MANAGING THE TRANSITION FROM PUBLIC TO PRIVATE SECTOR DELIVERY OF SERVICES.

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Abstract

Over the past ten years Australian governments' have increased their reliance on the private sector in the provision of services. Whilst privatisation has been one component of this change, another method has been the tendering of contracts to supply particular services to the government. This 'contracting out' has occurred across a wide range of services including the cleaning of government buildings, railway maintenance, and the provision of information technology services to government departments. The effectiveness, in terms of cost and quality, of these policies has varied significantly. For economies in transition to a higher reliance on market provision of goods and services it is important to be able to identify which aspects of government services are the most suitable for market provision and which ones are not.

This paper attempts to provide a framework for analysing whether 'contracting out' will have desirable effects or not. Factors that are important determinants of success include the depth of the market; the extent of transition and monitoring costs; and the extent of linkages between the service being contracted out and the rest of the system.

In determining the effectiveness of contracting out it is important to rely upon a wide definition of efficiency, that is, one that includes dynamic as well as static factors and one that incorporates quality. Using the Australian experience some policy recommendations are presented for both the identification of services that can be efficiently contracted out and the optimal design of contracting out procedures.

Introduction

Over the past ten years in Australia there has been a substantial trend towards government reliance on private sector contractors for the provision of services to the public (Industry Commission 1996). This 'contracting out' has occurred across a wide range of services including the cleaning of government buildings, maintenance, information technology and the provision of job matching services to the unemployed. The effectiveness, in terms of cost minimisation and quality of services, of these policies has varied significantly. For economies in transition to a higher reliance on market provision of goods and services it is important to be able to identify which aspects of government services are suitable for market provision, and under what conditions. This paper will deal primarily with one form of private sector provision, the 'contracting out' of government services.

In Australia there has been a rapid increase in the reliance on contracting with the Commonwealth Government currently contracting out the provision of over $8 billion worth of services (Industry Commission 1996). Contracting out has been relied upon by both conservative and labour parties, however, conservatives have in general gone much further. Politically the advantages seem to arise through the resultant lower costs, often through reduced union power, and in turn, lower wages and reduced employment (Quiggin 1994).

What is Contracting Out?

Contracting out refers to the process of using the tendering process to open up service provision to external suppliers. That is, rather than itself employing staff and providing services, the government seeks to have that service provided on its behalf by the lowest price tenderer. In some cases an 'in-house' bid may be made by the existing employees, but this bid will be evaluated against the same criteria as all others.

It should also be noted that it is not just governments who have expanded their reliance on the external provision of services (Prager 1994) . Many large corporations have also adopted contracting out as part of their 'downsizing' process. Whilst it is argued that both firms and governments can benefit by focussing on their 'core activities' it will be argued below that governments must be more careful in identifying the impact of contracting out due to the difficulties of multi criterion decision making that governments must undertake.

Unlike privatisation, the process of contracting out does not result in the removal of government responsibility for the delivery of services. Although the private sector may be contracted to deliver a service, that service is still delivered on behalf of the government. It is therefore essential that mechanisms for monitoring the performance of contractors are developed early in the tendering process so as to ensure the delivery of high quality service as well as to provide certainty for intending contractors.

Depending on the extent of contracting out it may be more efficient for a central government agency to write and monitor contracts rather than allow individual government agencies to undertake their own tendering process. Centralisation will allow for consistency of contract conditions, increased efficiency in the drafting and tender evaluation process, and improved contract monitoring. However, unless input from individual agencies is effectively incorporated into the tendering process it is unlikely that contracts will be sufficiently detailed to capture the complexity associated with the provision of some government services.

The arguments for contracting out

The argument which is most commonly advanced in support of contracting out is that it leads to an increase in 'efficiency' savings (Domberger et al 1986, Milne and McGee 1992). In order to evaluate this claim though, it is essential to carefully define the term 'efficiency' and apply it

consistently. The following is a list of different notions of efficiency that can be used to support contracting out. These notions are not necessarily mutually exclusive.

- Cost minimisation
- Improved service quality
- Access to external skills/experience
- Improved dynamic efficiency

Whilst it is possible that contracting out may result in an improvement in more than one of these notions of efficiency, it is also possible that improvements in one measure of efficiency cause reductions in others, for example, cost reductions may result from lower quality service provision.

