to meet the needs of other customers. Indeed, under the theoretical free market conditions outlined in Chapter 2 the exit of firms from an industry would be the typical response to declining profit rates or other undesirable conditions.

Unfortunately, firms in government-dominated markets must exist in a real, rather than theoretical world. And, in a real market situation it is often the case that the very strengths that are desirable and beneficial in a particular government market represent major limitations on the transferability of resources of two types: the specialization of technical and productive resources; and the specialization of marketing and managerial resources.

## Specialization of Technical and Productive Resources

The market areas in which the government's monopsony power is greatest are those characterized by large, complex systems that are at the frontier of the technological state-of-the-art, i.e., by a unique product line. In general, these systems have high unit values, relatively small production runs and unusually long development leadtimes. These market areas are typified by, but by no means limited to, the aerospace industry.

Within these high-technology markets, the selection of a contractor to undertake a major new program is dependent upon possession of the full range of resources needed for what is essentially a highly specialized project effort. Spiro,<sup>12</sup> in an analysis of the military hardware industry (MHI) notes:

"The ready accessibility of necessary factors within an organization are a prerequisite to the marketing success of a firm in the MHI. The type of contract an organization wishes to attract has implications for the composition of its labor force, its investment in human and physical resources, the composition of its fixed assets, and its total capitalization. Similarly, once an organization has acquired a particular volume and composition of factors, it has developed skills in attracting and executing particular contractual prototypes with efficiency."

<sup>11</sup>Grossbaum, *op. cit.*, pp. 210-14.

<sup>12</sup>Spiro, *op. cit.*, pp. 62-63.



He continues:

“Demonstration of knowledgeability of the customer’s problems is an accepted marketing tool. Firms customarily absorb these as costs of ‘being in business.’ The unique problem of the MHI is the magnitude of these costs. Applied research and design-development for high-technology programs are prohibitively expensive if viewed as marketing costs for production awards. The tendency of firms to pursue this expensive strategy must therefore be viewed as a consequence of the buyer’s market power. *Thus, in the MHI, monopsony on the demand side tends to lead to vertical integration on the supply side of the market.*”

The above argument demonstrates that firms engaged in the development and production of large-scale systems have developed specialized resources and capabilities within a single, narrowly defined product line. One example of this tendency is represented by the extremely high proportion of scientists and engineers employed by the aerospace industry. The R&D capability contained in the aerospace industry is a major national asset when applied to the development of large-scale high-technology systems. Its transferability to purely commercial or low-technology programs may, however, be limited by one or more of the following factors:<sup>13</sup>

- The technological specialization of scientists and engineers.
- The limited requirement for major technological advances in many commercial markets.
- The requirement for cost minimization (including R&D costs) in medium- and low-technology markets.

Analogous arguments pertain to the transferability of production-oriented resources. Although there are some exceptions, the physical and human resources

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<sup>13</sup>Employment experience in recent years provides ample, if unfortunate evidence of the difficulties associated with transfer of R&D resources.

that are optimal for high-technology, low volume production are often poorly suited to the mass production of low unit value items. Indeed, the highly skilled (and well paid) production worker needed for the production of closely tolerated high-technology items may represent an expensive liability in a different production environment.

### Managerial and Marketing Specialization

The management and marketing skills that are essential to success in government-dominated markets are, in many respects, as specialized as technical and production skills. The unique capabilities of top management are those of managing the development, production and integration of large and complex systems. They are familiar with the arcane ways in which the government conducts its business. Again, however, these skills while essential to success in government-dominated markets may be neither needed nor transferable elsewhere.

Government marketing skills are another highly specialized resource involving a knowledge of requirements, practices and policies in a highly centralized, high value market. Alternative markets may be geographically diffuse, lower in individual volume and less dependent upon technical marketing skills. Certain firms that are active in government-dominated markets, for example, may not have the national (or international) distribution networks that are required to serve commercial markets.

The foregoing considerations provide the basic answer to the argument that firms that are dissatisfied with the government’s exercise of monopsony power should simply refrain from undertaking government contracts. Firms cannot, in fact, leave government markets without dissipating the human and physical resources that will be needed to re-enter the market. Further, it is doubtful that the dissipation of these resources is consistent with long-term national interests. The solution, therefore, must lie in reducing the negative impacts arising from the governmental exercise of monopsony power. These impacts are discussed in the following chapter of this report.



## CHAPTER

# 4

## Consequences of the Government's Monopsonistic Power

### PURPOSE

The previous chapter of this report discusses the specific factors that support the monopsony power of the government in certain markets. This chapter examines the consequences of that power from two viewpoints:

1. particular policies and practices which the government, by reason of its monopsony power imposes on the procurement process;
2. the impact of those policies and practices on government and industry.

