Abstract

We discuss outsourcing risk in relation to different governance models, and provide a framework for classifying the risk related to an outsourcing choice. We argue that different kinds of outsourcing have different degrees of risk, and that the governance model needed for successful outsourcing is contingent on the nature and amount of that risk. As a result, municipalities need to use several different governance models, each attuned to the degree of risk of the service being outsourced. Moreover, a municipality's managers must be especially careful not to outsource a service unless they have the capability to manage the requisite governance model.

Key words

Outsourcing, municipalities, new public management, governance, risk assessment and contingency theory

A CONTINGENCY APPROACH TO MANAGING OUTSOURCING RISK IN MUNICIPALITIES

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INTRODUCTION

Many public sector organizations (PSOs), especially municipalities, rely on outsourcing as a way to increase their ''value for money'' (VFM) in providing public services. As a result, the topic of outsourcing has been addressed with some regularity in the public management literature for many years. Increasingly, attention is being directed toward the nature of the risk associated with an outsourced activity, and the resulting implications for a municipality's managers.

In this paper, we present a framework that managers of PSOs (mainly cities and towns, but also counties, provinces, and similar entities) can use to assess the nature of the risk they face in an outsourcing decision. We argue that, as the risk of an outsourced service increases, so too does the sophistication of the governance model needed to manage it. Thus, the decision to outsource a high-risk service must depend, in part, on whether the municipality has the capability to work within the more sophisticated governance model.

We begin by discussing the roots of outsourcing, with a particular focus on Considine's (1999, 2001, 2003) Four-Governance Model framework. We juxtapose his framework with our research in Italian municipalities that led to our framework for assessing outsourcing risk, arguing that a municipality does not need to have a single governance model, or even strive for the most sophisticated one. Rather, it needs several governance models operating simultaneously, each attuned to the risk associated with the outsourced service it is managing.

THE OUTSOURCING CONTEXT

In some countries, the impetus for outsourcing has been legislative, such as the U.K., where the Local Government Act of 1988 requires competitive outsourcing at the municipal level. Similarly, as part of its public sector reform initiative, New Zealand requires municipalities to use public-private competition to improve local public services. In Australia, where there is rapid growth in public-private partnerships, some states, such as Victoria, require that half of all local public service expenditures be submitted to competitive bidding.

A move toward outsourcing does not need a legislative mandate, however. In Italy, for example, although local government reforms *encourage* outsourcing, they do not require it, and, yet, some 67 percent of Italian local services are outsourced (Antonioli *et al*. 2000). Similarly, in the U.S., where there are no mandates, outsourcing has been increasing steadily for many years (Anthony and Young 2003).

Outsourcing and contemporary public management

Outsourcing is a logical consequence of efforts by PSOs over the last three decades to minimize waste and promote efficiency and effectiveness (Nolan 2001), shift toward greater managerial autonomy, promote competition through the development of contracts that decrease costs and increase quality, and move toward private-sector management approaches. It also is an essential element of what has been called the *New Public Management (NPM) Paradigm* (Hood 1991, 1995), or, more recently, the *New Public Governance (NPG) Model* (Box *et al*. 2001; Pollitt 2002; Cabrero 2005; Osborne 2006). Regardless of the paradigm or model chosen, however, outsourcing is a key element in efforts to transform governments into leaner, more effective entities—ones that ''can do more with less'' (Osborne and Gaebler 1992; Koppenjan and Klijn 2004). Managing it well is thus an essential activity for a municipality that wishes to provide its citizens with high VFM.

Outsourcing and the four governance model framework

Outsourcing also can be seen in the context of changes that have taken place in municipal governance in general. One description of these changes in western democracies is Considine's (1999, 2001, 2003) ''Four Governance Model Framework.'' Clearly, there are other frameworks that could be used to view outsourcing (Hutt and Walcott 1990; Peters 1996; Pierre 1999; English *et al*. 2005), but most are some variation of Consodine's.

Consodine's four models (procedural, corporate, market, and network) are shown in Table 1. As this table indicates, each model can be assessed in terms of its source of rationality, form of control, primary virtue, and service delivery focus. One logical conclusion emerging from the work of Consodine and others, is that, as a municipality expands its outsourcing activities, it must seek to evolve from the least sophisticated model (procedural) to the most sophisticated one (network).

Our findings contradict this evolutionary view. To see how, we must first briefly describe each of the models.

