PM PUBLIC MANAGEMENT

January/February 2006 · Volume 88 · Number 1

FEATURES

Managing High-Risk Outsourcing

by Emanuele Padovani and David Young

Outsourcing is a strategy used by local governments in an effort to provide high-quality public services at a low cost. The underlying idea is that a locality can take advantage of a vendor's considerable experience and economies of scale. The result will be comparable or better-quality services than provided by the locality itself, at a reduced cost to taxpayers, while still allowing the vendor to earn a reasonable profit.

During the past three decades, local governments in both the United States and abroad have undertaken such disparate outsourcing activities as animal control, legal services, fire protection, trash collection, health care, snow plowing, building maintenance, bill collection, data processing, street cleaning, street repair, and recycling. Unfortunately, outsourcing has not always achieved the dual goals of high quality and reduced cost. In part, this is because of poor vendor management by localities.

The way in which a locality must manage its vendors depends on the risk associated with the outsourced activity. The purpose of this article is to present two frameworks that can assist local governments in outsourcing. The first framework is designed to assess the nature of the risk of a potentially outsourced activity. The second, on which we place most of our emphasis, comprises techniques that can be used to manage the vendor of a high-risk outsourced activity.

In this regard, it is important to note that many communities tend to avoid high-risk outsourcing. Yet, just because an activity is high-risk is not a good reason to avoid it; rather, it must be managed differently from a low-risk outsourced activity if it is to achieve cost-effective results for the citizenry.

Framework 1. Assessing Outsourcing Risk

The nature of risk in a potentially outsourced activity can be viewed from three perspectives: citizen sensitivity, the supplier market, and the costs of switching.

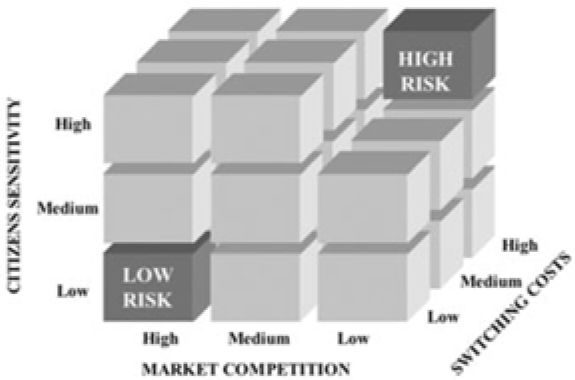
Citizen Sensitivity

From the citizens' perspective, a city's sanitation service clearly is much more important than, say, its publications department. Citizens are extremely concerned about the timely removal of waste and only minimally concerned about printing quality. In large part, this is because they are the final clients, so that, for the local government, the risk of nonperformance is much higher. As a result, any external outsourcing decision must weigh the impact of poor performance or nonperformance on residents.

Supplier Market

Competitiveness in the supplier market can range from many potential suppliers (high competition) to few, or perhaps only one, potential supplier. For example, there usually are many printing companies competing for a community's publication business, but there may be few vendors offering sanitation services or nursery schools. With only a few potential vendors, the community's ability to negotiate on price and features is low.

FIGURE 1. THE THREE DIMENSIONS OF RISK ASSESSMENT



Switching Costs

Occasionally, outsourced activities are carried out using some highly unusual resources that cannot be transferred easily from one vendor to another. When this happens, a community will have difficulty, and no doubt incur substantial costs, in replacing an existing vendor. Finding a new vendor for, say, a sanitation service or nursery school could be difficult because of a variety of investments that must be replicated if a new vendor is selected. In a nursery school, teachers have learned about the children's needs, established relationships with parents, and so forth. In instances like this one, the switching costs are high.

From the vendor's perspective, the cost of losing a contract can be great. For many high-risk outsourced activities, the vendor has purchased expensive equipment and incurred training and other start-up costs to carry out the contract. For this reason, if problems arise some managers will give the vendor time to improve; other managers may be unconcerned with the vendor's onetime costs and decide to use a new vendor before the situation worsens. Much depends on the terms of the contract and the nature of the relationship between the local government and the vendor.

In contrast, if a service like snow removal is outsourced, the locality's switching costs are likely low, as are the vendor's start-up costs. If one vendor does not perform according to the contract, the locality usually has little difficulty in replacing that vendor. Indeed, the city or county may have contracts with several other providers as well, to protect it from any sort of "vendor holdup."

The three dimensions of risk assessment are illustrated in Figure 1. As indicated, the low-risk cube embodies services such as a publication department, with a combination of low citizen sensitivity, high market competition, and low switching costs—a situation with a high probability of successful outsourcing and without the need for careful vendor management. A service like snow removal might fall into the upper-left, front corner, where citizen sensitivity is high but where a poorly performing vendor can be replaced easily and quickly.

