MANAGING HIGH-RISK OUTSOURCING IN MUNICIPALITIES

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Outsourcing is a strategy used by many municipalities in an effort to provide high quality public services at a low cost. The underlying theory is that by having an external vendor provide a service, a city or town can take advantage of the vendor's considerable experience and economies of scale. The result will be comparable or better quality services than provided by the municipality itself, at a reduced cost to the taxpayers, while still allowing the vendor to earn a profit.

During the past three decades municipalities have undertaken a wide variety of outsourcing initiatives, including such disparate 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. In Italy, where we conducted our research, extensive local government reforms that began in 1990 created an impetus toward outsourcing, such that, at present, some 27 percent of Italian local services are provided by privately-owned companies, and 40 percent are outsourced to companies owned by the public sector.[1]

Unfortunately, outsourcing has not always achieved a municipality's dual goals of high quality services at reduced cost. In part, this is because some municipalities have not managed their vendors as well as they might have. Yet, in many instances, an external vendor needs to be managed in much the same way the municipality would manage its own department if it kept the activity in house.

The extent to which a municipality needs to manage its vendors, and the techniques it uses to do so, depend to a great extent on the risk associated with the outsourced activity. The purpose of this paper is to present two frameworks that can assist a municipality's managers in outsourcing. The first can be used by a municipality's senior management and department heads to assess the nature of the risk they will face if they outsource a service. The second focuses on the activities that a municipality can use to manage the vendors of high-risk outsourced services.

FRAMEWORK #1. ASSESSING OUTSOURCING RISK

Some outsourced activities are almost risk free. If, for example, a municipality outsources its publications department, the quality and service goals can be stated relatively easily in the contract (e.g. turnaround time, maximum number of reworks, etc.), all of which can be monitored with little difficulty. Moreover, there is little risk to the citizenry because of poor vendor performance. By contrast, there are activities such as waste collection, water supply, street lighting, animal control, and many other services where the quality and service goals are more elusive and where the citizenry is more directly affected by a vendor's performance.

To identify the nature of the risk, a municipality's management needs to assess a service that is a candidate for outsourcing from three perspectives: citizen sensitivity, supplier market, and switching costs.

Citizen Sensitivity

From the citizens' perspective, a municipality's sanitation service clearly is much more important than, say, its publications department. Citizens are very concerned about the timely removal of waste and only minimally concerned, if at all, about printing quality. In large part, this is because they are the final clients, such that, for the municipality, the risk of non-performance is much higher. As a result, any external outsourcing decision must weigh the impact of poor performance or non-performance on the municipality's citizenry.

Supplier Market

The supplier market can be characterized by its degree of competitiveness, ranging 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 municipality's publication business but there may be very few vendors offering sanitation services or nursery schools. As the number of potential vendors decreases, the ability of the municipality to negotiate with them declines, as does its ability to benchmark performance.

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1 For additional details, see Antonioli, B., Fazioli, R. and Tiraoro, L.,, "La struttura dei costi per il servizio di raccolta e smaltimento dei rifiuti in Italia: un'analisi econometria", *Laboratorio Servizi Pubblici Locali*, working paper n. 5, Nomisma, Bologna, 2000.