The first three sections of this chapter present examples of procurement policies and their impact in three major areas: contractor selection, price and profit reduction and contract administration. The final section examines the overall impact on industry profits in government-dominated markets and the resulting consequences for both the private and public sectors.

It should be noted that no attempt has been made to examine all of the specific policies and impacts that arise from governmental monopsony power. Instead, the analysis encompasses a fairly wide range of practices that are significant in terms of actual or potential impact and that are illustrative of the practices and problems that result from the virtually unrestricted use of governmental monopsony power.

### CONTRACTOR SELECTION

#### Excessive Proposal Specifications and Costs

The process by which the government under existing regulations, must select major systems contractors is both complex and cumbersome. It consists, at a minimum, of the following steps:

1. preparation and issuance by the government of a Request for Proposal (RFP);
2. preparation by a number of contractors of extensive and detailed technical and management proposals in response to the RFP;
3. selection of several contractors within a competitive range for further negotiation;
4. negotiation and proposal modifications;
5. selection of the winning contractor and contract execution.

The primary purpose of an RFP is to describe the government's requirements so that contractors can respond with appropriate technical, management and cost proposals. In addition, however, the RFP and proposal process is often used by some government agencies as an opportunity to obtain technical approaches from various competitors which are then "exposed" to other firms in successive revisions of the RFP's so that improved proposals can be developed by all competitors. The competing contractors not only respond completely to the RFP but also provide additional data and information in an effort to win the contract. No contractor, faced with the government's overwhelming monopsony power, can afford the risk of being "non-responsive" to the RFP regardless of how costly the proposal requirements are or how many times the proposal must be resubmitted.

A major criticism of the current use of RFP's is that they require excessive detail and are extremely costly to both the government and industry. (The impact of the 5000.1 Directive in reducing proposal requirements cannot yet be assessed.) A recent *Fortune* article,<sup>14</sup> for example, in discussing the space shuttle contract award noted that the winner:

"had employed some \$40 million and 500 people to compile 4,000 odd pages of specifications to receive the prize—the only new manned U.S. space venture planned for the 1970's."

Proposals of this magnitude are by no means unusual. Indeed, proposals exceeding 50,000 pages have been reported. When individual proposal costs of this magnitude are multiplied by the number of contractors involved, it is clear that proposal costs may represent a significant proportion of total program costs.

The excessive detail required in proposals, in addition to increasing direct proposal preparation costs, serves to increase total costs in still another way by increasing the time and effort required to evaluate the proposals. During the period of proposal evaluation, which may last six months or more, proposal teams must be kept together by each of the competing contractors in order to maintain the capability that will be needed to perform the contract. Further, the costs to the government of the in-house evaluation effort may reach several million dollars.

<sup>14</sup> "Businessmen in the News," *Fortune Magazine*, September 1972, p. 35.

The division of these costs between government and industry will depend upon the practices of the government agencies with which the potential contractor deals and on the mix of government and commercial contracts he performs. Some portion of the cost will be charged to existing contracts as overhead while other costs (particularly those in excess of agreed upon ceilings) will be written off against profits or reserves. The central point, however, is not the division of costs but the fact that excessive proposal requirements serve to increase total economic costs.

It should be emphasized that the ability to require and obtain massive and expensive proposals without direct total reimbursement is a result of governmental monopsony power. As discussed in the previous chapter, the individual contractor is faced with a situation in which 1) he must maintain a specialized technical capability to be considered for contract awards; 2) the government represents virtually the only market; 3) individual procurements are large in size but few in number; 4) the government's market power is backed by extensive legal and regulatory power; and 5) contractor resources are not readily transferrable to other markets. Under these conditions, the pressure on individual contractors to be "responsive" to government requests, no matter how extreme, is enormous.

In short, excessive proposal requirements, backed by the government's monopsony power, serve to increase both private and public sector costs. Were a private firm to issue RFP's similar to those of the government (without direct and total reimbursement), the result would be incredulous silence rather than "responsiveness."

### Imbalances in Contract Negotiations

It is during the contract negotiation process that major inequities in the exercise of governmental monopsony power are apparent. A single buyer is in the position of conducting parallel negotiations with several highly competitive sellers, each of whom, for the reasons summarized earlier, is desperately eager to win the award. Although it would be possible to identify a large number of undesirable practices that result from this imbalance, the following discussion emphasizes two of the more significant practices: the "reverse auction" and "buying-in."

A "reverse auction" occurs when a procuring agency conducts successive rounds of negotiations with sev-



eral contractors who are all considered to be within the competitive range. In many cases the successive rounds of negotiations are coupled with requests to modify the original proposals to remove deficiencies or to clarify an earlier submission. Each revision of the cost and technical proposals is, of course, made under intensive competitive pressure.

