

# Contracting/outsourcing in the public sector

## Main factors determining their outcomes

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### ABSTRACT

*The purpose of this article is to explore the effectiveness of contracting/outsourcing as an alternative way of improving the quality of public service delivery in the Czech Republic and Slovakia. The findings from the research have been used to establish the trends of contracting/outsourcing when applied in the Czech Republic, Slovakia and even in other countries. Contracting/outsourcing has been considered to be the solution for poor public service delivery. In cases where governments have been struggling to achieve their mandate of efficient, cost-effective and timeous provision of public goods and services, contracting/outsourcing has been viewed as the most viable alternative. The private sector has been called upon to fill the gap regardless of the fact that they are profit oriented. Thus this article examines the effectiveness of contracting/outsourcing. The findings of the research reveal that contracting/outsourcing remains problematic unless the issue of accountability is reinforced so that it becomes not only real but also binding. Intervention strategies should focus on both processes and results if contracting/outsourcing is to play a positive role in public service delivery.*

### INTRODUCTION

Contracting/outsourcing public services to private sector and non-profit firms represents the most common types of alternative service-delivery arrangements in the Czech Republic and Slovakia. Relevant literature suggests that if, and only if the contracting/outsourcing is properly implemented, then there may be no need to improve individual choices, cost-

effectiveness, delivery quality, equity and expenditure control. The quality of contracting/outsourcing decisions starts to be more and more important because of the financial and economic crises in most countries in the world and consecutive need for greater public sector efficiency. This article provides data about results from contracting and outsourcing in the Czech Republic and Slovakia and tests the factors determining their success. Under contracting means externalisation of the delivery of public services and outsourcing refers to the externalisation of the supporting services in public organisations. Our research is supported by the Czech Grant Agency GACR under the contract No. P403/12/0366 Identification and evaluation of region specific factors determining outcomes of reforms based on NPM—the case of CEE.

## **THEORETICAL BACKGROUND**

Contracting/outsourcing stems from the organisational decision to make or buy goods or services (Prager 1994:176). Modern public organisations are expected to decide whether to produce goods and services internally or to contract them out. The guiding principle behind the choice is to increase efficiency, while maintaining or increasing the quality of delivery of a public service (Engelbeck 2004; Epstein 1984).

The potential benefits are mainly linked with improving cost-effectiveness and quality of services. Contracting may also increase individual choice and equity (Bailey 1999; Ovretveit 1995; Lane 2000). Such potential has not been fully confirmed by hard data. However, many empirical studies (e.g. Bel and Costas 2006) cannot even confirm the effect of the mode of production on costs, which has been the main positive argument for contracting. Moreover some authors stress the barriers to effective contracting/outsourcing as well as the negative impacts connected with the use of competition and contracting (Bailey 1999; Pollit and Bouckaert 2000; Lane 2000). Lowery (1998), for example, discusses three types of quasi-market failure of which two of them are; market formation failure and preference error. Both are closely connected with externalisation. Market formation failure results from a lack of competition, often due to the small number of potential suppliers for many public services. If privatisation merely substitutes a private monopoly for a public one, then savings will likely disappear after the initial contract. Preference error failure is connected with limited information, and one of its dimensions; the principal-agent theory will be discussed below.

According to Prager (1994:84), the general rule of public sector organisation is to “internalize operations to the point where the costs of further expansion are perceived to be greater than the costs of acquiring the components or services in the market.” In addition, production should be internalised when there is need for close control of the production process.

The theoretical basis for assessing the potential of contracting/outsourcing in developed countries comes from both management sciences and the new institutional economics (Gruening 2001). The latter views governmental decision makers as self-interest seeking individuals, working in an environment in which information asymmetry, bounded rationality and opportunism leads to problems of transaction costs and agency costs. Two core theoretical concepts important for evaluating the potential of contracting/outsourcing



shall be mentioned: principal-agent theory (Arrow 1985; Cooper, 2003; Kettl, 1993; More 1984; Pratt and Zeckhauser 1986) and the theory of transaction costs (Ferris and Graddy 1996; Prager 1994; Hirsch 1991).

Establishing and maintaining a legal contractual relationship between principal and agent is connected with many problems and risks. According to Shetterly (1998:23), this process occurs in three phases: pre-solicitation, contractor selection and contract management. All of these phases may be connected with classic "principal-agent" problem situation in which the relevant characteristics and actions of agents are not directly observable by principals. Arrow (1985:37) notes two subsets of the principal-agent problem: "moral hazard or the problem of hidden action and adverse selection or the problem of hidden information."