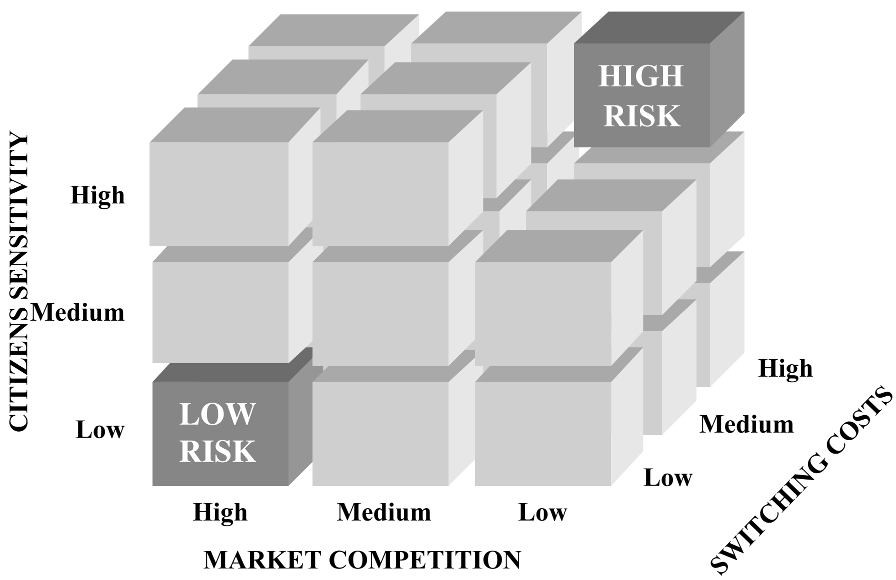
Switching Costs

Occasionally, outsourced activities are carried out using a mixture of unique resources, which cannot be transferred easily from one vendor to another. When this happens, a municipality will have difficulty, and no doubt incur substantial costs, in replacing an existing vendor with a new one. For example, finding a new vendor for, say, a sanitation service or nursery school could be quite difficult, due primarily to a variety of investments that will need to be replicated if a new vendor is selected. A sanitation service vendor no doubt has established efficient routes for its vehicles, has determined how many vehicles it needs on each route due to the average volume of waste to be removed, perhaps has established relationships with certain citizens for specific kinds of waste removal, and so forth. In a nursery school, teachers have learned about children and their needs, have established relationships with parents, and so forth. In both instances, as well as in many other similar ones, the switching costs would be high.

By contrast, if a service such as snow removal is outsourced, the switching costs are likely quite low. If one vendor does not perform according to the contract, the municipality usually has little difficulty replacing that vendor with another. Moreover, a municipality may have contracts with several vendors to protect it from any sort of "vendor holdup."

The three dimensions of risk assessment are illustrated in Exhibit 1. As this exhibit indicates, the low-risk cube embodies services such as a publications with a combination of low citizen sensitivity, high competition, and low switching costs. These situations have a high probability of successful outsourcing without the need for careful management of the vendor. Similarly, a service such as snow removal might be in the upper left, front corner, where citizen sensitivity is high but where a poorly performing vendor can be replaced easily and quickly.

Exhibit 1: The Three Dimensions of Risk Assessment



At the other end of the spectrum (high citizen sensitivity-low competition-high switching costs) are services for which outsourcing is more risky. In most of these cases, the vendor needs to be managed much like the city or town would manage its own department.

An example of the nature of the risk in a high-risk contracting strategy was seen some years ago in the United States. The Commonwealth of Massachusetts had outsourced its Medicaid Management Information System, a system that mailed several hundred thousand checks each month to the state's indigent citizens. Citizen sensitivity was high, there were almost no vendors other than the one chosen that had computer systems of sufficient size and sophistication to undertake the various activities (only one of which was sending out checks), and, due to the need to transfer software (or rewrite code in some instances), plus the difficulty of moving data files from one vendor to the next and performing the necessary audits, the switching costs were high. When the vendor went bankrupt, the Commonwealth and several hundred thousand Medicaid recipients, learned quite painfully what "high risk" really meant.

FRAMEWORK #2. MANAGING HIGH-RISK OUTSOURCING

Even though a service lies in the high risk area of Exhibit 1, it may still have considerable potential for improving the cost-effectiveness of a municipality's operations, To achieve this potential, however, the municipality must manage it carefully. In some cases, for example, vendors, while abiding by the "letter" of the contract with the municipality, have made reductions in quality and features in an attempt to save costs. Other vendors may not be responsive to citizen concerns. Still others may attempt to raise switching costs to make it difficult for the municipality to consider other vendors at the time of contract re-negotiation.