Under these conditions, it is not surprising that contractor "buy-ins" occur. "Buying-in" may be defined as the practice of attempting to obtain a contract award by knowingly offering a price less than anticipated costs with the expectation of either 1) increasing a contract price or estimated cost during the period of performance through change orders or other means; or 2) receiving future follow-on contracts at prices high enough to recover any losses on the original "buy-in" contract.

In Chapter 2 it was observed that firms may attempt to maximize long-term profits by undertaking relatively unprofitable contracts with the hope of being in a favored position to receive large follow-on awards. Given the negotiating process described above, "buying-in" may in effect be forced upon a firm that needs a particular award in order to maintain its work force and ensure short-term survival. This is particularly true when the government has developed its own program cost estimate; contractors may then be under significant pressure to agree with an unrealistically low government budget estimate.

It should also be noted that the government's unlimited monopsony power during contract negotiations enables it to impose contract terms and conditions that, as noted in Chapter 2, can be described as one-sided and "overreaching." These terms may, for example, restrict the contractor's rights of recourse to the courts, limit his recovery of damages in the event of contract termination and restrict his freedom of management action.

The immediate consequences of the imbalance of power in the negotiating process may be summarized as follows:

1. acceptance by the contractor of lower cost and profit levels and/or greater risk than would result from a more equal balance of power;
2. commitment to higher performance levels than may be technically or economically justified;
3. acceptance of burdensome and costly contract restrictions and requirements.

The above consequences lead ultimately to higher

risks and costs for both industry and government. Of greater importance, however, is the distinct danger that national resources will be misallocated due to optimistic cost targets developed under the one-sided pressures of the negotiating process. The fault here lies not with the participants in the process but rather with the unlimited monopsony power that permeates the negotiating process.

### **Forced Cost Sharing**

Cost sharing, which is closely related to the "reverse auction" concept, is the practice of inducing private contractors to share the costs of research with the government either directly or by accepting reduced fees.

Despite prohibitions in the ASPR, DOD and other agencies may practice informal cost sharing by, in effect, auctioning off technology contracts to the lowest bidder. The firm fixed price established by these contracts may be knowingly negotiated at a level which does not cover the cost of performing the specified tasks.

In addition, the use of formal cost sharing arrangements, which was generally limited to projects undertaken by universities and non-profits, has been extended significantly as a result of legislative and executive actions. Specifically, Public Law 92-78, enacted in 1970 imposed mandatory cost sharing on research contracts resulting from unsolicited proposals to independent agencies; Office of Management and Budget Circular A-100 extended the provisions of that law to all departments and agencies within the Executive Branch.

An obvious consequence of forced cost sharing is to reduce industry profits. Of far greater importance, however, is that this practice acts as a limit on the fuller use of technological and innovative resources. Clearly a contractor will be less willing to commit his technological capabilities to support government programs if his return for doing so is either zero or negative.

### **PRICE AND PROFIT REDUCTION**

The above discussion focused attention on the process by which prices and profits are established in government-dominated markets. The following examines the manner in which government is able to



utilize its monopsony power to further reduce profits and prices, retroactively, through the practices of cost disallowance and renegotiation. The actual profit levels that result from these practices are discussed in the final section of this report.

The following discussion uses DOD practices and statistical data for purposes of illustration since a longer historical record and more detailed data exist for DOD than for civil agencies. As is true throughout this report, however, the major thrust is that of illustrating the practices and consequences that result from monopsonistic power—a power that will grow as the level of civil agency procurement rises.

### Cost Disallowances

Current government statutes, practices, and regulations arbitrarily designate certain necessary costs of doing business as being unallowable or nonrecoverable in government contracts. These unallowable costs include such standard elements of business expense as interest, charitable contributions, and most types of advertising. In addition DOD, for example, has set arbitrary limitations on certain other costs such as independent research and development and training and education so that contractors recover only a portion of those costs. It should be emphasized that all of these costs are considered normal costs of doing business; indeed, all of them are recognized as acceptable expenses by the Internal Revenue Service.

The magnitude of disallowable costs has increased sharply, mainly due to the growing list of disallowed cost items. Available estimates show that during the 1953-60 period disallowable costs on DOD contracts, expressed as a percentage of sales, increased from 0.4 percent to 1.0 percent;<sup>15</sup> by 1968 the total reached over 1.7 percent.<sup>16</sup>

From the viewpoint of economic analysis, the entire concept of disallowable costs is simply a device by means of which the government exercises its monopsony power to reduce prices and profits. A firm does not exist to perform one particular contract. It exists to conduct a variety of business activities and to earn a profit that will enable it to survive and grow. The cost items disallowed by the government are normal

and legitimate costs of doing business in both government and commercial markets; to the extent that the government refuses to pay its share of such costs it is simply exercising its power to reduce profits.

