

Dispelling the Myths About Indirect Costs

By Gary Talesnik NOVEMBER 02, 1994 PREMIUM

To no one's surprise, the controversy over universities' indirect research costs is heating up again. In times past, you could count on this issue to turn up every few years; now it returns so often it never really seems to go away. This time around, the Clinton Administration, led by the Office of Management and Budget and the White House Office of Science and Technology Policy, is meeting with representatives of university administrators, scientists, and federal research agencies to try to reach a long-term solution to the problem. The group plans to submit recommendations to the Administration and Congress within the next few months.

Federal policy on reimbursement of indirect costs is crucial, because such payments are a significant part of the way we support research in this country. Indirect-cost payments for federally sponsored research at universities total about \$3-billion a year. It is not surprising that indirect-cost policy is a continuing source of controversy, given the tension between the researchers who rely on federal funds to pay the direct costs of their research and the institutions that depend on indirect-cost payments to help cover the expenses of administrative support and facilities.

Furthermore, the Executive Branch and Congress have tried to cut indirect-cost payments numerous times over the years, either to achieve budget savings or to stem alleged "abuses." Most of these efforts failed, because they were arbitrary and inequitable. The Bush Administration did manage to impose a limit on reimbursement for administrative costs, in response to allegations that institutions were charging the government for questionable or "unallowable" costs. Two weeks ago, Stanford University and the Office of Naval Research signed an agreement settling a dispute over 12 years of federal indirect-cost payments to the institution.

For over 20 years, I was in charge of indirect-cost negotiations and the development of cost-reimbursement policy for the Department of Health and Human Services. In my experience, the periodic debates about indirect costs have usually been, as Yogi Berra put it, "*deja vu* all over again." Given the nature and importance of this subject, periodic reviews that honestly deal with the facts can be constructive. All too frequently, however, the debates about indirect costs have been based on faulty assumptions and perceptions.

The handling of indirect costs can certainly be improved, and I have some suggestions that I believe can help. But to deal intelligently with this subject, we first need to clear away the smoke and misconceptions. Let me take a stab at dispelling several of the most troublesome, counterproductive -- and perennial -- myths.

* Myth: Indirect costs pay mainly for administrative bureaucracies that provide little benefit to research programs.

* Fact: Indirect costs include expenses related to facilities as well as to administration, and both sets of costs are important to the success of research programs.

Costs related to the use of facilities and expenses for administrative support now each represent about half of the total indirect costs of university research. Facilities expenses include depreciation and financing costs for buildings and equipment, utilities, maintenance and repairs, and janitorial services. Those costs have nothing to do with administrative bureaucracy and are clearly necessary to provide the buildings and equipment used to conduct research.

Administrative costs include an equally wide range of services: accounting, purchasing, personnel management, and legal services, among many others. They also include staff support to help institutions comply with federal laws, regulations, and the specific conditions of research grants and contracts, including safeguards for the protection of human subjects and the care and use of laboratory animals.

While one might call these functions "administrative bureaucracy," they are hardly frivolous or unnecessary to the functioning of research. We expect institutions to account for the money they receive, to use it efficiently, to follow sound and lawful personnel practices, and to comply with the legal and administrative requirements of federal programs. None of this comes free. Someone has to pay and, if the sponsors of research don't pay their fair share, institutions will have to look to tuition or other sources to cover the costs. In my view, this would be neither fair nor sound public policy.

* Myth: Indirect costs are escalating rapidly and are eroding the money available to pay for the direct costs of research.

* Fact: Indirect costs, as a portion of the total cost of research grants, have been stable for the past decade.

Indirect costs accounted for 31 per cent of the total cost of research grants awarded to universities by the National Institutes of Health in fiscal 1983; the comparable figure for fiscal 1993 was 30.9 per cent. During the entire 10-year period, the proportion never exceeded 31.6 per cent. (The institutes support about 50 per cent of all federally

sponsored research at educational institutions.) These simple, straightforward facts constantly get lost in the rhetoric.

Although the indirect costs claimed by institutions did increase significantly from the early 70's to the early 80's, the rise took place after a long period in which reimbursement of indirect costs was capped at an artificially low level. It took the institutions considerable time after the cap was removed in 1966 to begin recovering anything approaching their actual indirect costs. An increase in costs that occurred more than 10 years ago doesn't justify a concern about "escalating" costs today.

* Myth: Indirect costs are higher at universities than at other types of organizations.

* Fact: As a portion of total research costs, universities' indirect costs are lower than those of hospitals and other non-profit organizations and are much lower than the indirect costs of for-profit companies.

Data gathered by the Public Health Service for the research grants and contracts awarded by all of its agencies, including the N.I.H., show a clear pattern in the average indirect costs at different types of organizations. The most recent analysis by the Public Health Service, which covers fiscal 1985 through fiscal 1992, shows the following indirect costs, as a percentage of total costs, for fiscal 1992: universities, 31.0 per cent; hospitals, 33.4 per cent; other non-profit organizations, 33.7 per cent; state and local governments, 27.6 per cent; commercial companies, 50.1 per cent.

Although differences in organizational structures, accounting systems, and other factors may account for some of the variations, this formation strongly suggests that overall indirect costs at universities are reasonable and in line with those of other organizations -- and are substantially less than those of commercial contractors.