What is efficient?

It is in defining the term 'efficient' that the biggest differences between the public and private sector emerge. Private companies have much clearer objectives against which efficiency can be measured. Whilst there may be a tension between profits, dividend payments and capital growth, the units of measurement are at least clear and calculable: dollars. The same is not necessarily true for the public sector. Whilst costs are an important consideration, the objective of the public sector is not to make a profit; rather, its objective should be to maximise the welfare of its citizens both in the present and in the future. Whilst companies can be considered successful if they can exploit customers to provide high returns to their shareholders, the same is not true for governments whose taxpayers and service recipients are the same group.

Cost Minimisation

In a perfectly competitive environment, price signals can be used to ensure that allocative efficiency arises. Where market failure exists though, such an outcome will not be achieved. Cost minimisation will therefore only be a good proxy for the achievement of efficiency to the extent that the service being considered approximates the perfectly competitive model.

For many services that are commonly provided by the public sector the extent of the deviation away from the perfectly competitive model is substantial, with some of the larger problems arising due to the existence of imperfect information, externalities and monopoly provision.

If citizens or government agencies do not have cheap access to important information, such as information about quality, contractors may seek to reduce costs via reduced quality. Such a situation is particularly problematic when the implications of lower quality provision do not arise until future periods, for example maintenance services or education provision.

Another problem associated with relying on cost minimisation as a proxy for allocative efficiency will arise if substantial externalities are associated with the production of a service. Such externalities may be either positive or negative, and may impact upon either the public or private sector. Reduced employment may reduce costs in the provision of a particular service, but it may also lead to an increase in welfare payments, reduced income tax revenue and reduced investment in training. Such effects are irrelevant for a private contractor, but may be important to the public sector as a whole. Similarly, reduced provision of health services in the home to the elderly may result in an increase in hospital admissions.

On a smaller scale, a byproduct of the production processes may be information which can be used by decision makers elsewhere in an organisation. Maintenance, manufacturing and design departments in a large organisation may profitably share information so as to minimise costs. If such services are contracted to separate suppliers then the flow of information will be reduced. In analysing the potential for contracting out it is therefore important to consider the

extent of any interrelationships between different aspects of service delivery. When strong interrelationships exist the benefits from contracting out will be lessened.

Many studies have shown that contracting out can lead to budgetary savings (Domberger et al 1986, Milne and McGee 1992). However, whether or not such cost savings can be considered to be increases in efficiency will be determined by the notion of efficiency that is adopted.

Dynamic Efficiency

Another important concept of efficiency is how well an organisation copes with changing conditions, and how appropriate current decisions are in relation to expected future needs. Whilst 'just in time' methods of production may reduce inventory costs they may be inappropriate if the costs borne by citizens associated with a breakdown in supply are high. For example, costs associated with the storage of human blood for transfusions may be reduced by attempting to forecast demand more accurately. The costs associated with the inability to cope with an unanticipated increase in demand would, however, be very high.

The costs associated with not being to cope with unanticipated circumstances were starkly highlighted by the failure of electricity supply to the central business district of Auckland in New Zealand. Supply was interrupted for six weeks following the failure of all four major electricity supply cables. A government inquiry into the failure (New Zealand Government 1998) found that:

- The 1988 and 1989 AEPB Annual Reports indicate a high level of awareness of the unreliability of the gas cables and the potential need to advance consideration of their replacement; and

- Despite awareness of the increased unreliability of the gas cables, the cause of repetitive gas leaks on the 110 kV gas cables was not resolved by systematic investigation.

It also found that

- While Mercury Energy is a competent distribution company, it did not have the required expertise, operations and management procedures for the 110 kV cables;

- The cause of repetitive gas leaks and faults was not resolved by systematic investigation;

- A well-developed asset audit and asset management program for the 110 kV cables did not exist;

- Maintenance contracts for the 110 kV cables were deficient in terms of their specification, management and monitoring.