To address these sorts of problems, a municipality must focus on three separate but interrelated managerial activities: performance measurement, ongoing communication and coordination, and linkages to the municipality's management control process.

Performance Measurement

As the Massachusetts example illustrates, with high-risk outsourcing, simply monitoring a contract is not enough. Rather, monitoring must be supplemented with a variety of other activities to ensure not only effectiveness, but responsiveness of the service provider to citizen needs and problems (including taking steps to ensure that problems are resolved quickly).

In addition, as it moves northeast and toward the rear in Exhibit 1, a municipality must be increasingly focused on exactly what it is purchasing from a vendor. In this regard, it must begin to differentiate between inputs and outputs. With traditional *regulatory contracting*, a municipality specified the inputs (or processes) in detail. By contrast, with *performance contracting,* a municipality simply states the outputs the vendor is to provide, and allows the vendor to determine the appropriate mix and quantity of inputs.

Defining Output. A shift to performance contracting requires a municipality to define output in operational terms, and to distinguish among social indicators, result measures and process measures.[2] A *social indicator* is a broad measure of output that reflects changes in societal conditions. Typical examples of social indicators that reflect improved societal conditions are reductions in the crime rate, the percentage of effluents in the air, and the suicide rate. Similarly, measures such as increases in health status, education, and housing conditions also reflect improvements in societal conditions.

In general, a social indicator is affected by both external forces and the activities of many different organizations, not just a single vendor. As such, it is useful to a municipality's elected officials and senior managers for strategic planning, but is not especially helpful for vendor monitoring.

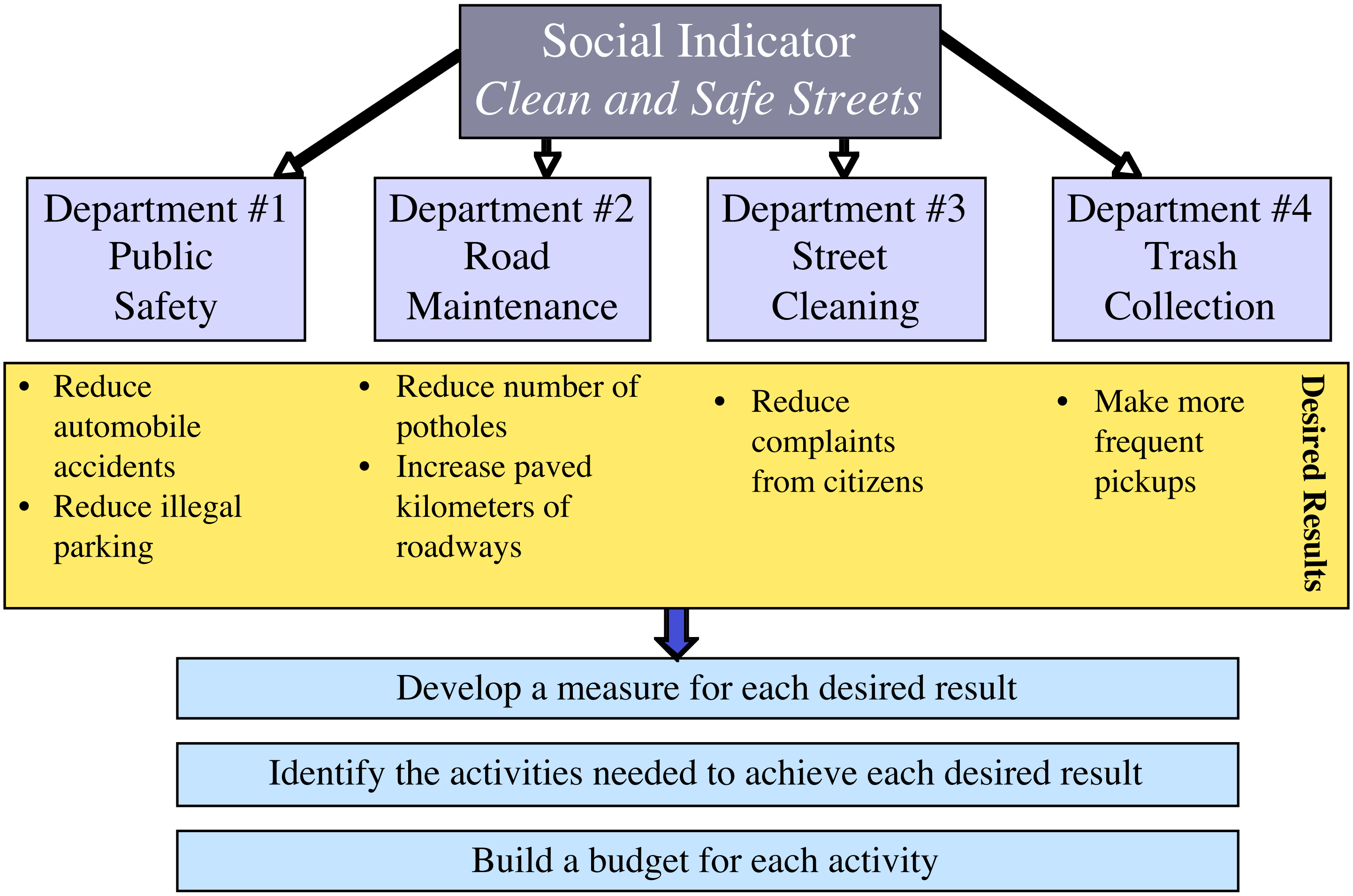
By contrast, *result measures* express output in terms that are related to the municipality's goals. They measure the services provided to citizens and are a direct result of the activities of a municipality's department or the vendor to which the department has outsourced a service. Typical examples are number of passengers of a urban transport service, amount and quality of street cleaning, tons of waste collected, and gallons of water distributed.