Moral hazard can occur in contracting because the behaviour of the private partner is imperfectly controlled. When behaviour is imperfectly controlled, it creates a situation where either shirking in performance of duties or inappropriate actions by the private partner adversely impacts on the goals of the public partner.

In the adverse selection problem, the private firm has some information that is not shared with the public sector organisation and uses that information to make decisions that affect the public organisation. The public organisation, however, cannot check to see if the information is serving the public interest. For example, consider a public sector organisation that wants to hire the best private partner. The private firms bidding for the contract know more about their own qualifications than the public sector organisation ever will, and this information asymmetry may render impossible a full ex ante evaluation of the private offers. Bailey (1999:290-292) examines the effects of such public services contracting problems.

According to More (1984:756-757), "The principal must weave these interrelated components into a contractual framework that, in mitigating the informational asymmetries and structuring rewards, prompts the agent to behave as the principal himself would under whatever conditions might prevail."

The transaction costs associated with contracting/outsourcing and the relationship of these costs to benefits derived from external delivery are essential elements of the contracting relationship. When contracting for services, governments incur contracting costs which are implicitly or explicitly part of the make or buy decision. The transaction costs are of two types: "those associated with the contract formation stage and those associated with the contract performance stage" (Hirsch 1991:56-57).

Changing service delivery involves changes to both production and management systems, all of which entail transaction costs. These changes require establishing new performance criteria, constructing monitoring systems, changing job responsibilities, and reducing the number of public employees. Activities such as crafting requests for proposals, establishing systems and protocols for reviewing proposals and selecting vendors, crafting contracts, negotiating with vendors, and installing contract monitoring systems must be undertaken before the internal delivery system can be taken off-line. These transaction costs are important to the make or buy decision. Different services have different levels of transaction cost factors, in part determined by asset specificity and ease of measurement explained by the transaction cost theory noted above.

## Contracting and outsourcing – do they have potential to help to respond to public sector fiscal constraints?

After the relatively long period of economic growth, the financial crisis in the US soon started to affect directly and indirectly almost all countries in the world. The growth of world economy and particularly the advanced economies had slowed down substantially in 2008, but went into deep recession in 2009. Some signs of returning to positive growth were visible from 2010, but recent fiscal problems of many countries signal that “the problem might not be over”.

The shift of the costs banded with the financial crisis to public finance has been referred to by Rosengard (2004) as fiscalisation of the financial crisis. This process is long, not very transparent and leads to the increasing fiscal non- equilibrium with the increasing the public deficit and public debt. Hoggart, Reis, Saporta (2001) estimated the fiscal costs related to the financial crisis, mainly systemic as 12,1% of GDP in the developed countries and 17,6% of GDP for transition and developing countries. In the case of the Asian financial crisis, they estimate these costs to be more than 40% of the GDP for Indonesia and Thailand. However, that was then. That was a financial crisis largely limited to emerging economies in Asia and South American states. This current crisis is different in both its impact and scale.

Deficit spending and process of quantitative easing cannot carry on indefinitely. It will have to be paid for and that means reducing spending and increasing taxes in the years to come. This will have an impact, in some countries a very large impact, on all areas of government spending in all countries. This problem was largely hidden as the emphasis was on avoiding a prolonged economic recession, but many authors (for example Dvorak, 2008 and 2010 in our case) immediately warned that it will have an increasing effect. Today we can clearly see that the situation is unfolding in that direction.

The crisis and its treatments created urgent need for revitalisation of public finance. Two standard types of measures (and their combinations) are hypothetically available for any government:

- increasing taxes and
- decreasing expenditures.

Both of them have been and are used by almost all governments involved. However, from the point of view of a standard economic theory it is not very advisable to increase the level of taxation during the recession or early recovery period. Moreover tax increases might even be more unpopular than well augmented and realised expenditure cuts. Thus, our view is that the main focus should be on expenditure side, where again, according to the theory, two options exist:

- lump sum (cross-sectional) expenditure cuts and
- efficiency improvements.

The hypothetical choice between these two options is very simple – focus on efficiency, because of the large scale pervasive effects of any lump sum cuts (limiting consumption, scale of services provide, etc.). From this point of view, efficiency increases derived from proper contracting/outsourcing decisions represents crucial part of public sector reforms everywhere.



# CONTRACTING AND OUTSOURCING IN THE CZECH REPUBLIC AND SLOVAKIA AND ITS RESULTS

In this part we provide existing data (collected mainly by our team) about the scale and results of contracting and outsourcing in the Czech Republic and Slovakia.