Model 1. Procedural governance

The procedural governance model (PGM) is characterized by centralized and hierarchical public administration, and is rule-bound, with protocols and defined

Table 1: The four governance models

Model	*Source of rationality*	*Form of control*	*Primary virtue*	*Service delivery focus*
Procedural governance	Law	Rules	Reliability	Universal treatments
Corporate governance	Management	Plans	Goal-driven	Targets
Market governance	Competition	Contracts	Cost-driven	Prices
Network governance	Relationships	Co-production	Flexibility	Brokerage

Source: Considine (2001).

practices. There is a strong top-down authority that requires layers of checking to reduce the likelihood of errors. This model is designed to guarantee standardized services at the lowest per-unit cost. The PGM was prevalent during a time when there was minimal outsourcing taking place in most municipalities.

Model 2. Corporate governance

The corporate governance model (CGM) emerged because of a perception that the PGM no longer fit with a variety of administrative requirements, mainly the need to maintain greater control over public expenditures (Pallot 1992; Pierre and Peters 2000). In addition, the PGM was not able to deal with the increasing complexity of government (Lapsley 1988) and with the need to target specific services for certain citizens, but not for everyone.

In the CGM, officials manage public organizations like private sector ones, and they give considerable importance to planning, budgeting, and reporting. They also concentrate on outputs instead of inputs, and they focus on specific groups of citizens to receive services. As a result, under the CGM, a PSO's emphasis shifts from adhering to arbitrary rules to achieving results.

Model 3. Market governance

In the market governance model (MGM), contracts are used for many services, and ''competition and *quasi* markets are relentlessly introduced into the public sector, and contracts underpin relationships within the sector, and those between the public sector and its private suppliers'' (English *et al*. 2005: 29). With this model, VFM is enhanced by stressing quality as well as cost, and by placing an increased emphasis on contracts, citizen needs, pricing, and competition (Pierre and Peters 2000).

The MGM may include arrangements with a commercial company, a public authority, a nonprofit organization, or all three (Goldsmith and Eggers 2004; Pollitt 2003). It promotes greater use of performance-based service contracting, thereby encouraging contractors to be innovative and seek increasingly cost effective ways to deliver services (General Accounting Office 2002).

In Australia, where the MGM began in the mid 1990s, various levels of government have introduced ''market discipline'' and ''best commercial practices.'' In some instances, the public sector has begun to use the ''corporate form'' for its public sector business activities, and in others, a governmental unit has been ''privatized'' by selling its assets to a private entity (Broadbent and Guthrie 1992).

Despite these advantages, the MGM has been problematic. Although it can create market dynamism and increased autonomy within the public context, and help ensure accountable managerial behaviour, it also can present difficult challenges (Osborne and Gaebler 1992). This is because, when a public agency outsources a complex good or service under the MGM, it needs to be certain that it measures the vendor's outputs (rather than inputs), and structures an appropriate set of reporting and feedback relationships. For many municipalities, this runs contrary to their long-standing, input-based, managerial cultures, and is a difficult transition to make.

Model 4. Network governance

Although the MGM strives to increase competition so as to help contain costs, it does not necessarily lead to high quality services, or to a tailoring of services to the needs of individual citizens. Further, when some outsourced services need to be coordinated with others, the MGM, with its heavy contractual emphasis, is too unidimensional.

The network governance model (NGM) is designed to overcome these difficulties. It does so, in part, by focusing on linkages between customers and suppliers, and thus is best able to respond to complex citizen needs. Indeed, because of these linkages, some have argued that if municipalities are to serve their citizenry most effectively, they must move toward the NGM (Mandell 2001).

The goal of the NGM is to combine a high level of public-private collaboration (characteristic of the MGM) with a robust network of service providers. To achieve this goal, PSOs first establish long-term relationships with their vendors. They then use sophisticated information technology to connect the entire network of vendors (and other involved organizations) so as to give citizens a wide range of service delivery options. Under the NGM, a key task of government is the management of these networks (McGuire 2002; McLaughlin and Osborne 2005).

The essence of the NGM, then, is cooperation among government, nonprofit, and (sometimes) private organizations to help ensure a high level of service coordination (Considine and Lewis 2003), and thereby a growth in a community's social capital (Moran 2005). In fact, the NGM has spawned a stream of research that extends beyond social capital, and into the realm of *relational* capital, a topic that has been explored considerably in the private sector (Sawhney and Zabin 2001), but with clear applicability to the public sector.

Relational capital is important if a municipality is to successfully outsource a complex set of activities, such as social services or pollution control, where it must develop partnership-like coordination, and invest in relationships that encompass a wide network of vendors. These relationships can include ''joint investments, shared research, common development ventures and flexible methods for linking financiers, regulators and a host of public and private service providers . . .'' (Consodine 2001: 30). They also can include the sharing of cost information with other public or private organizations. The goal is to meet a complex set of citizen needs in a highly cost-effective manner.