Finally, *process measures* refer to activities that are the department's or vendor's means to accomplish the results. For example, number of maintenance interventions, number of documents processed in a office, number of hours dedicated to inspections by a department of public health, number of applications processed in a nursery school, and so forth.

Linking the Measures. Prior to any outsourcing decision, a municipality's senior management must undertake the very difficult analysis of how each department's results contribute to an improvement in the municipality's strategic aims (as measured by its social indicators). An example of how this activity might be done for the strategic aim of clean and safe streets is shown in Exhibit 2. As this exhibit indicates, achieving the strategic aim requires a coordinated effort among several different departments. The municipality's senior managers must determine how the services of each department contributes to the social indicator. They then must determine the desired results from each department, and develop a corresponding set of results measures for each.

2 For an in-depth discussion of these three types of measures see, Anthony, Robert N. and David W. Young, *Management Control in Nonprofit Organizations, 7th edition,* Burr Ridge, IL, McGraw-Hill Irwin, 2003.

Exhibit 2. Linking the Three Types of Measures in a Municipality: An Example



As Exhibit 2 also shows, there are three domains at work. The strategic aims and accompanying social indicators lie within the domain of the municipality's elected officials. They presumably know what their constituents want, and where tradeoffs can be made most appropriately.

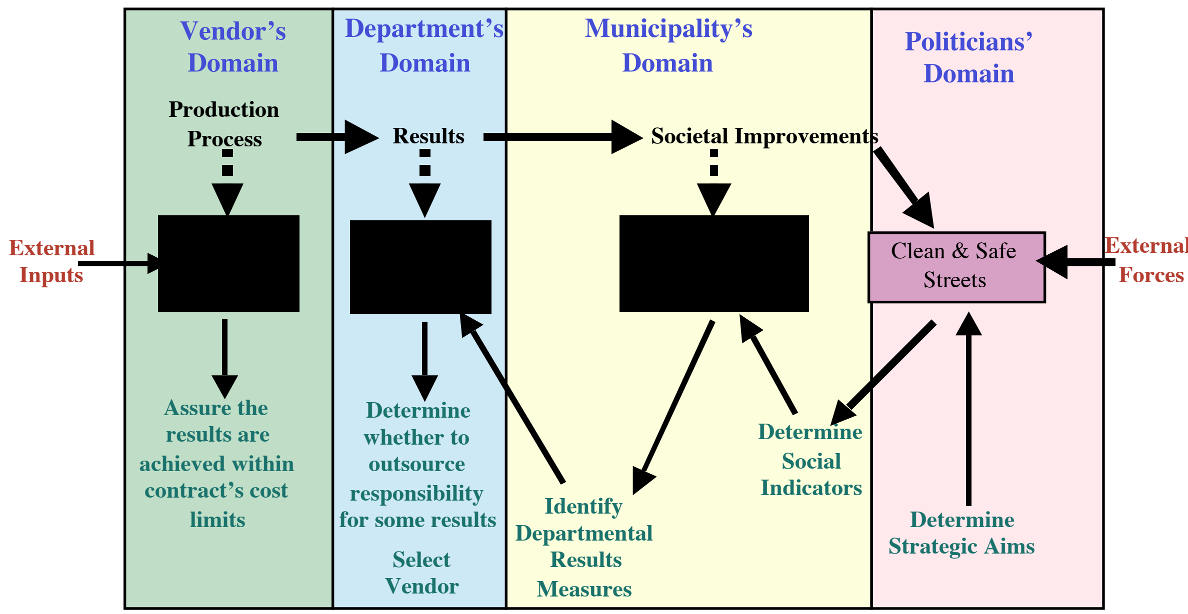
Once strategic aims have been chosen, the municipality's senior management must consider how each department can contribute toward progress in achieving them. In this second domain, the municipality's senior management determines the relevant departments to accomplish the strategic aims, sets the goals for each, and specifies the relevant results measures.

Finally, once the goals and results measures have been developed by senior management, each department must determine the activities or processes it needs to undertake to achieve the desired results. Each department then must select a series of process measures to assess its efficiency in achieving the desired results. The department's domain also includes building a budget based on these activities and process measures.