* Myth: Wide variations in the indirect-cost rates of individual institutions are inappropriate and unjustified.

* Fact: There are legitimate reasons why indirect-cost rates vary among institutions, and there is no evidence that a high or low rate has any relationship to an institution's cost-effectiveness.

Variations in the negotiated indirect-cost rates of universities arise from two factors: differences in the actual costs of facilities and administrative services at specific institutions, and differences in how aggressively an institution pursues recovery of indirect research costs.

Although the actual costs of both facilities and administrative services vary considerably among universities, the variations in facilities costs can be especially

great. Such costs are affected not only by obvious factors such as geographical location and climate, but also by numerous factors specific to an institution, such as the age of its buildings, their energy efficiency, the nature and mix of research the institution performs, and the demands the research puts on its buildings and equipment. The extent and timing of the institution's investments in upgrading its physical plant are also major factors, because they can have a substantial impact on the interest and depreciation costs included in the indirect-cost rate.

Variations in indirect-cost rates are also due to differences in how aggressively an institution tries to recover indirect costs. Many public universities do not attempt to identify and claim the full amount of indirect research costs. As a result, they tend to have rates significantly lower than those of private universities. Public universities generally have less incentive to try to recover full indirect costs, because state policies usually require institutions to return indirect-cost payments to the states, rather than allowing universities to retain them.

Clearly, the differences in actual costs and in aggressiveness in recovering indirect costs will produce a substantial spread in the rates of individual institutions. There is no evidence, however, that these variations are unreasonable or unjustified.

If you line up all the information I've presented and consider it carefully, you could reasonably ask, "So what's broken? What are we trying to fix?"

Those are good questions, which ought to be answered before we spend much more time or money on this issue. As a practical matter, much has already been done to constrain the growth of the government's reimbursement of indirect costs to universities. The measures include a cap on administrative costs, imposed on most universities at the beginning of their 1993 fiscal years; tighter rules on "unallowable" costs, such as lobbying expenses; and more-extensive audits. In fact, universities are the only organizations that do business with the government that are subject to an arbitrary limit on a major part of their indirect costs.

Having said all this, however, I know that the issue won't simply fade away. I don't have any magic bullets, but I do have several suggestions that I think merit consideration. These ideas are not new, but they should be given a fresh look. I understand that some of them are being seriously considered in the current discussions between the Administration and the universities on indirect costs.

First, we should stop using the terms "indirect costs" and "overhead." The terms are technically correct, but they contribute to the misconceptions about what these costs involve. Something like "facilities and administrative support," though longer, would provide a much clearer picture of what these costs actually represent.

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In a similar vein, serious consideration should be given to publishing a university's indirect-cost rate broken down into its two parts -- the percentage for facilities and the percentage for administrative support. This would allow everyone to see more readily where costs are increasing or decreasing and would improve public understanding of what the costs represent. The Association of American Universities recommended such a step several years ago, and, at the time, I thought it would be largely cosmetic and of little value. I was wrong. Because the indirect-cost controversy is driven mainly by perceptions, we should try to make the perceptions match the facts. Since universities negotiate separate rates for the two groups of expenses with government officials, it would be relatively easy to display the two components of the rates in published rate agreements. These agreements are routinely provided to federal research agencies and could be made available to others, including members of Congress and university researchers.

I make my third suggestion with some reluctance. Even though the overall level of indirect costs, as a percentage of total federal research costs, has been stable for a decade, facilities costs have grown considerably. This is not surprising. Unlike the 60's and 70's, when direct federal grants were available for construction of research facilities, reimbursement of indirect costs now is the only broad mechanism available to universities to help cover the costs of such facilities.

While the growth of these costs is understandable, some researchers and federal officials continue to be concerned that institutions are building more facilities than they need or that the facilities are too large or too elaborate. I have not personally seen much evidence of this, and the hoops -- in the form of approvals from governing boards and financing agencies, for example -- that universities already have to jump through to justify new construction and major renovations would seem to be a sufficient check on such expenditures.

Nonetheless, to deal with this concern, I think the Administration and universities should seriously consider creating some external process for reviewing major new investments in facilities, when the costs are expected to be charged primarily to the government. This could be done by the federal agency that supports most of a particular institution's research, a panel of representatives from other universities, or some combination of federal and peer reviewers.

I know this suggestion will be anathema to some institutions, because it would add another step to an already lengthy and arduous review process. But I don't think it is unreasonable for the organization that ultimately will be paying the bills to be involved in evaluating a new facility. It also makes a lot more sense, in my view, than other possible alternatives, such as caps on facilities costs, flat percentage rates, or

other formulas that ignore the actual costs that individual institutions incur to support research programs.

Finally, it would be useful to know more about what the full indirect costs of research programs really are. Because of differences in how aggressively institutions seek recovery of indirect costs, the cap on administrative costs, and the dynamics of the process of negotiating indirect-cost rates, current rates do not reflect universities' full expenses for facilities and administrative support. A comprehensive study by a representative cross section of institutions that identified the full indirect costs of their research programs would go a long way toward allaying concerns and improving understanding of this issue.

I think that these recommendations could help federal officials and university representatives reach a long-term resolution of this controversial topic. Maybe this time it can be put to bed for at least a couple of years.

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