Unfortunately, as with the MGM, many municipalities are not prepared for the challenges posed by the NGM, which requires skills, knowledge, and technology that they do not currently possess. As a result, they have had varying degrees of success in managing their networks (Sorenson 2002; Goldsmith and Eggers 2004).

A STRATEGIC FRAMEWORK FOR OUTSOURCING

In all four governance models, municipalities are attempting to improve the quality and cost-effectiveness of their public services. However, as a municipality moves from the PGM to the NGM, there is an increase in the cost of governance, as well as in the skills and technology needed to manage the vendors. The question, therefore, is not which governance model is ''best,'' in some abstract sense, or whether all municipalities should be moving as deliberately as possible toward the NGM. Rather, from an outsourcing perspective, the question is which model is most appropriate for the particular service being outsourced. This question must be looked at in light of the potential for low quality and/or unduly expensive vendor performance.

Before selecting the most appropriate governance model, however, a municipality must decide whether to outsource some or all of its services. Part of this decision entails assessing the risk of unsatisfactory vendor performance, and considering what it might mean for the overall satisfaction of the citizenry. For example, if a city or town decides to have a youth program brochure prepared by an outside vendor, the citizenry most likely is unaware of, and unaffected in any significant way by, the outsourcing decision.

By contrast, when a vendor provides a service directly to the citizenry, rather than to the municipality itself, there is a considerable potential for citizen dissatisfaction. Waste collection, snow removal, and street repair are all examples of services where the citizenry is aware of the choices, directly affected by them, able to assess their quality (however subjectively), and concerned about the resulting cost. In these latter instances, despite its potential for enhancing VFM, outsourcing can be a tricky way to provide public services.

The need for risk assessment

Because of these differences in risk, a municipality must assess the risk associated with poor vendor performance anytime it is faced with an outsourcing decision. In the case of printing a brochure, for example, the risk is low. Clearly, quality specifications can be included in the contract, and the results can be easily monitored. But this is not the central issue. Rather, the question is ''what are the consequences of poor vendor performance?'' In the brochure decision, the answer is that it will have little impact on the citizenry, and the vendor can be easily replaced, if necessary, for future printings.

On the other hand, services such as waste collection, water and sewer provision, and traffic control have quality and service goals that are more difficult to measure and monitor. Moreover, poor vendor performance will directly affect the citizenry, and it may be difficult to replace a poorly performing vendor in a timely way. Clearly, the risk is higher.

A great deal of literature has emerged in recent years concerning outsourcing risk in both the public and private sectors. In some instances, risk has been largely of a *financial* nature, and has been assessed in light of the difficulty of providing services within a set of budgetary constraints (Ball *et al*. 2003). In others, it has been viewed in terms of a vendor's *capacity* to deliver the requisite services, or the *uncertainty* of the task to be performed (Venkateswar 2005). In still others, it has focused on the *logistics* of managing the vendor (Steane and Walker 2000). In all of these areas, a central issue has been the information asymmetry between the vendor and a municipality, which can lead the municipality to assume more risk than it realizes (Demetz 1968).

From the perspective of a municipality's outsourcing decisions, however, risk can be addressed more strategically. Here, the focus is on such matters as (a) increased dependence on external suppliers, resulting in a potential loss of control over critical activities; (b) greater difficulty in cost management, especially when there are adversarial relationships; (c) loss of essential competencies in the public entity, (d) loss of control over suppliers of the resources needed to conduct the outsourced activity, and (e) loss of flexibility in response to the needs of the citizenry (Kettl 1993; Quinn and Hilmer 1994; Domberger 1998).

Most of these latter concerns relate to the three-way juxtaposition of (a) sensitivity of the service to the citizenry, (b) the competitive nature of the ''market'' for vendors, and (c) the ease or difficulty of switching vendors (or returning to internal service provision) if a given vendor's performance is unsatisfactory (Padovani and Young 2006). With a brochure, for example, not only is there a low potential for citizen dissatisfaction, but the market is highly competitive, and the cost of switching from one vendor to another is low. By contrast, a service such as waste removal is highly important to the citizenry. Moreover, if the vendor's performance is unsatisfactory, the municipality may have difficulty finding a replacement—there may be few other vendors in the marketplace capable of performing the service – and the cost of switching from one vendor to another may be very high.

The interaction of these relationships is shown in Figure 1. As this figure indicates, from the perspective of these three dimensions of risk—citizen sensitivity, market competition, and vendor switching costs—some services will rather clearly fall into the high-risk category while others will be low risk. It is the juxtaposition of risk assessment in this figure with Considine's Four Governance Model framework that gives rise to our contingency approach.