Whilst the electricity supply in question was provided by a hybrid public/private corporate structure, the important point is that in the pursuit of financial returns, a potentially profitable, although risky, strategy of asset maintenance was adopted. The final cost of this strategy was, however, borne by consumers and citizens. A strategy of short term cost minimisation lead to the imposition of large financial and external costs. If reductions in costs are associated with an increase in risk then these risks should be quantified in order to appraise the extent of any changes in 'efficeincy'.

Another aspect of dynamic efficiency is associated with the level of investment in infrastructure and training. Reductions in short term costs may be achievable via a reduction in staff training. However, in addition to the possibility of reduced quality in the short term, the risk of reduced capacity in the future must also be considered. That is, over time the pool of trained staff may decline, resulting in either further reductions in quality or an increase in the cost of labour associated due to excess demand. According to Toner 1998, the reduction in

employment in many government agencies has resulted in economy wide shortages of some forms of skilled labour.

Quality

In a properly functioning market the optimal combination of price and quality will be resolved through the interaction of consumer information and choice of supplier. In the provision of many services, however, neither of these mechanisms will be present.

Although it may be possible for governments to collect and disseminate information about quality to the public such a process would involve costs. These costs must be considered when appraising the net benefit of proceeding with contracting out. Similarly, it may be inefficient or impossible for service delivery to involve multiple suppliers. In such cases the provision of information to customers will be of little use, and improvements will only be possible if the contract was well written with clearly specified requirements and mechanisms (including sanctions) for dealing with inadequate service quality.

Increased efficiency, or intensity?

Whilst the definition of an increase in efficiency as being an increase in output per unit of input is not contentious, the same can not be said of the definition of inputs and outputs. Measures of inputs and outputs can be particularly problematic in the provision of government services (Scott 1996, Vining and Globerman, 1996). Unmeasured reductions in quality will result in an unmeasured reduction in output. Alternatively, increases in work intensity may also result in an unmeasured increase in inputs.

Labour input is usually measured in units of time e.g. hours or days. But all hours of work are not the same, what is important to the worker is not just the amount of time spent at work, but the effort expended. However, unlike time, effort is difficult to measure. So difficult in fact, that its measurement is largely ignored (Quiggin 1994).

If firms can lower costs by employing a smaller workforce, but making them work harder, then whilst this may result in a reduction in costs it is not an increase in economic efficiency. Rather, it is a transfer from workers (who now provide more effort) to the firm (who now make larger profits). This problem is compounded if increased intensity of work will also be related to an increased number of accidents, stress and unmeasured reductions in the quality of work.

If cost reductions associated with contracting out are achieved by increasing the intensity of work effort then such a transfer from workers to the contractor cannot be considered to be an increase in efficiency. That is, the conditions for Pareto optimality have been broken, and the equity implications of such a transfer must be discussed outside the economic framework.

When will contracting out be most effective?

In determining the effectiveness of contracting out it is essential to first determine what objectives the government wishes to achieve. Similarly, it is important that in determining its objectives governments are made aware of the possibility of a tradeoff between the different notions of efficiency.

Mixed market economies such as Australia, as well as countries making the transition to a greater reliance on market provision, must rely on a wide range of alternatives when attempting to coordinate resources with the greatest efficiency in order to maximise the welfare of citizens. The optimal mix of public and private sector involvement, and the optimal amount of regulation of private sector activity should be determined by prevailing market conditions

Assuming governments are clear as to what outcomes they consider desirable, what then are the optimal conditions for implementing contracting out to achieve them? Contracting out will be most effective when the following conditions are met:

- The goods or services being provided can be clearly defined and their quality easily identified.

In order for a tendering process to deliver lower cost and improved quality it essential that the services to be contracted out can be clearly and precisely specified so that the tender appraisal process can make accurate comparisons. The exact nature of the service must be able to be specified, performance objectives, quality measures, procedures for resolving complaint, and procedures for winding up the contract in case of poor performance must all be clearly outlined.

- A wide range of potential suppliers exist ensuring that sufficient price competition between suppliers exists.

Another important consideration is the depth of the market for the services being tendered. If competition is to result in minimum cost provision then there will need to be a significant number of competitors. Similarly, benefits will only arise if collusion between tenderers can be controlled. Substantial evidence exists in Australia regarding collusion between building contractors, particularly when tendering for public sector work (Royal Commission 1992)

The existence of a viable in-house tenderer provides several advantages. Firstly, it ensures that the organisation retains the skill base necessary to adequately evaluate outside tenders. Secondly, it increases market depth and reduces the capacity for collusive price fixing. And finally, it could be expected that internal tenderers will have different motives, and prepare bids based on a more labour intensive, higher quality production process than private sector contractors.