It is interesting to consider the probable reaction of a builder, for example, were a prospective purchaser to suggest that the selling price be reduced by the amount of such disallowable items as interest and advertising. Clearly, the practice of cost disallowance rests upon governmental monopsony power.

### Renegotiation

The renegotiation principles now in effect were developed early in World War II on the premise that in a national emergency the opportunity to make excessive profits through government contracts is abundant. Legislation authorizing renegotiation of profits on an overall basis was enacted, and renegotiations and repricing were separated. The present Renegotiation Act was initially enacted in 1951, establishing the Renegotiation Board as independent of the executive agencies which are authorized to make contracts.

Since the early days of renegotiation there have been very significant changes in procurement policies including the statutory requirements imposed by the "Truth in Negotiations" Act (PL 87-653). The result has been to prevent, in large measure, the possibility of unwarranted or excessive profits.

Nonetheless, the Renegotiation Board continues to require the return of profits it deems "unreasonable" on the basis of criteria that appear to contractors to be vague, subjective and inconsistent. Further, the Board may recapture profits earned on fixed price and incentive type contracts, a practice that is directly counter to the principle of using those contract types as a mechanism for rewarding superior performance.

Renegotiation provides another clear example of the government's ability to use its monopsonistic power to reduce profits by introducing practices that have no counterpart in the commercial sector. The practice of renegotiation eliminates "excess" profits but does not provide compensation for major losses. Further, the contractor must also contend with additional uncertainties in determining and reporting his financial status since renegotiations are retroactive and may require years to complete. Again, the net impact is to reduce industry profits while increasing risk and uncertainty.

<sup>15</sup>Stanford Research Institute, *The Industry-Government Aerospace Relationship*, Vol. 1, May 1963, p. 46.

<sup>16</sup>Logistics Management Institute, *Defense Industry Profits Review*, March 1970, p. 29.



## CONTRACT ADMINISTRATION

### Excessive Reporting Requirements

In the area of contract administration, the government uses its monopsony powers to impose reporting requirements that are far in excess of those found in the commercial sector. Management systems and data requirements expanded enormously during the 1960's, proliferating without due regard to practicality or cost. These systems were developed and/or promoted within each agency and then accorded the status of requirements merely by the inclusion of suitable language in the RFP and subsequent contracts.

The costs of these management systems are of startling magnitude and represent a significant proportion of total system acquisition costs. Studies conducted by the Blue Ribbon Defense Panel, for example, estimated the cost of management systems and related data at \$4.4 billion in FY 1969.<sup>17</sup> Another study estimated such costs at ten percent of total procurement dollars.<sup>18</sup>

The imposition of excessive and unnecessary reporting requirements serves, of course, to increase the costs to the government of the programs it undertakes. Further, although the direct costs of reporting systems may be borne by the government customer, elaborate reporting requirements hurt industry by restricting its flexibility and its capability to attract other customers. Commercial customers and state and local governments, for example, are generally unwilling to pay for the complex reporting system that a contractor maintains to meet Federal Government requirements.

### Restrictions on Management Decision-Making

The regulations under which government contractors operate are detailed, massive and extremely restrictive. The ASPR, for example, now exceeds 3,000 pages in length and is supplemented by hundreds of directives, instructions, procedures, manuals, reports, management systems and data requirements. The gov-

ernment, employing its monopsony power, incorporates these regulatory provisions in its RFP's and contract documents.

The comprehensiveness and complexity of the procurement regulations increases administrative costs to both government and industry. Of greater importance, however, are the regulations that give the government supervisory and veto powers in areas which are traditionally within the decision-making authority of the seller rather than the buyer.

One such regulation states that:

"Although the Government does not expect to participate in every management decision, it may reserve the right to review the contractor's management efforts, including the proposed make-or-buy program."<sup>19</sup>

Weidenbaum<sup>20</sup> has noted that other regulations give the government customer the power to review and veto decisions as to:

1. the activities to be performed in-house and those to be subcontracted;
2. the selection of subcontractors;
3. the products to be purchased domestically rather than to be imported;
4. the internal financial reporting system to be established;
5. the type of industrial engineering and planning system to be utilized;
6. the minimum and average wage rates to be paid; and
7. the amount of overtime work to be authorized.

All of these terms and conditions can be imposed by virtue of the government's monopsony power. Indeed, it has been pointed out that:

"Government contracts have become known as contracts of adhesion and administration in the sense that their provisions have become almost wholly decreed by the Government with the contractors having almost no voice in the selection of the contract's terms and provisions."<sup>21</sup>

<sup>17</sup>Blue Ribbon Defense Panel, Report to the President and the Secretary of Defense on the Department of Defense, *Appendix E*, Staff Report on Major Weapons Systems Acquisition Process, July 1970.