It is at this point that the outsourcing decision becomes relevant. That is, in some instances, as it engages in its budget formulation effort, a department may decide to outsource an activity, presumably because of the cost savings that outsourcing can achieve while providing comparable or improved service quality.

As Exhibit 3 indicates, when it decides to outsource an activity, a municipal department has created a new domain—that of the vendor. When this happens, the department is no longer concerned with process measures, but rather with the vendor's ability to achieve the results for which it is responsible, and at a cost that is less than what the department would have incurred had it undertaken the production process itself.

Exhibit 3: The Impact of Performance Contracting



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."

At the same time, the department needs a model that links functioning traffic lights to some of the results for which it is responsible, such as, say, a reduction in traffic fatalities, fewer accidents at intersections with traffic lights, a smoother flow of traffic during rush hours and hence a reduction in fuel use. Of course, some of these "results" border on social indicators, and some are affected by the activities of other departments, such as street maintenance, or by external conditions, such as weather, driving habits, use of seat belts and air bags in automobiles, and so forth. Nevertheless, all of these elements factor into the department's, and hence the municipality's thinking about achieving its strategic aim of clean and safe streets. The department in charge of traffic light maintenance plays only a small part in this bigger picture.

Clearly, not all types of result measures can be in a contract. Many qualitative aspects, such as "cleanliness" in a street-cleaning contract or the quality of an outsourced social service, can be measured by subjective evaluation only, and cannot be clearly stated inside the contract. Sometimes, surrogate measures of vendor performance can be used, such as citizen complaints about cleanliness, number of people who request assistance, length of assistance period, and so forth, but in general some results measures cannot be easily written into a contract.

Finally, unless the municipality 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.[3] For example, it would be extremely difficult to include a focus on continuous quality improvement (CQI) in a performance contract since the associated results measures would be quite elusive. To obtain a CQI focus, a municipality must rely instead on ongoing communication and coordination with its vendors.

