



Fiscal First Aid Quick Reference

Outsourcing

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Introduction

In times of fiscal stress, there may be renewed interest in contracting out public services to private firms to achieve efficiencies. "The government and its citizens deserve the best possible quality of government services. Government must ensure that those services are produced in an effective, fair, and affordable manner. But whether any given service should actually be accomplished by a government employee, a government contractor, or a combination of both depends on the service itself and the relative capabilities of the private and public sectors in that realm" (Stephen Goldsmith, "Insourcing, Rightsourcing," *Governing.com*, October 21, 2009, <http://www.governing.com/hidden/Outsourcing-Insourcing-Rightsourcing.html>).

Steps to Take

- I. **Identify services with potential for outsourcing.** Outsourcing has particular potential for services where low-skill labor is predominant because compensation for low-skill positions often tends to be higher in the public sector. Also, look for areas where government lacks economies of scale that a private sector may be able to provide. Outsourcing works best when a given service meets certain conditions:
 - A. The service to be performed can be precisely specified in advance and its performance evaluated after the fact. This helps create the conditions for competition between contractors.
 - B. The government understands how the production process for the service creates value for the public. If a process is outsourced, does the government understand all the sources of value that would have to be replicated for the public or given up?
 - C. The government is more interested in the results than the way the service is performed. If the contractor has flexibility to provide the results in the way it sees fit, it can bring to bear the traditional advantages of the private sector, such as lower cost of labor for unskilled positions and greater capacity for innovation.
 - D. Disappointing contractors can be readily replaced or penalized. There is an established pool of firms that can provide the service. The government has the wherewithal to take action against non-performing contractors.

- II. **Analyze avoidable costs.** Determine the true cost of providing service and validate that the organization can calculate avoidable costs – costs that can be truly eliminated or reduced by outsourcing. Outsourcing decisions should be made based on avoidable cost accounting, not on fully allocated costs, because a substantial overhead cost will continue to exist in the contractual environment.

- III. **Analyze the market.** Examine the market to get a better feel for the real potential of outsourcing a given service.
 - A. Is there an established industry of private firms that provide the service?
 - B. Are there non-profits or other government agencies that provide the service? Contracting with these organizations may help reduce some of the challenges of contracting with a private firm (e.g., cultural differences).
 - C. Are there examples of other governments that have outsourced the service successfully?
 - D. Are there more creative sourcing arrangements that have not been previously considered? For example, rather than outsourcing an entire service, perhaps contractors could perform certain the specific duties for which they are best suited.



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- IV. **Moving forward.** Outsourcing can be risky proposition. Exercise caution.
- A. Conduct a thorough cost analysis of bids, using avoidable cost accounting. Compare the costs that will be reduced with new costs such as contract administration and vendor management.
 - B. Negotiate a contract, avoiding common risks. These include vendor lock-in, where moving vendors becomes difficult or impossible because the vendor gains specialized knowledge, personnel, or assets; and price escalation, which can occur when prices are not fixed or are based on unclear metrics.
 - C. Identify several smaller areas for outsourcing so government can get a feel for how outsourcing can work successfully. This will also provide the opportunity to build up crucial contract management skills.
 - D. Enter into contractual arrangements that fix the fees over multiple years or provide for predictable and agreeable increases.
 - E. Ensure that government employees are prepared to serve in a quality management role (focusing on key performance metrics) and that they understand the fundamentals of the arrangement between the government and the vendor.
 - F. Provide for periodic formal quality reviews with the vendor.
- V. **Evaluate results.** Keep in mind the following:
- A. Immediate savings may be difficult to achieve in many cases.
 1. There are significant transaction costs to creating the outsourced arrangement.
 2. There are often transition costs. For example, perhaps the outsourced service must be run in parallel with in-house services for a time in order to avoid service interruptions.
 3. Realigning staffing may take some effort and can only be done once all activities are moved to the outsourced vendor.
 - B. Make sure there is a long-term plan for gaining advantages from the outsourcing.
 - C. Keep communications with vendor open and jointly address problems.

Evaluating Success

Outsourcing is a way to put the advantages of private firms to work for public. The success of an outsourcing initiative can be measured in a number of ways:

- **Costs are reduced.** Has the organization experienced a net reduction in its costs?
- **Service quality is maintained.** Is the vendor living up to the objectives outlined in its contract?
- **Customers are satisfied.** Are the recipients of the outsourced service satisfied?

Resources

- John D. Donahue, *The Privatization Decision: Public Ends, Private Means* (Jackson, TN: Basic Books, 1991).
- Elliott D. Sclar, *You Don't Always Get What You Pay for: The Economics of Privatization* (Ithaca, NY: Cornell University Press, 2001).