<sup>18</sup>Harbridge House, Inc., A Report to the Office of the Director of Defense Research and Engineering, *A Study of Requirements for Data and Management Control Systems in Three Engineering Programs*, Vol. 1, February 1970.

<sup>19</sup>*Armed Services Procurement Regulations*, Section 3-902. 1.

<sup>20</sup>Murray L. Weidenbaum, "Arms and the American Economy: A Domestic Convergence Hypothesis," *American Economic Review*, Vol. LVIII, No. 2, 1968.

<sup>21</sup>F. Trowbridge vom Baur, "Fifty Years of Government Contract Law," *Federal Business Journal*, Vol. 29, November 4, 1970, pp. 352-53.



An important aspect of these types of regulations is that they deny management the freedom of choice needed to allocate and utilize resources efficiently. In a sense, contractors are being required to abide by regulations and procedures that may be even more cumbersome than those employed internally by the government—despite the fact that the responsiveness and flexibility of private industry are major reasons for contracting work out.

Unless one is willing to adopt the view that the government buyer can manage a private organization better than can the company's own management, it follows that excessive restrictions on management decision-making serve to increase costs. Again, no matter how the costs are divided between government and industry, the overall impact is a cost increase due to increases in administrative expense and less efficient allocation and use of resources.

## THE CONSEQUENCES FOR GOVERNMENT AND INDUSTRY

The foregoing has identified a number of procurement practices that result from governmental monopsony power and examined their economic impacts. The remainder of this chapter is devoted to a discussion of the broader consequences of governmental monopsony power from the viewpoint of industry and that of the government itself.

### The Consequences for Industry

The analysis of procurement practices presented earlier in this chapter demonstrated the wide range of instances in which government monopsony power is used, intentionally or unintentionally, to reduce profits. One would expect, therefore, that a major overall consequence of governmental monopsony power would be a level of industry profits significantly below profit levels in commercial markets. This expectation is fully supported by the results of recent studies of profits in DOD contracts. (Here, as elsewhere, DOD examples are used because the background data and studies are more extensive; the argument applies with equal force to civil agencies.)

A recent GAO study examined the profits of 74 large DOD contractors during the four year period 1966-69. Profits were measured as a percentage of sales, total capital invested (TCI) and equity capital

investment (ECI). All three measures showed a higher return on commercial work than on government contracts. Somewhat more specifically, the GAO findings are summarized as follows:

“Profit before Federal income taxes, on defense work, measured as a percentage of sales, was significantly lower than on comparable commercial work for 74 large DOD contractors included in the GAO study. For example, profits on DOD contracts averaged 4.3 percent of sales over the 4 years, 1966 through 1969, but profits on comparable commercial work of the 74 contractors averaged 9.9 percent of sales for the same period. When profit was considered as a percent of the total capital investment (total liabilities and equity but exclusive of Government capital) used in generating the sales, the difference narrowed—11.2 percent for DOD sales and 14 percent for commercial sales. Further, when profit was considered as a percent of equity capital investment of stockholders, there was little difference between the rate of return for defense work and that for commercial work. The 74 large DOD contractors realized average returns before Federal income taxes of 21.1 percent on equity capital allocated to defense sales and 22.9 percent on equity capital allocated to commercial sales.”<sup>22</sup>

