

MEMORANDUM



DATE: October 24, 2003
TO: House Appropriations Subcommittee on Audit, Litigation, and Fiscal Oversight
FROM: William E. Hamilton
RE: Personal Service Contracts

Summary

Most of the work of Michigan state agencies is performed by state employees within classified civil service. However, under certain circumstances state agencies may contract for personal services with persons who are not classified state employees.

This memo reviews the statutory authority governing personal service contracts, controls over the contract procurement process, and legislative contract reporting requirements. This memo updates a House Fiscal Agency "Fiscal Focus" dated April 1998 on personal service contracts.

Note: This memo is identical in all material respects to our September 16, 2003 memo to the House Appropriations Subcommittee on Audit, Litigation, and Fiscal Oversight with the following exceptions. The current memo expands the discussion of contract disbursements exempt from Department of Civil Service review (page 3, paragraph 2), it clarifies language regarding reporting requirements for retired state employees in the 3rd paragraph under "Civil Service Report" on page 7, and it corrects the two tables at the end of this document to reflect final FY 2001-02 personal service contract authorizations and disbursements. The tables in the September 16, 2003 memo were based a preliminary personal service report.

Definitions

Civil Service Rules provide definitions for several terms used in this analysis:

- *Personal services* means work performed for the direct benefit of the state by an individual for compensation.
- *Disbursements for personal services outside the classified service* means disbursements of appropriated funds by a state agency for the personal services of a person who is not a classified employee of the state.
- *Independent contractor* means an individual contractor or an employee of a contractor who provides personal services and who is not an employee of the state of Michigan.
- *Special personal services employee* means a contractor who is an employee of a state agency and who is not a classified employee, an exempt employee, or an excepted employee.

Authority of the Michigan Civil Service Commission

Constitutional Authority - Article XI, Section 5 of the 1963 Michigan Constitution establishes the Civil Service Commission. Among other things, the section requires the commission to “*approve or disapprove disbursements for all personal services.*” The section also states that “*No payment for personal services shall be made or authorized until provisions of this constitution pertaining to civil service have been complied with in every particular.*” As noted in a previous House Fiscal Agency analysis, “*This requirement was designed, in part, to deter operating agencies from contracting out work that can be performed by classified employees, which would circumvent the civil service system in the provision of state services.*”¹

Effectively, all disbursements for personal services outside of the classified civil service must be approved by the Civil Service Commission.

Civil Service Rules - Chapter 7 of Michigan Civil Service Rules concerns “Disbursements for Personal Services Outside the Classified Service.”² The current version of these rules was approved by the Civil Service Commission September 28, 2001, effective October 1, 2001.³ Rule 7-3 establishes four standards (A,B,C,D) for approval of disbursements for personal services outside of classified service.

Standard A. The personal services are temporary, intermittent, or irregular.

Standard B. The personal services are (1) so specialized, technical, peculiar, or unique that they are not recognized as normal to the classified service or (2) the appointing authority is unable to recruit enough qualified candidates willing to accept a classified position.

Standard C. The personal services involve (1) the use of equipment, materials, or facilities not reasonably available to the agency at the time and place required and (2) the estimated cost to the agency in procuring such equipment or materials and establishing the needed positions would be disproportionate to the contract cost.

Standard D. The personal services would be obtained at substantial savings over the proposed period of disbursements when compared with having the same personal services performed by the classified work force. The personal services do not meet this standard if, despite the savings over the proposed period of disbursements, substantial savings would not likely be realized over the long term. Savings are "substantial" if the average annual savings over the proposed period of disbursements are equal to or greater than the minimum required savings computed using the table below:

Projected Average Annual Disbursements:	Minimum Required Average Annual Savings
From: To:	Must Equal:
\$ 1 - \$ 25,000	25% of average annual cost
25,001 - 50,000	20% (minimum \$6,250)
50,001 - 100,000	15% (minimum \$10,000)
100,001 - 200,000	12.5% (minimum \$15,000)
200,001 - 500,000	10% (minimum \$25,000)
500,001 - 1,000,000	Minimum \$50,000
1,000,001 and above	5% of average annual cost

¹ House Fiscal Agency *Fiscal Focus*, “Personal Services Contracts: An Overview, prepared by Craig Thiel, Fiscal Analyst, April 1998.