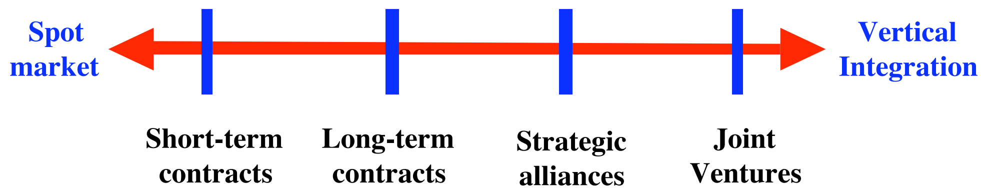
Ongoing Communication and Coordination

The relationship between a municipality and a vendor depends to a great extent on the nature of the contract. Sometimes, contract terms are relatively unambiguous, and, other than administrative transactions, no ongoing communication with the vendor is needed. At other times, the contract cannot define all future contingencies, especially

[3] For additional discussion of this point, see Behn, R.D., Kant, P.A., "Strategies for avoiding the pitfalls of performance contracting", *Public Productivity & Management Review*, 22 (4), June 1999). See also Domberger, S., "*The Contracting Organization. A Strategic Guide to Outsourcing*", Oxford University Press, New York. 1998.

in situations where the task to be completed is complex and evolving. Here, the relationship between the municipality and the vendor may be more tightly linked, perhaps characterized by mutual trust, altruism, cooperation, and a close working relationship. The range of possibilities is shown in Exhibit 4.

Exhibit 4: Range of Possible Contractual Relationships



To illustrate, consider the printing example discussed earlier. In a "spot-market" relationship, a municipality might wish to 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-priced one, knowing that the quality would be acceptable and the delivery on time. Alternatively, the municipality might have some short-term contracts with several local printing companies to meet needs such as this. If one company were unavailable, a request, to another could be made.

Another possibility is a long-term contract with a single printing company, with the idea that the company would be devoted exclusively to the municipality's printing needs. This sort of contract might evolve into a strategic alliance if the municipality had some uncertain printing needs in which the vendor agreed to provide services as demanded without knowing in advance exactly what kinds of 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 between a municipality and a printing company where the company becomes of a partner with the municipality and perhaps is guaranteed a certain percentage profit each year. Finally, vertical integration would exist if the municipality obtained all of its printing needs from an in-house department with no reliance on outside vendors.

Nature of the Task. In assessing an outsourcing possibility, department managers must consider the nature of the task. As the task becomes higher risk, in terms of the framework shown in Exhibit 1, it is likely that a shift to the right in Exhibit 4 would be beneficial. In effect, the working relationship between the municipality and the vendor becomes more important than the specific terms of the contract.

In effect, communication and coordination between the municipality and its vendor has the objective of remedying problems that could cause citizen dissatisfaction. These problems may be either routine or structural, based on their repetitiveness. While routine problems can be solved by daily contacts (phone calls, E-mails, etc.), structural problems require a working relationship characterized by a high level of communication and coordination.

Linkages to the Municipality's Management Control Process

Outsourcing a service does not mean excluding it from a municipality's ongoing process of programming, budgeting, measuring and reporting, and evaluating.[4] Changes in the municipality's strategy, for example, may mean that a vendor needs to consider new or different activities, such as a program to pick up recyclable waste, or one to synchronize traffic lights along a major artery. Similarly, the budgeting phase of the municipality's management control process must incorporate the vendor's budget; otherwise the municipality's budget will be incomplete.

Perhaps most importantly, the various results measures for the outsourced services need to be an integral part of the measurement and reporting phase of the management control process, as do measures concerning the municipality department's monitoring activities. As a result, the measurement and reporting phase focuses on the results being produced by the vendor, and on the department within the municipality charged with managing the vendor. Otherwise, the municipality's senior management may learn too late of emerging problems.