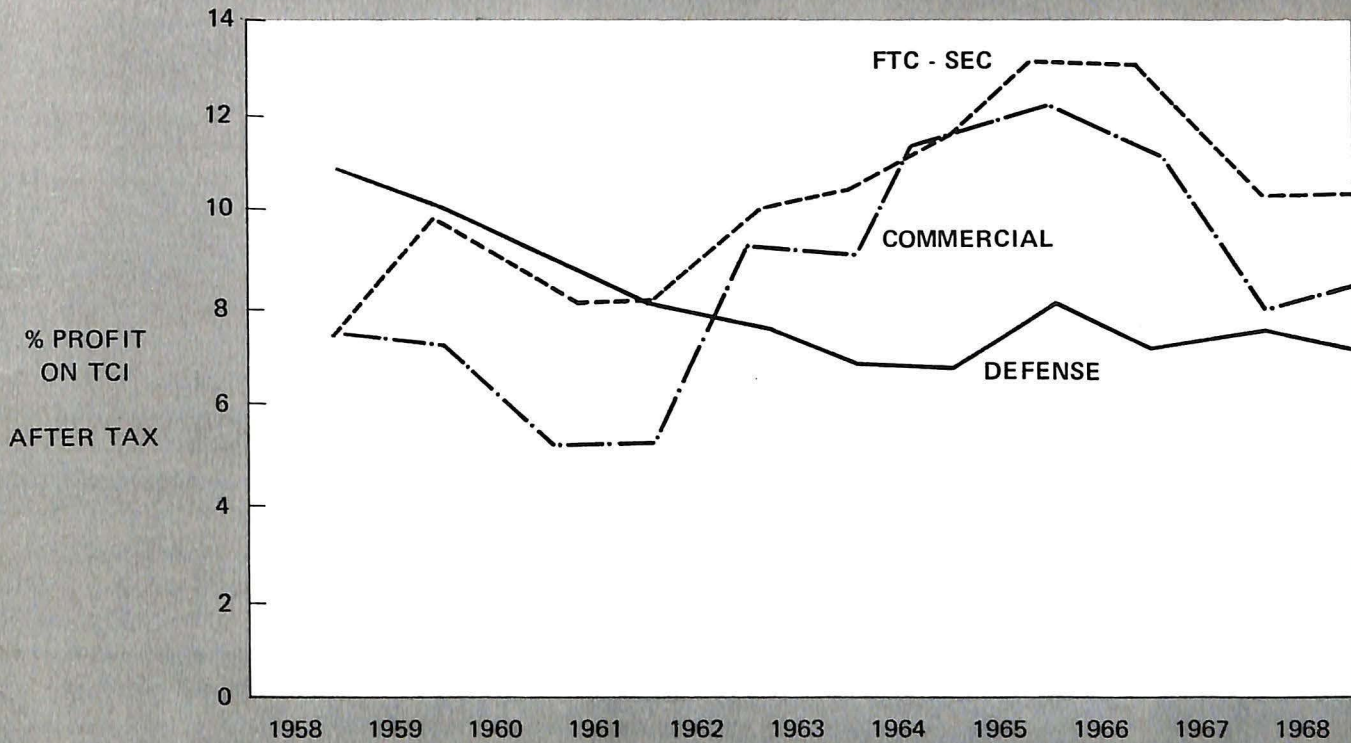
To avoid misunderstandings concerning the somewhat narrower gap that results when equity capital investment is used as a base, it should be noted that the GAO report itself states that profit as a percentage of total capital investment provides a more meaningful base:

“We believe that of the various ratios available for evaluating profits earned by contractors under negotiated defense contracts, the percentage of profit earned on TCI is the most meaningful for evaluating defense profits. The rate of return on TCI related earnings to total capital employed, regardless of whether it was provided by the owners of a business, its creditors, or its suppliers, and the Government, should not be particularly concerned with

<sup>22</sup>Comptroller General of the United States, Defense Industry Profit Survey, March 1971, p. 1.



**GRAPH**  
**PROFIT ON TOTAL CAPITAL INVESTMENT**  
**MAJOR DEFENSE COMPANIES**



DEFENSE % PROFIT ON TCI	10.1	9.5	8.7	7.5	7.4	6.5	6.3	7.6	7.0	7.3	6.8
COMMERCIAL % PROFIT ON TCI	7.0	6.8	4.8	4.7	9.0	8.7	10.9	11.6	10.0	7.4	8.3
FTC-SEC % PROFIT ON TCI	7.1	9.3	7.8	7.4	9.3	9.8	10.8	12.6	12.4	10.1	10.2

Source: Logistics Management Institute, *Defense Industry Profit Review, 1968 Profit Data*, March 1970, p. 11.

whether contractors obtain capital from creditors or from stockholders. Further, since interest is not an allowable cost under government contracts and must be paid out of profits, it seems only equitable to consider total capital in determining profits."<sup>23</sup>

The GAO conclusions are supported by the findings of a similar study covering 1958 through 1967 made by the Logistics Management Institute (LMI). This study covered defense business, commercial business performed by defense industry companies for their non-government customers, and FTC-SEC business (durable goods manufacturers whose business is comparable with that of defense industry companies). Graph shows the findings of the LMI study.

<sup>23</sup>*Ibid.*, pp. 13-14.



Low profit levels in government-dominated markets will lead, of necessity, to difficulties in attracting equity capital investment. The comparisons, shown in Table 6 of equity/debt ratios in the aerospace industry with those of all manufacturing provide an example of an industry that has been forced to shift to loan financing. As a consequence, borrowing is becoming more difficult and the bonds of the companies are generally rated low. Further, the low equity/debt ratios increase the risk of equity investments and depress the price/earnings ratios on equity stocks, making capital still more difficult to obtain.

### The Consequences for Government and its Programs

As has been noted earlier in this report, the monopoly power of the government, while affecting industry adversely, also serves to increase governmental costs and limit the effectiveness of its programs. Both the short- and long-term effects of the practices outlined earlier certainly must be regarded as negative from the viewpoint of government as well as industry.