Relationship to the four-governance model framework

An underlying theme of the Four-Governance Model Framework is that municipalities should be attempting to move along the spectrum from the PGM to the NGM. But this is not necessarily appropriate from the standpoint of outsourcing. Our research suggests

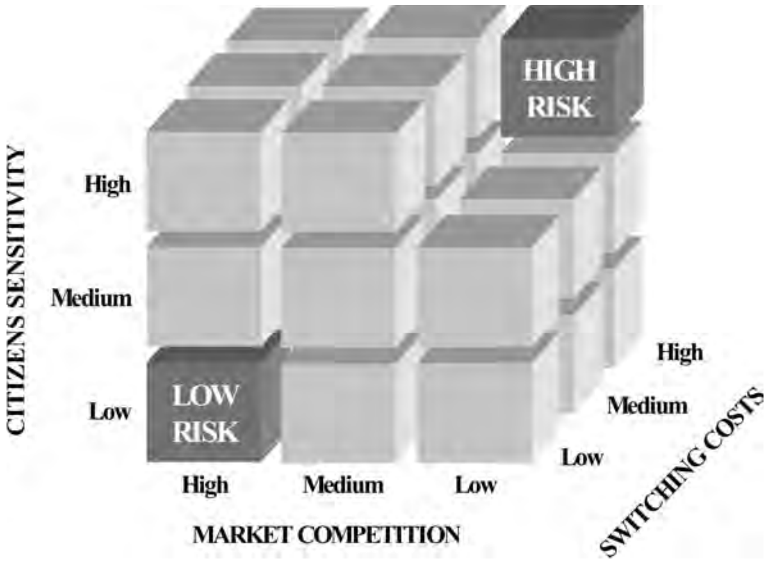

Figure 1: A framework for assessing risk
Source: Padovani and Young (2006).

that a municipality needs to assess the kind of service being outsourced, and then, given the risk, select the most appropriate governance model.

In effect, as shown in Table 2, different outsourced services require different governance models, and while some of a municipality's outsourced services may require the NGM, others may need only the low level of sophistication inherent in the PGM. For example, at the same time as a municipality is using the NGM for its social welfare services, it may use the PGM for very simple services, such as printing and mailing a brochure. In the latter, the risk of citizen dissatisfaction is nearly non-inexistent, vendors are plentiful, and they can be replaced easily if they don't perform well. Similarly, a municipality may need to use the CGM when it outsources services such as snowplowing, building or traffic light maintenance, or landscaping. These services have a moderate risk of citizen dissatisfaction, but the market is robust, and the municipality can change vendors relatively easily if performance is unsatisfactory.

Even services with somewhat high citizen sensitivity and moderate difficulty in switching vendors, such as street cleaning or waste removal, may not require the NGM. If there is no need for coordination among multiple vendors, the MGM may suffice. Indeed, the NGM, with its requirement for highly skilled managers and sophisticated technology, is needed only for complex, high-risk services, such as social welfare, housing, health care, or pollution control. With all of these services, citizen sensitivity

Table 2: Outsourcing risk and the four governance model

Governance model	*Kinds of risk*	*Overall level of risk*	*Examples*
Procedural governance	Low citizen sensitivity; high, market competition; low switching costs	Low	Printing a brochure; routine maintenance
Corporate governance	Low-medium citizen sensitivity; high-medium market competition; low-medium switching costs	Moderate	Building maintenance and repair; traffic-light maintenance
Market governance	Medium-high citizen sensitivity; medium-low market competition; medium-high switching costs	High	Street cleaning, waste collection; local tax collection
Network governance	High citizen sensitivity; low market competition; high switching costs	Very high	Social welfare services

Source: Authors.

is high and, because there is a complex network of relationships, changing vendors would be very disruptive, to both clients and the other vendors.

A dynamic process

Choosing the most appropriate governance model is not a one-time decision. Rather, as a municipality grows, and as its outsourced services increase in complexity, the associated risk is likely to increase, and it may need to shift to increasingly sophisticated governance models. Perhaps most importantly, however, before it decides to outsource a high-risk service, a municipality's senior management needs to make sure that it has the capability to use the requisite governance model.

This latter point suggests, perhaps counter-intuitively, a two-directional flow of causality in our contingency model for managing outsourcing risk. First, the appropriate governance model for a particular outsourced service depends on the degree of risk. Using the NGM for a low risk service, for example, is akin to shooting a fly with an elephant gun.

Second, the decision to outsource a high-risk service must depend, in part, on whether the municipality has the capability to operate the requisite governance model. To outsource a service that requires a high degree of coordination, but *without* possessing the managerial and technological capability for the NGM, may be a recipe for disaster. In the first instance, the cost of governance is excessive for the job at hand. In the second, insufficient (or inappropriate) resources are being devoted to the job, resulting in a potentially dissatisfied citizenry. Neither increases the municipality's VFM, and neither should be acceptable to its senior management team.

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