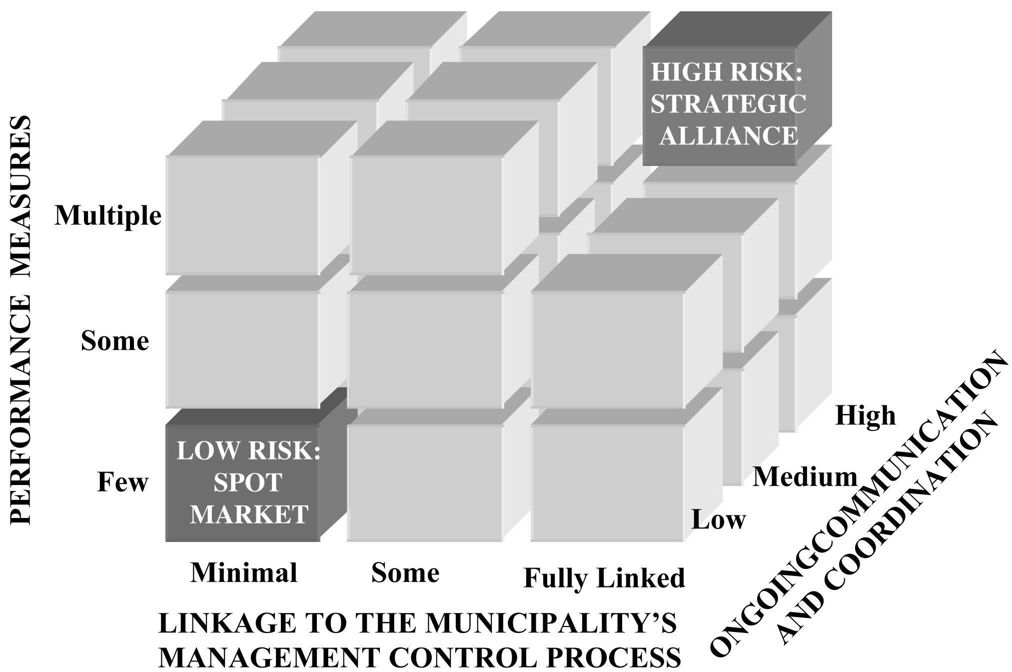
[4] For a description of this process in municipalities and other nonprofit organizations, see the Anthony and Young text cited earlier.

Finally, recognizing that outsourcing is a matter of tradeoff choices, and that the environment in which these choices are made is constantly evolving, a municipality needs to undertake a periodic evaluation of the outsourced service. In part, this is because even the best-designed set of results measures may fail to indicate whether the citizenry is satisfied with the service as it currently is operating. Also, however, for any number of reasons, an outsourced activity may have moved from one cube in Exhibit 1 to another, and this might call for a change in the municipality's outsourcing strategy. Similarly, technology may have changed, such that it would be more beneficial for the municipality to shift from in-house to outsourcing or vice versa. Finally, it is possible that another vendor, working in another municipality, 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/or opportunities will not become apparent during day-to-day operations, or even during the annual budgeting phase of the management control process. Municipal managers have much on their minds and many demands to meet. For perfectly understandable reasons, they frequently are unaware of the sorts of changes that might affect the economics of an outsourcing decision. Ordinarily, only a thorough evaluation can bring new opportunities or as-yet unseen problems to light.

A conceptual framework that includes these three perspectives is shown in Exhibit 5. As it indicates, a high-risk an outsourcing contract requires strong 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 municipality's management control system (including process measures concerning the contract manager's activities).

Exhibit 5: The Three Perspectives for Managing Outsourced Services



In short, when a municipality engages in high-risk outsourcing (the northeast, rear corner of Exhibit 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 many outsourcing arrangements are of a high-risk nature, a focus on these activities is essential for municipalities who wish to assure their citizens of effective services at a reasonable cost.