In the short run, increased governmental costs and decreased program effectiveness result from a number of the procurement practices discussed earlier. Excessive proposal requirements, unnecessary management systems and restrictions on management flexibility, all have negative impacts.

From a longer term viewpoint, the extremely low profit rates in government-dominated markets (which may appear to represent a short-term saving to the government) will have an even more serious effect: the dissipation of the technical and managerial capability required to develop and implement the innovative systems that are essential to meeting the current and future needs of our society.

Low profit rates mean, inevitably, a long-term flight of capital away from firms that are today responsive to national needs as expressed by governmental programs. Some firms will go out of business, others will be absorbed by more financially stable companies. Of the remaining firms, some will be forced to reduce their scale of operations while others will decline to undertake government programs. Teams of highly trained scientists, engineers and production workers will be broken up, thereby destroying a valuable national resource. All of these effects will occur not in response to normal market competition, but rather as the result of unlimited monopoly power.

There are, in fact, some preliminary indications that

TABLE 6  
EQUITY/DEBT RATIOS

End of Year	Aerospace Industry	All Manufacturing Industries
1964	2.75	3.88
1965	2.91	3.54
1966	1.67	3.12
1967	1.65	2.86
1968	1.72	2.65
1969	1.48	2.43
1970	1.29	2.25

Source: Aerospace Industries Association Aerospace Profits vs. Risks June 1971. p. 13

capital is leaving certain major government-dominated markets, such as defense and aerospace. The declining equity/debt financial ratios in aerospace provide one such indicator. Another indicator is the attitudes of industry and banking executives as expressed in a poll<sup>24</sup> of top financial and business leaders from the 500 largest U.S. manufacturing companies and the 50 largest banks. The survey found that 83 percent of manufacturing executives interviewed were not interested in seeking additional defense contracts despite the fact that 48 percent of these considered defense business as in their line of work. In the case of the bankers, 78 percent were not interested in increased involvement in financing defense work.

Closely tied to the question of industry viability is the availability and utilization of national resources for innovative technology. The analysis presented in this chapter shows major areas in which government procurement practices have weakened the nation's technical capability by 1) reducing the management flexibility needed to utilize technical resources efficiently; 2) failing to provide the profit levels needed to support a strong technological capability; and 3) reducing the incentives to allocate private technological resources to public sector problems.<sup>25</sup>

In today's climate of increasing public concern over growing domestic problems—many of which will re-

<sup>24</sup>Opinion Research Corporation, Caravan Survey, November 1970.

<sup>25</sup>See also Aerospace Research Center study, "National Technology Program," November 1972.



quire technological solutions brought to bear through governmental support—more attention must be given such a fundamental problem. The same monopsonistic procurement practices that threaten the viability of today's major government contractors are being increasingly applied in the expanding civil agencies. Inevitably, these practices will limit national capability to undertake effective programs in such areas as environmental protection, transportation, manpower development and health services.

In short, what is in jeopardy is not one or two industries but rather our capability, as a nation, to undertake programs in which the resources of government and industry must be committed to the development and implementation of solutions to society's problems. The continued existence and effective use of the necessary management, technical and production resources will be feasible only if current policies and practices in government-dominated markets are reformed significantly.

CHAPTER

# 5

## A Program for Reform of Government- Dominated Markets

### PURPOSE

This chapter presents a five-point program for reforming government-dominated markets by restricting the use—and consequences—of the monopsony power described in earlier chapters.

The program presented below is deliberately broad in scope. It recommends the establishment of principles and mechanisms for the resolution of a multitude of specific issues rather than addressing each issue or abuse in a piecemeal fashion. Specific issues and abuses may increase or decrease in importance or prominence. This program of reform (and the analysis from which it is derived) is based on the recognition that specific abuses—and their remedies—must be viewed in the context of the broader issue of monopsony power.

### THE PROGRAM FOR REFORM

The five point program for reform of government-dominated markets may be summarized as follows:

1. *Congress should act to establish a Government Procurement Practices Board (GPPB) charged with the responsibility for limiting the use of governmental power through the implementation of the functions and principles defined in this program.*

The primary mission of the GPPB would be to limit the use—and consequences—of monopsony power, a role analogous to that of the Anti-Trust Division of the Department of Justice in limiting the use of monopoly power. Because the central monopsonist is the Federal Government itself, however, it is essential that the GPPB be accorded the same general status as the independent regulatory agencies. Hence, the members of the Board should be appointed for extended terms to represent the national interest and should hold no concurrent assignments.

2. *The Government Procurement Practices Board should conduct a continuing review of current and proposed procurement policies, regulations and practices on its own initiative and on appeal from industry.*

The GPPB should be responsible for evaluating all proposed changes in procurement policies, regulations and practices; its approval should be required prior to the adoption of such changes. In addition, the GPPB should review existing policies, regulations and practices. Finally, procedures should be



established to enable individual firms or associations to request GPPB review of existing or proposed guidelines that are considered contrary to the principles set forth in this program. (Questions of fact in specific cases would, under this proposal, continue to be handled through existing contract dispute procedures.)