At the other end of the spectrum (high citizen sensitivity/low competition/ high switching costs) are services for which outsourcing poses a high risk. An example was seen some years ago when the commonwealth of Massachusetts outsourced its Medicaid Management Information System, which mailed several hundred thousand checks each month to indigent citizens. Citizen sensitivity was high, and there were almost no vendors, other than the one chosen, having computer systems of sufficient size and sophistication to undertake the various activities needed (only one of which was sending out checks).

Moreover, because of the need to transfer software (or rewrite code, in some instances), plus the difficulty of moving data files from one vendor to another and performing needed audits, the switching costs were high. When the vendor went bankrupt, Massachusetts and several hundred thousand Medicaid recipients learned, quite painfully, the true meaning of high-risk outsourcing.

Framework 2. Managing High-Risk Outsourcing

Even though an outsourced service may fall into the high-risk area of Figure 1, it still may have considerable potential for improving the cost-effectiveness of public services. To achieve this potential, the local government must manage the vendor carefully. In some cases, vendors, while abiding by the “letter” of a contract, may make reductions in quality and features in an attempt to save costs. Or they may not be responsive to citizen concerns. Or they may attempt to raise switching costs to make it difficult for the local government to consider competitors at the time of contract renegotiation.

To address these sorts of problems, a city or county must focus on three distinct activities: performance measurement, ongoing communication and coordination, and links to the management control process. As Figure 2 shows, a high-risk outsourcing contract requires multiple performance measures; a high level of ongoing communication and cooperation to fill the gaps that are inevitable in any high-risk contract; and a full linkage with the management control system, including process measures concerning the contract manager’s activities.

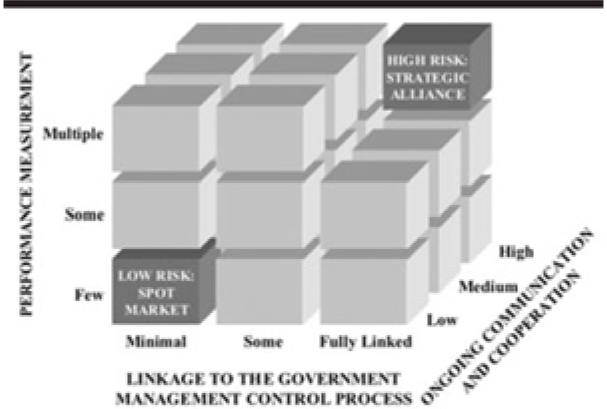
Performance Measurement

With high-risk outsourcing, contract monitoring must involve a variety of activities to ensure not only service effectiveness, but also responsiveness of the vendor to citizen needs and problems. These activities must include taking steps to ensure that problems are resolved quickly. In effect, a local government must shift from traditional *regulatory contracting* (whereby it specifies inputs, or processes, in detail) to *performance contracting* (whereby it simply states the outputs wanted and allows the vendor to determine the appropriate mix and quantity of inputs). Thus, the community is no longer concerned with processes, or their measures, but with the vendor’s ability to achieve the agreed-upon results at a lower cost than if it had undertaken the activity itself.

To illustrate, consider a decision by the department of public safety to outsource traffic-light maintenance. The department is unconcerned with how often the vendor inspects each plant or the efficiency of the vendor’s employees in conducting the inspections— both of which are process measures. Instead, the department focuses on such results measures as the percentage of operating traffic lights or the amount of time needed to restore a broken light. In effect, the department is purchasing functioning traffic lights, not inspections.

Clearly, not all types of results measures can be included in a contract. Many qualitative aspects, such as cleanliness in a street-cleaning contract or the effectiveness of an outsourced social service, can be measured by subjective evaluation only. Sometimes, surrogate measures of vendor performance can be used, like citizen complaints, length of assistance period, and so forth.

FIGURE 2. THE THREE KEY ACTIVITIES IN MANAGING HIGH-RISK OUTSOURCED SERVICES



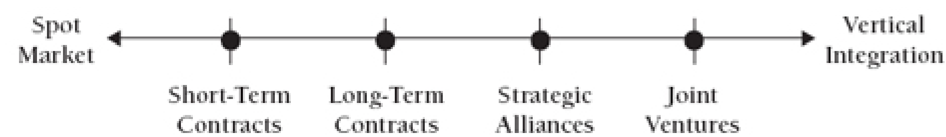
Finally, unless the community is careful, a vendor may develop a rigid focus on the results measures specified in the contract, rather than on creative thinking about how the service might be improved at no or minimal additional cost. To avoid this sort of focus, community staff must engage in ongoing communication and coordination with the vendors.