² Michigan Civil Service Rules are available at http://www.michigan.gov/mdcs/0,1607,7-147-6877_8155---,00.html

³ The provisions of Chapter 7 are implemented through DCS Regulation 7.01.

Rule 7-2 exempts certain types of disbursements from Civil Service review – effectively disbursements which are not for personal services. Included in the exempt disbursements are “Mixed disbursements” – defined as “*Disbursements for personal services that are included with other disbursements if (1) the predominant purpose of the mixed disbursements is not for personal services and (2) the personal services are logically or practically related to the predominant purpose of the mixed disbursements.*”

Examples of contracts which are not considered personal service contracts include Michigan Department of Transportation (MDOT) contracts with private contractors for highway construction, and contracts for state highway maintenance with county road commissions. Because they are not considered to be personal service contracts these contract disbursements do not require Civil Service authorization. In addition, Michigan Economic Development Corporation (MEDC) does not obtain authorization for personal service contract disbursements, and MEDC contract disbursements are not listed in the Civil Service annual personal service contract reports.

Independent Contractors versus Special Personal Service Employees - State agencies may contract for personal services from *independent contractors* or from *special personal service employees*. Independent contractors are not directly supervised by the employer and are paid on a per-job basis. Unlike independent contractors, special personal service employees work under the direct supervision of a state employee, typically work in a state office using state materials and resources, are paid through the state payroll system, and are considered employees by the Internal Revenue Service. Examples of special personal service employees are MDOT summer youth corps and co-op students.

Civil Service rules permit the use of personal service contracts for independent contractors if the personal services meet any one of the four standards provided in Rule 7-3. However, state agencies may contract for special personal service employees only if the personal services meet Standards A or B. Disbursements for special personal service contracts represent a very small percentage of total personal service contract disbursements – approximately 1%.

Approval process - Rule 7-6 of the Civil Service Rules provides a process for state agencies (appointing authorities) to follow in obtaining Civil Service approval of personal service contracts. Civil Service rules require that appointing authorities submit to the Department of Civil Service (DCS) a request for approval (form CS-138) to make disbursements for personal services outside the state classified service. The DCS approved request must contain the following:

- (a) The maximum aggregate dollar amount the appointing authority is authorized to disburse for the requested personal services during the approved period.
- (b) The specific personal services that the appointing authority is authorized to purchase outside the classified service with approved disbursements.
- (c) The period during which the appointing authority is authorized to make approved disbursements.
- (d) Any other requirement, condition, or restriction on the disbursements necessary to ensure that the appointing authority complies with article 11, section 5, of the constitution and the civil service rules and regulations.

The rules require the appointing authority to comply with all requirements, conditions, and restrictions established in the Civil Service approval. The appointing authority is prohibited from disbursing funds in excess of the maximum amount authorized, for services other than those authorized, or outside of the approved contract period.

From October 1, 1997, through September 30, 2001 Civil Service Rules permitted appointing authorities to “self-approve” certain disbursements for personal services, under a “decentralized” approval process. The agency “self- approval” was subject to subsequent DSC audit. This decentralized process was repealed effective October 1, 2001, with the amendment of Chapter 7 of the Civil Service Rules. The DCS indicates that the decentralized process was never used by any state agency.

Preauthorized Services - Civil Service Rule 7-7 requires the DCS to establish and publish a list of personal services deemed to meet the standards established under Rule 7-3. The rules allow appointing authorities to make or authorize disbursements for these “preauthorized” services without prior written approval from the DCS. The preauthorization of certain types of personal services limits the need for DCS review of routine and on-going services. The DCS preauthorization may be for all state agencies or may be limited to a specific state agency.

Scope of Authority –The DCS has the responsibility and authority to approve or disapprove an appointing authority’s request to disburse funds for personal services. However, the DCS does not approve actual contracts. As noted in Rule 7-12, “*Approval by the department of civil service under this chapter does not relieve an appointing authority of an obligation under any other law or non-civil service rule or regulation that may apply to a contract. Approval by the department of civil service under this chapter does not constitute approval of any contract or agreement by the state of Michigan under which an appointing authority makes or authorizes approved disbursements for personal services outside the classified service.*”

Authority of the Department of Management and Budget

Management and Budget Act - Section 261 of the Management and Budget Act (MCL 18.1261) grants to the Department of Management (DMB) responsibility and authority for the procurement of goods and services for state agencies. The section indicates that *“the department shall make all discretionary decisions concerning the solicitation, award, amendment, cancellation, and appeal of state contracts.”*

The section also indicates that *“the department may delegate its procurement authority to other state agencies within dollar limitations and for designated types of procurements.”* The section further states that the *“The department may withdraw delegated authority upon a finding that a state agency did not comply with departmental procurement directives.”*⁴

Section 141 of the Management and Budget Act (MCL 18.1141), makes the department is responsible for the establishment of internal controls over state financial transactions. Even if authority for procurements is delegated to other state agencies, DMB retains oversight responsibility.