3. *The basic criterion that should govern the procurement process, and the actions and approvals of the Government Procurement Practices Board, should be the conditions and outcomes that would result under balanced free market conditions.*

The central problem that underlies the specific issues and abuses examined in this report is that the government can, by virtue of its monopsony power, force industry to accept terms and conditions that differ significantly from those that would result in a free market in which the powers of the buyer and seller were more evenly balanced. In turn, the imposition of such one-sided terms and conditions has extremely serious and negative consequences for both industry and the nation as a whole. Accordingly, the basic criterion that should govern the procurement process is that procurement policies and procedures should, to the extent feasible, result in the same terms and conditions that would be developed under balanced free market conditions. ("Terms and conditions" here refers to the entire range of elements in the buyer-seller relationship including price, profit and procedural and regulatory factors.) It has often been noted that government procurement should be guided by such principles as fairness, equity and the public interest. That assertion, while true, is perhaps too generalized because they have not been effectively implemented in many existing policies. The market test criterion proposed here can, when further detailed, serve effectively as a guide for operational decision-making in the procurement process.

4. *Exceptions to the "free market test" criterion should be minimal and should require extraordinary justification.*

It is recognized that unusual circumstances such

as the procurement of weapons during time of war will require exceptions to the criteria for free markets. Such exceptions should, however, be rare if the basic objectives of this program are to be realized. Pressure to erode the basic free market criterion will be intense as individual agencies seek to reduce their short-term costs without regard to broader, long-term consequences. For this reason, specific justification, documenting the unusual reason for the departure from the basic criterion, and approval at senior governmental levels must be required. Vague generalities such as "national interest" or "best interests of the government" should not be accepted without detailed supporting material.

5. *The Government Procurement Practices Board should formulate a set of procurement principles, in support of the above concepts, that can be submitted to Congress and enacted into law.*

No explicit set of principles governing the fundamental contracting relationships between the Federal Government and the private sector now exists. These principles should be derived from, and supportive of, the basic free balanced market criterion defined in this program. They should establish guidelines for major facets of the procurement process and provide explicitly for the monitoring of compliance with basic procurement criteria and principles.<sup>26</sup>

Clearly, the above program will require additional detailing and amplification. It will, however, serve as a starting point from which a full range of remedial actions can be developed. More important, it will provide the basic guidelines for reforming and improving a procurement process and climate that are totally inadequate to meet today's—and tomorrow's—needs.

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<sup>26</sup>See, for example, Aerospace Research Center, *Federal Procurement Principles, A Proposal in the National Interest*, November 1971. The ten Federal Procurement Principles proposed in this publication are set forth in the Appendix.

## APPENDIX

### PROPOSED FEDERAL PROCUREMENT PRINCIPLES<sup>27</sup>

The procurement of goods and services by federal agencies from private enterprise is a significant factor in the national economy and contributes substantially to the economic growth and world leadership position of the United States. To foster the continued growth and strength of the nation, it is declared in the public and national interest that certain principles be set forth defining the fundamental relationships between the public and private sectors of our society in all federal procurement actions. These principles shall have precedence unless otherwise barred by law:

- The Government favors the use of and will procure to the maximum extent from private enterprise to fulfill its needs for goods and services.
- All Government procurement actions, including those resulting from actions of sovereignty, shall be based on a doctrine of fairness and equity.
- The Government shall abide by the same business principles that govern others in the field of commerce.
- The Government, when its procurements comprise the sole or dominant share of a market, shall recognize and avoid the use of its monopsonistic leverage to exact unfair or inequitable contractual arrangements or conditions.
- The opportunity to earn a reasonable profit shall be

fostered in Government procurement commensurate with the risks assumed and comparable to similar commercial endeavors.

- Government procurement shall acquire the benefits of competition through the use of either formal advertising or negotiation.
- The Government shall pay fair prices for goods and services by accepting all ordinary and necessary costs, consistent with accepted commercial practices.
- The Government shall issue procurement regulations as required to establish equities and protect the public interest while at the same time assuring that regulations are not excessive, conflicting or impose undue costs.
- Formal criteria for the content, development and approval of all procurement policies, regulations and procedures shall be established by each agency, be common among agencies where possible, and be consistent with these Federal Procurement Principles.
- The Government recognizes and shall protect the rights of affected parties to participate in the procurement regulatory process and to seek independent review of such regulations for amendment or repeal based on these Federal Procurement Principles.

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<sup>27</sup> *Ibid.*





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