Whilst savings may be made in the short term by relying on competition to provide lower costs, these savings will only be maintained over time if a competitive environment is maintained and that barriers to entry are low ensuring that the market remains contestable (Baumol et al 1982). In house providers have an essential role in ensuring that alternative provision is always available.

- Economies of scope are not substantial

Where a range of different contracts is to be tendered it is important to realise that the potential to realise any economies of scope will be lost. If different firms receive contracts to provide different processes then there is no potential for economies of scope, whilst if one firm wins all contracts it will be under no commercial pressure from other contractors to pass on any savings.

- Transition costs are low ensuring that the initial contractor faces substantial and regular competition to maintain their incumbent status.

It is also important to consider the extent of any transition costs associated with a move from in house to contracted provision of service. In simple terms, the present value of long run cost savings must be greater than the transition costs if efficiency is to be increased.

Examples of costs that must be included as transition costs are: redundancy payments to workers; establishment costs of the administrative capacity to oversee contracting out and; expenses related to determining the nature of the services to be provided and the form in which contracting will occur. In addition to the expenses incurred by the relevant departments or agencies on these items, allowance should also be made by related expenditures by any central departments that have an involvement in the process.

Another element of transition costs which must be considered is the existence of any costs associated with the transition from one contractor to another. If such costs exist then it creates a barrier to entry for other firms. The existence of any such barriers limit the possibilities for market forces to impose pressure on incumbent firms to minimise their price.

- There are few linkages (including the flow of information) between the process being contracted out and the rest of the system.

Information is a commodity which market theory often prices at zero. In reality it is a valuable resource. System wide efficiency relies on the rapid flow of useable information between relevant parties. Contracting out has the capacity to reduce this flow of information as competing firms are unlikely to share it. Conversely, if such information is being shared then other problems, such as the likelihood of collusive conduct, emerge.

When assessing the benefits of contracting out an individual component of a complex production system it is therefore important to consider the implications for the flow of information. In most production processes the generation of information is a beneficial by product. In ceasing to undertake the process internally organisations also give up information which cannot be generated costlessly elsewhere in the production process.

- Monitoring costs are low

If any ongoing benefits are to arise from contracting out then the cost benefits associated with it must be less than any monitoring costs. Monitoring costs will increase with the complexity of both the task to be performed and the complexity of any performance criteria used. Other things equal, the boundary of the organisation should be determined by the minimisation of transaction costs (Quiggin 1996)

In summary, when products are homogenous and markets are competitive it could be assumed that contracting out would be successful. Although such markets flourish in economics textbooks, they are much less common in modern developed economies. Whilst many factors cause the observed divergence between observed market structures and the 'perfect competition' model, with regard to contracting out, one of the most important is the lack of perfect information.

Though the process being contracted out would appear to be a relatively simple one, government departments in Australia have had difficulties ensuring that building cleaning services have been satisfactory after contracting out has occurred (Industry Commission 1996). Attempts to apply a system of resource allocation which is incompatible with the conditions that surround the provision of that service will lead to a reduction, not an increase, in efficiency, especially in the long term.

The extraction of one component from an intricate system is possible, but not without an impact on other components. It is essential that when analysing any such proposal that these wider impacts are considered and fully costed.

When will contracting out be least likely to succeed?

Whilst the above conditions are necessary to extract the full range of benefits from contracting out, there are also circumstances in which contracting out is likely to reduce welfare. These include when significant market failure exist or when the nature of the service being tendered is such that it is impossible to achieve the necessary conditions simultaneously, for example, the multiple suppliers necessary to ensure price competition in the provision of a service may lead to a reduced flow of information between suppliers and customers alike.

The Australian government has recently contracted out the provision of job matching services (see Vardon 1997). Hundreds of private agencies compete to place unemployed people in jobs, with the agencies both charging employers for recruitment services and receiving a

payment from the government for the successful placement of an unemployed person. The scheme has several fundamental flaws.