The section also requires that the department utilize competitive bidding for all authorized purchases unless *“the department has determined that another procurement method is in the state's best interests.”*

DMB directives regarding contract procurement and management are included in the “Administrative Guide to State Government.”⁵ Procedure 510.13 of the Guide establishes the process for procurement of commodities and services at Executive Branch agencies. Procedure 510.08 identifies the contract monitoring and evaluation duties and responsibilities of agency contract administrators at contracting agency.

Auditor General Report 19-125-95 – On June 27, 1996, the Office of Auditor General (OAG) issued a performance audit on Statewide Contractual Personal Services for the period October 1, 1992 through May 31, 1995. Among other things, the audit found that the DCS and DMB had not taken active roles in enforcing their rules, policies, and procedures related to personal services and that the two departments did not monitor operating departments to help ensure compliance with the rules and regulations. The audit also found that operating departments were not adequately monitoring the progress of contractors or evaluating their performance after project completion in accordance with Administrative Guide Procedure 510-08.

On February 4, 1998, the OAG issued Special Report 19-125-95F on its follow-up review of the findings in its audit of Statewide Contractual Personal Services. The follow-up report indicated that the DCS and DMB had complied with the prior audit recommendations and had developed procedures to improve accountability over contractual personal services and by establishing monitoring functions to help ensure agency compliance.

Although the OAG may include a review of the effectiveness of agency contract administration procedures in the scope of audits of state agencies, it has not conducted an audit of statewide contractual personal services since Report 19-125-95.

⁴ Executive Directives 2003-5 and 2003-8 effectively withdraw procurement authority from state agencies and give greater direct oversight responsibility to DMB. These Directives are described in additional detail below.

⁵ The Administrative Guide to State Government is available at http://www.michigan.gov/dmb/0,1607,7-150-9131_9347---,00.html

State Administration Board

PA 2 of 1921 (MCL 17.3) grants to the State Administrative Board “*general supervisory control over the functions and activities of all administrative departments, boards, commissioners and officers of the state, and of all state institutions...*” With certain exceptions, the Board reviews requests for services which exceed \$250,000, or when amendments to existing contracts would cause the contract to exceed \$250,000, or when changes to existing contracts exceed \$125,000.

Note: State Administrative Board Resolutions 2003-1 and 2003-2, effective March 25, 2003, reduced the thresholds for State Administrative Board review – with certain exceptions - from \$250,000 to \$25,000 and the threshold for state contract and grant amendments from \$125,000 to \$25,000.⁶

Executive Orders/Directives

Governor Granholm has issued several executive orders and directives regarding state procurement.⁷

Executive Order 2003-1 (1/3/2003) – authorized the Department of Management and Budget to debar vendors from consideration for the award of a contract for provision of goods or services as a result of instances of non-compliance with state or federal law, including conviction of criminal offenses, failure to perform a state contract, or violation of bid procedures.

Executive Directive 2003-5 (2/20/2003) restricts state agencies from creating new positions, hiring new employees, and acquiring contractual personal services.

Executive Directive 2003-8 (2/27/2003) restricts state contracting and creates a task force on state contracts and procurement.

⁶ New procedures for contract and grant submission, including State Administrative Board Resolutions 2003-1 and 2003-2 are available at <http://www.michigan.gov/doingbusiness/0,1607,7-146-6597-69052--,00.html>

⁷ Executive Orders are available at <http://www.michigan.gov/gov/0,1607,7-168-21975---,00.html>
Executive Directives are available at http://www.michigan.gov/gov/0,1607,7-168-21975_22515---,00.html

Reporting Requirements

There are two reporting requirements regarding personal service contracts established in the Management and Budget Act (PA 431 of 1984, as amended).