## Contracting local public services in Slovakia and Czechia

Our “team” has collected data on direct production and contracting of local public services in Slovakia and the Czech Republic covering more than a decade. Taking account of data limitations we have focused on the following selected services:

- maintenance of local communications;
- maintenance of public lighting infrastructure;
- management of cemeteries;
- waste collection and waste disposal;
- management of public parks and green areas.

Below we describe the Czech and Slovak situation using our original survey data, except where otherwise indicated, collected from 2000 to 2010. The data includes:

- a sample of 53 Czech municipalities, of varying sizes, from 2000
- a sample of 55 Slovak municipalities, of varying sizes, from 2001
- a sample of 100 Czech municipalities, from 2004, researched by Pavel (2007) with the support of Transparency International Czechia
- a sample of 17 Slovak municipalities, of the same size, from 2005
- data gathered by the 2006 research project (including our team) of Transparency International Slovakia; focusing on the relationship between the local public service delivery arrangements and costs efficiency of service delivery. The sample covered 100 Slovak municipalities.
- a sample of 28 Slovak municipalities, of varying sizes, from 2008
- a sample of 131 Slovak municipalities, of varying sizes, from 2009
- a sample of 141 Slovak municipalities, of varying sizes, from 2010

**Table 1 Percentage of contracted local public services**

Service	2000 CZE	2004 CZE	2001 SK	2005 SK	2006 SK	2008 SK	2009 SK	2010 SK
<b>Waste</b>	71	80	49	64	69	80	69	80
<b>Cemeteries</b>	42	26	27	12	16	13	29	50
<b>Public green areas</b>	45	24	16	18	33	14	21	49
<b>Communications</b>	31	38	21	41	45	38	36	52
<b>Public lighting</b>	23	60	30	35	40	39	50	35

Source: See 8 studies listed above.

**Table 2 Efficiency of contracting out local public services**

Service	2004 CZE	2001 SK	2005 SK	2006 SK	2008 SK	2009 SK	2010 SK
<b>Waste management</b>	137	94	94	125	184	100	138
<b>Cemeteries</b>	95	64	13	67	146	87	84
<b>Public green</b>	86	82	192	150	151	120	97
<b>Maintenance of local communications</b>	142	70	109	119	114	100	84
<b>Maintenance of local lighting</b>	118	100	138	128	156	104	103

Source: See 8 studies listed above. Note: efficiency is measured by comparing the cost of outsourced services to the cost of internal delivery (costs of internal delivery = 100).

Two main issues are included in all the above mentioned analyses: the frequency of use of contracting (Table 1) and the efficiency of contracting local public services, measured by the cost data (Table 2).

The data clearly shows that contracting out of local public services is very common in both countries. The results from contracting are contradictory, and there are several methodological problems, of which we are fully aware. The core problem is the reliability and complexity of the data provided by municipalities. In fact there is no full cost accounting at the local self-government level in Slovakia, and this devalues the cost data on internal service delivery. Some of the selected municipalities also use a mix of internal and external production for service delivery—in such cases we asked for data about the dominant delivery form.

We may conclude that our own primary research (Meričková, Nemeč, Vítek, 2005; Meričková, Nemeč, 2007; Meričková, Nemeč, Ochrana, 2008; Meričková, Nemeč, Šumpíková, 2010) as well as the studies by other researchers in this area (Balážová, 2006; Beblavý, Sičáková Beblavá, 2007; Fantová Šumpíková, Rousek, 2009; Ochrana, Nekola, 2009; Vozárová, 2011) indicate that contracting of public services in Slovakia and Czechia delivers less positive outcomes than the existing literature suggests as attainable.

## Outsourcing in Slovakia and Czechia

There is less data about outsourcing processes in the Czech Republic and in Slovakia – some samples are described on Tables 3 and 4.

We also tested results from outsourcing on the basis of our data from the Slovak Republic. The research (Table 4) was conducted by our team in 2008 and 2009 and focused on most important dimensions of outsourcing of selected internal services—cleaning, catering, maintenance, IT, transport, and security the scale of outsourcing, deciding about outsourcing and way of selecting supplier, costs and quality of outsourced services. On the basis of data obtained, we tried to compare efficiency of outsourced and in house produced services. The methodology was multifactor analysis, with the following main factors:

- unit costs per employee (weight 20%),
- unit costs per production unit – Table 5 (weight 20%),



**Table 3 Frequency of use of outsourcing of internal services – the Czech Republic, 2009**

Service	Number of responses	Percentage of outsourced services
Cleaning	158	6,96%
Catering	25	31,20%
Maintenance	132	11,36%
IT	125	38,40%
Transport	111	18,02%
Security	92	26,09%