Ongoing Communication and Coordination

One characteristic of many high-risk outsourcing arrangements is that the contract cannot define all future contingencies, especially when the task to be completed is complex and evolving. Here, the relationship between the community and the vendor must be tightly linked, ideally characterized by mutual trust, altruism, cooperation, and a close working relationship. The range of possibilities is shown in Figure 3.

To illustrate, consider the outsourcing of some printing needs of a publications department. In a "spot market" relationship, a locality would make a one-time purchase of, say, 5,000 copies of a brochure about a youth program. It would call several local printing companies for bids and choose the lowest one, knowing from prior experience that the quality would be acceptable and the delivery made on time. Alternatively, the community might have some short-term contracts with several local printing companies to meet needs like this one. If one company were unavailable, a request to another could be made.

FIGURE 3. RANGE OF POSSIBLE CONTRACTUAL RELATIONSHIPS



Another possibility is a long-term contract with a single printing company, with the idea that the company would be the sole provider of printing needs. This sort of contract might evolve into a strategic alliance if the locality had some uncertain printing needs for which the vendor agreed to provide service as demanded without knowing in advance exactly what requests it would receive. The contract might be a loosely worded one, calling for, say, quarterly discussions and a settling-up of balances due.

Going even further, a joint venture might take place in which the company becomes a partner with the community and perhaps is guaranteed a certain percentage profit each year. Finally, vertical integration would exist if the community obtained all of its printing needs from an in-house department with no reliance on outside vendors. In effect, vertical integration returns the service to in-house provision.

More generally, with high-risk outsourcing, a shift to the right in Figure 3 (or to the rear in Figure 2) is essential to assure citizen satisfaction. While routine problems can be solved by daily contacts (phone calls, emails, and so on), structural problems (ones that are or could become repetitive) require a working relationship characterized by a high level of communication and coordination. In effect, with high-risk outsourcing, the working relationship between the community and its vendor is at least as important as the specific terms of the contract, perhaps more important.

Links to the Management Control Process

Outsourcing a service does not mean excluding it from a community's ongoing process of programming, budgeting, reporting, and evaluating. Changes in its strategy, for example, may mean that a vendor—as an integral part of the community—needs to consider new or different programmatic activities, such as a program to pick up recyclable waste or one to synchronize traffic lights along a major artery.

Similarly, if new programmatic activities will begin in the upcoming year, the budgeting phase of the management control process must incorporate a revised vendor budget; otherwise, the community's budget will be unrealistic. Perhaps most important, the various results measures for the outsourced services need to be an integral part of the reporting phase of the management control process, as does information concerning the department charged with managing the vendor. For this reason, the reporting phase focuses on both the results being produced by the vendor and the monitoring activities of the internal department. Otherwise, senior management may learn too late of emerging problems.

Finally, recognizing that outsourcing is a matter of trade-off choices, and that the environment in which these choices are made is constantly evolving, a local government needs to evaluate the outsourced service periodically. In part, this is because results measures may fail to capture some of the more subjective elements of citizen satisfaction. Also, however, for any number of reasons an outsourced activity may have moved from one cube in Figure 1 to another, which might call for a change in the outsourcing strategy.

Similarly, technology may have changed, such that it would be more beneficial to return from outsourcing to in-house service provision. Alternatively, it is possible that another vendor, working in another city or county, has developed some considerable expertise in the outsourced activity, such that a change in vendors would improve the quality of the service, lower its cost, or both.

In general, these sorts of problems and opportunities will not become apparent during day-to-day operations or even during the budgeting phase of the management control process. Ordinarily, only a thorough program evaluation can identify new opportunities or as-yet-unseen problems.

In short, when a community engages in high-risk outsourcing (the upper-left, rear corner of Figure 1) and wishes to assure its citizens that the savings realized from the outsourced activity are not matched by a reduction in service quality and features, it must develop an appropriate set of outsourcing- management activities. Given that a considerable number of outsourcing arrangements are of a high-risk nature, a focus on these activities is essential for those localities that wish to assure their citizens of effective services at a reasonable cost.

Emanuele Padovani, Ph.D., is assistant professor at Forlì Campus Facoltà di Economia, University of Bologna, Italy (emanuele.padovani@unibo.it). David W. Young, D.B.A., is professor of management in the public and nonprofit management program at the Boston University School of Management, and visiting professor at Forlì Campus Facoltà di Economia, University of Bologna, Italy (DWY204@cs.com).

This article is based on a paper prepared for the Ninth International Research Symposium on Public Management (IRSPM IX) held April 8, 2005, at Bocconi University, Milano, Italy.