Civil Service Report - Section 281 of the Management and Budget Act (MCL 18.1281) requires the DCS to report to the House and Senate appropriations committees and the House and Senate fiscal agencies on personal service contracts approved by the DCS. The section provides for monthly reports throughout the year, and an annual report prior to January 30 for the preceding fiscal year.

The section requires that the both the monthly and annual reports provide, by state agency, and for each contract for services request approved by the DCS, the name of individual or contractor and the dollar amount and source of financing. The section requires that the annual report also provide cumulative data on contractual services by department.

The section requires that both the monthly and annual reports identify state employees who had retired under Section 19a of the State Employees Retirement Act who were working as special personal service employees or as employees of independent contractors. There were no individuals in this category after July 1996.

The DCS extracts the data for the report from the state's MAIN accounting system data base.

In looking at the reports, it is important to remember that that each approved CS-138 represents Civil Service authorization for an appointing authority to make disbursements for a requested personal service outside the state classified service. The authorization period may be for more than one year. And the authorization does not necessarily represent a single specific contract. The requested personal service may be performed by multiple vendors under a number of separate contracts. As a result, the report lists two separate things – authorizations, and contract disbursements.

Department of Management and Budget Report - Section 281a (MCL 18.1281a) of the Management and Budget Act requires DMB and each principal executive department and agency to provide to the House and Senate appropriations committees and the House and Senate fiscal agencies a monthly report on personal service contracts in an amount greater than \$10,000 awarded without bidding, pricing, or rate setting, as well as a report on new personal service contracts in excess of \$100,000. The section requires that the reports identify the total dollar amount of the contract, the term of the contract, the name of the vendor, and the type of service provided.

This report is generated monthly by DMB's Office of Financial Management from data recorded in the MAIN system data base. Copies of the monthly report may be found at <http://mainweb.state.mi.us/reports.asp#fin> under "Statewide/Monthly Contracting Activities".

Boilerplate Requirements – A number of appropriations bills contain boilerplate language which establish additional limitations on, or reporting requirements for, agency personal service contracts. For example, Section 173 of PA 528 of 2002 (HB 5646, the FY 2002-03 General Government Appropriations act) requires DMB to report on any proposed revisions exceeding \$500,000 to current contracts for computer software development, hardware acquisition, or quality assurance at least 14 days before the department finalizes the revisions.

<i>Personal Service Contracts – Requests/Disbursements</i>				
Fiscal Year	Requests Approved	Reported Disbursements		
		Independent Contractors	Special Personal Service Employees	Total
1996-97	2,820	\$779,032,294	\$11,238,750	\$790,271,044
1997-98	3,250	730,524,722	11,720,830	742,245,552
1998-99	2,814	869,308,640	7,196,041	876,504,681
1999-2000	2,937	916,325,590	9,493,715	925,819,305
2000-01	3,128	964,341,963	8,417,893	972,759,856
2001-02	3,045	1,139,364,892	10,053,611	1,149,418,503

Source: Michigan Department of Civil Service Annual Personal Service Contract Reports

State Personal Service Contracts by Department FY 2001-02			
	CS-138s	Total	Percent of
	Approved	Disbursements	Total
Agriculture	110	7,814,462	0.68%
Attorney General	25	1,715,932	0.15%
Legislative Auditor General	3	65,009	0.01%
Career Development	138	7,604,575	0.66%
Civil Rights	15	460,940	0.04%
Civil Service	20	7,627,473	0.66%
Community Health	291	47,724,606	4.15%
Consumer and Industry Services	122	14,254,435	1.24%
CIS - Unemployment Agency	67	17,398,650	1.51%
Corrections	296	126,041,737	10.97%
Education	158	10,820,599	0.94%
Environmental Quality	122	81,159,803	7.06%
Family Independence Agency	346	320,542,894	27.89%
Casino Gaming Control Board	21	237,724	0.02%
History, Arts, Libraries	140	948,844	0.08%
Lottery	29	30,665,869	2.67%
Management and Budget	210	162,155,090	14.11%
Mich. State Housing Develop. Auth.	41	9,394,603	0.82%
Military and Veterans Affairs	132	16,176,438	1.41%
Natural Resources	225	47,236,632	4.11%
State	73	13,950,217	1.21%
State Police	171	18,546,959	1.61%
Transportation	213	149,515,281	13.01%
Treasury	77	57,359,732	4.99%
TOTAL	3,045	1,149,418,503	100.00%

Source: Michigan Department of Civil Service, Annual Personal Service Contracts Report.