Source: Own research

**Table 4 Frequency of use of outsourcing of internal services – Slovakia, 2009**

	Administration	Education	Health care	Social	Culture	Total
Catering	90,00 %	17,74 %	21,43 %	20,00 %	62,50 %	42,33%
Maintenance	27,59 %	14,52 %	35,71 %	42,86 %	25,00 %	29,14%
IT	25,00 %	27,59 %	42,86 %	25,00 %	37,50 %	31,59%
Transport	3,70 %	15,15 %	7,14 %	0,00 %	0,00 %	5,20%
Security	64,00 %	42,50 %	45,45 %	0,00 %	42,86 %	38,96%

Source: Own research, sample 127 organisations

- quality (weight 30%) – measured by satisfaction of users and
- method of awarding contracts to external supplier (weight 30%) – scale from 100 for open tender to 0 for direct award, in house production = 0).

**Table 5 Selected production units' indicators**

Service	Indicator
Cleaning	m2
Catering	Number of users
Maintenance	Number of actions
IT	Number of actions
Transport	Average km yearly
Security	m2 of protected area

Source: Own research

**Table 6 Weighted results – efficiency of internal versus outsourced services (four criteria)**

		Administration	Education	Health care	Social	Culture	Total
<b>Cleaning</b>	Internal	63,72	83,32	87,81	–	100,00	83,71
	External	100,00	100,00	100,00	–	94,85	98,71
<b>Catering</b>	Internal	57,65	50,40	100,00	40,65	55,50	60,84
	External	100,00	100,00	87,94	100,00	100,00	97,59
<b>Maintenance</b>	Internal	38,61	73,19	88,20	63,93	77,68	68,32
	External	100,00	100,00	100,00	100,00	100,00	100,00
<b>IT</b>	Internal	53,10	49,79	82,93	63,20	62,35	62,27
	External	100,00	100,00	100,00	100,00	100,00	100,00
<b>Transport</b>	Internal	98,38	55,20	66,66	–	–	73,41
	External	100,00	100,00	100,00	–	–	100,00
<b>Security</b>	Internal	59,88	48,34	72,54	–	51,60	58,09
	External	100,00	100,00	100,00	–	100,00	100,00

Source: Own research

**Table 7 Weighted results – efficiency of internal versus outsourced services (three criteria)**

		Administration	Education	Health care	Social	Culture	Total
<b>Cleaning</b>	Internal	94,88	82,48	100,00	–	100,00	94,34
	External	100,00	100,00	70,33	–	94,85	91,30
<b>Catering</b>	Internal	90,09	70,91	100,00	56,50	78,60	79,22
	External	100,00	100,00	87,03	100,00	100,00	97,41
<b>Maintenance</b>	Internal	53,06	100,00	100,00	91,01	100,00	88,81
	External	100,00	90,52	70,01	100,00	85,61	89,23
<b>IT</b>	Internal	75,16	69,76	100,00	63,20	62,35	74,09
	External	100,00	100,00	76,27	100,00	100,00	95,25
<b>Transport</b>	Internal	98,38	51,06	100,00	–	–	83,15
	External	100,00	100,00	93,00	–	–	97,67
<b>Security</b>	Internal	84,94	67,84	100,00	–	51,60	76,10
	External	100,00	100,00	85,16	–	100,00	96,29

Source: Own research





The planned sample was 300 public organisations from main sub-sectors—education, health care, social care services, culture and sport and general administration; unfortunately only 127 organisations responded (Table 4).

For purposes of this article, we do not provide all findings in absolute figures for all selected internal services (see Merickova *et al.* 2010). A summary of the data is presented in Tables 6 and 7.

Data obtained by questionnaires indicate that external delivery – outsourcing is more effective solution for most cases. But is this really true?

The first set of problems is, for sure, connected with our methodology, especially with the decision to evaluate in house production as fully non-competitive solution (value 0). To show the impact of such decision, we calculated results only for the first three criteria (Table 7). Weights for both cost indicators were set at 30%, while quality received 40%.

The second, even more important problem is the quality of cost data provided by public organisations. First, very few of them use accrual/full cost accounting and because of this fact, it is impossible for them to know the real costs (normally only direct costs are calculated). We will address this issue in the last part of this sub-heading.

If we abstract from above mentioned limitations, the data collected seems to tell that outsourced internal services are more effective. The consequence should be that outsourcing is the primary form of delivery. As indicated by the Table 4, the reality is different and efficiency gaps exist.