The first problem is related to the importance of the flow of information in the provision of job matching skills if frictional unemployment is to be reduced. The competitive nature of the new system provides an incentive for individual agencies to hoard information about job opportunities so as to ensure that they can place an individual in the position. A rival firm may have a more suitable applicant ready to start, but the system of price signals hinders rather than encourages such a flow.

The second major problem is related to the use of 'cost recovery' from employers. The previous public system allowed employers to use the job placement system at no cost, effectively subsidising their search for employees. Small employers and employers seeking part time and casual staff have been reluctant to pay for the new privately operated service. Although efficiency, in the sense of cost minimisation has been achieved, the result has been to increase the reliance on other less efficient, forms of job advertising.

In this case, the need to have multiple contractors competing with each other to minimise cost is incompatible with the need to facilitate the flow of information between parties. Similarly, the previous system provided a subsidy to employers in their search for labour, and whilst the new system is more efficient in terms of cost recovery, it can be considered less efficient if benefits to society arise from improved labour market matching.

The usefulness of price signals

The provision of government services if often complicated by the diversity of objectives imposed on managers (Tinbergen 1967). High quality, equitable provision to different demographic groups (sometimes involving cross subsidy), cost minimisation, and employment maximisation can often be expected simultaneously from public sector managers. Similarly, one of the major advantages attributed to both contracting out and privatisation is that it provides managers with more specific objectives, and in turn, ensures a more efficient allocation of resources.

If appropriate incentives are used, and managerial efficiency improved, contracting out can improve service and reduce cost. The difficulty is in devising an appropriate system of incentives. The complex interaction of service quality, cost and equity does not disappear with the writing of a contract with a private sector provider. On the contrary, if the contract is written properly the government will have had to determine the relative weight to be given to each of these many facets of service provision before calling for tenders.

Private sector provision may provide increased discipline in managerial decision making, but it does not remove the complexities associated with multiple objectives. Whether the service is provided by the private or public sector, it is the public sector that must determine the balance between these objectives.

Similarly, in considering any cost reductions associated with contracting out decision makers should pay close attention to the source of any cost savings. If the private contractor has access to particular expertise or equipment which can improve the management or delivery of a particular service then efficiency may be expected to have increased. If, however, the process being contracted out provides little scope for innovation in the form of delivery then it can be expected that either quality will be reduced or work intensity increased. In such circumstances the decision to proceed must be determined on grounds other than economic efficiency.

Policy Recommendations and Conclusions

Contracting out provides governments with the opportunity to draw on private sector resources and experience to increase the efficiency of service delivery and in turn increase the welfare of citizens. Like any tool though, it should only be used in the appropriate

circumstances, as if it is used incorrectly it has the potential to reduce the quality of service provision and reduce the welfare of citizens.

Contracting out will be most effective when the quality of the services is easily identifiable, there is a large number of potential suppliers to ensure ongoing price competition, and the links between the service being contracted and the rest of the organisation are small. It is in determining the nature and extent of these linkages where policy makers must be most cautious.

The process of carefully appraising the provision of a particular service, combined with the drafting of a comprehensive, transparent contract is an essential, and potentially expensive, first step down the path to contracting out. Particular attention must be given at this stage to the way in which contract monitoring will be conducted, with consideration given to who will be responsible for the collection and collation of all necessary data. The process for determining the effectiveness of the contractor should be clearly specified in advance, as should the procedure that will be adopted in cases where performance does not meet the predetermined standards.

Finally, consideration must be given to just how private sector providers will be able to reduce cost. If it is through access to new techniques or expertise then efficiency gains in the broad sense of the word can be expected. If, however, private sector firms intend to rely on lower quality service provision, or increased intensity of work, then the desirability and equity of such changes must be carefully considered.

The insertion of private sector profit seeking will not, in itself, reduce the complexity of balancing the multiple objectives of the public sector. When the public sector can identify a discrete, quantifiable task within a complex system it may generate efficiency savings by relying on contracting out. But, if contracts are poorly written, quality poorly measured, and the links between the contracted service and the other functions of the government are not well understood then contracting out can lead to a reduction in efficiency and quality and a transfer from workers and customers to the contractors.

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