## **Testing the “quality” of contract management: contracting local public services in Slovakia**

The absence of systemic contract management is one of the core causes of failures of contracting (Hodge 2000; Sclar 2000; Brudney *et al.* 2005, Kamerman and Kahn 1989; Stejskal, Charbusky, 2004). The literature suggests that the following factors determine the success of contracting related to quality of contract management: the degree of competition in bidding for the contract (Savas 1987; Kettl 1993; Greene 2002; Hodge 2000, Pavel and Beblavá, 2008); the quality of the ex-ante evaluation of the contractor/agent (Rehfuss 1989; Marlin 1984; Romzek and Johnston 2002); the clear definition of the contracted/outsourced service – contract specification (Rehfuss 1989, Marlin 1984); the quality of contract monitoring (Rehfuss 1989; Marlin 1984; Prager 1994; Seidenstat 1999; Brown and Potoski 2003; Hefetz and Warner 2004); sanctions (DeHoog 1990; Macneil 1978); the experience of the public body/government/principal responsible for contracting/outsourcing with contract management (DeHoog 1990; Rehfuss 1989; Romzek and Johnston 2002); and the technical knowledge of the contracted service (Kettl 1993). More recent approaches to contracting stress relational contracting as a more flexible and cooperative approach to managing contractual relationships based on mutual trust, shared norms and values, and standards of behaviour. Such approaches also deal with communication and joint problem solving between principal and agent as determinants of contracting performance (DeHoog 1990; Sclar 2000; Macneil 1978).

Given this theoretical background, and also having consulted local experts, we decided to use the following set of factors (determined by the Deplhi method) to investigate the quality of contract management: x1 – level of competitiveness of the award, x2 – selection

**Table 8 Conversion to quantitative data**

Factor	Description	Points
<b>X1 – Level of competitiveness of the award</b>	Open tender	100
	Restricted procedure	70
	Negotiated procedure	50
	Price quotation	30
	Direct award	0
<b>X2 – Selection criteria</b>	Best bid	100
	Lowest price	50
<b>X3 – Frequency of monitoring</b>	Regular	100
	Irregular	50
	No monitoring	0
<b>X4 – Contract sanctions</b>	Cancellation of the contract	100
	Financial sanctions	70
	Right to request improvements	30
	Other	0
<b>X5 – Method of payment to supplier</b>	Performance payment	100
	Mixed performance and lump-sum payment	50
	Lump-sum payment	0

Source: Own original research

criteria, x3 – frequency of contract monitoring, x4 – sanctions, x5 – method of payment to supplier/agent. All the five factors have a qualitative character, thus we transformed them into quantitative data as follows (Table 8).

Our quality of contract management analysis uses the primary data gathered in our own 2009 research on 131 Slovak municipalities. The findings are set out in Table 9 and are not very positive. The average contract management score is about 60 (out of 100). Better results are normally received for soft indicators, where evaluation is based on the subjective opinion/response from the staff involved.

The core problem, visible from our findings, is that despite the fact that competition is the most important factor for success of externalisation (as all authors argue); this contract management factor receives lowest marks. Both Czech and Slovak municipalities avoid competitive contracting despite it being compulsory on the basis of the public procurement legislation. Such situations may be the typical problem for all developing economies, significantly undermining the chance for positive results from contracting and outsourcing in transitional countries.

**Table 9 Quality of contract management for contracting local public services**

Service	Competitiveness	Ex-ante evaluation	Monitoring	Sanctions	Payment conditions
<b>Waste</b>	42,84	67,12	70,32	42,08	65,65
<b>Public lighting</b>	47,11	72,73	65,26	45,20	63,72
<b>Local communications</b>	50,12	64,40	64,13	43,50	74,15
<b>Public green</b>	58,89	66,39	54,72	46,81	75,90
<b>Cemeteries</b>	29,43	68,27	64,29	45,18	45,79
<b>Average</b>	45,68	67,78	63,74	44,55	65,04

Source: Own original research

## CONCLUSION

The article provides information about the scale of contracting/outsourcing and their results and tests the quality of contract management for externalisation using concrete data from the Czech Republic and Slovakia. Contracting and outsourcing are a very common solution in public sector practice, for example dominating practice for waste management services in both countries. But their efficiency is limited. Our findings indicate that there are several important factors limiting success. The most important is probably the degree of competition for the contract. In both Czech and Slovak conditions very few contracts follow a competitive bidding process between would-be suppliers. Our findings cover more than a decade, and it is clear that this problem has not been completely eradicated. It remains a common problem for all transitional countries. To change this situation accountability needs to become a real value in our public-administration systems, and intervention has to focus not only on processes but also on results.

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