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Outsourcing in the Public Sector

by

Honor Figgis and Gareth Griffith

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Gareth Griffith and Honor Figgis

NSW PARLIAMENTARY LIBRARY RESEARCH SERVICE

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EXECUTIVE SUMMARY

This paper presents a brief survey of contemporary arguments and research findings concerning **outsourcing** or **contracting out** in the public sector. Outsourcing is an arrangement whereby a contracting agency enters into a contract with a supplier from outside that agency for the provision of goods and/or services which typically have previously been provided internally. It is often combined with competitive tendering for the contract to provide the goods and services (pp 1-2).

While governments have always purchased some goods and services externally, in the last two decades there has been a movement to the wholesale use of competitive tendering and outsourcing as a tool of public management. These reforms have been driven both by budgetary pressures requiring reduced government spending, and by the influence of economic theories about public administration. **Policies on contracting out** have been adopted by the Commonwealth government and most State governments. Labor and Liberal/National governments have both supported the use of competitive tendering and contracting, although conservative governments have generally been more disposed to favour its use on theoretical grounds as a preferred method of service delivery. In New South Wales the use of competitive tendering and contracting has been growing rapidly; reported expenditure on contracting in the public sector in 1995-1996 was \$1.76 billion (pp 2-10).

The paper outlines some methodological and other considerations in assessments of the benefits and savings from contracting out (pp 10-13), and summarises some recent surveys on the **empirical findings** of studies of public sector contracting. Some studies report considerable savings and increased efficiency, while others find no benefit or even increased costs resulting from tendering and contracting (pp 13-16).

The **advantages** of contracting out include the potential for: cost savings; increased accountability of service providers through contract specifications and performance measurement; better work and management practices; access to greater skills, knowledge or technology; better use of capital and equipment; better service quality; greater flexibility in services; local industry development; and fewer industrial relations issues (pp 16-22).

The **disadvantages** of contracting out include the potential for: reduced accountability of government for contracted services; loss of privacy and confidentiality of personal information; collusive tendering and other tendering problems; loss of control by the government over the contracted services; reductions in quality of services; the costs of outsourcing; savings to government resulting from losses to other groups, rather than from increases in efficiency; and the effects on levels of employment and on the wages and conditions of employees of contractors (pp 22-29).

The question of **what kinds of government services should be outsourced** depends on one's theoretical perspective on issues such as the extent to which the private sector should be involved in the provision of government services. It also depends on practical considerations as to what services can successfully be outsourced, in the sense that the desired cost savings and service quality will be achieved. The paper includes guidelines on assessing the scope for competitive tendering and contracting published by the New South Wales Service Competition Project Advisory Committee of the Council on the Cost of Government (pp 30-32).

1. INTRODUCTION

The purpose of this paper is to present a brief survey of contemporary arguments and research findings concerning what is variously called 'outsourcing' or 'contracting-out' in the public sector. It does not make recommendations or form conclusions on any of the matters raised.

This paper begins with a definition of outsourcing and the reasons for its use (pp 1-2). It then outlines the history of public sector outsourcing in Australia, both at the Commonwealth level and in the States (pp 2-10). The findings of various studies and surveys are summarised in the section on empirical findings (pp 13-16), along with a discussion of the problems of measuring and assessing the costs and benefits of outsourcing (pp 10-13). The next sections outline the arguments for (pp 16-22) and against outsourcing (pp 22-28). The paper includes some guidelines on assessing the scope for putting government services to tender (pp 30-32). The appendix to this paper contains a summary of the results of a 1996 study on contracting in the New South Wales public sector.

2. DEFINITION AND RATIONALE

The Industry Commission's January 1996 report, *Competitive Tendering and Contracting by Public Sector Agencies*, include the following definition of the term 'contracting out':

An arrangement whereby a contracting agency enters into a contract with a supplier from outside that agency for the provision of goods and/or services which typically have previously been provided internally - not necessarily involving competitive bids. Also called 'outsourcing'.¹

Thus, while contracting out is often associated, practically and in theory, with 'competitive tendering', the two terms do not appear to be coterminous. The same report defines competitive tendering to mean, 'The process of selecting a preferred supplier from a range of potential contractors by seeking offers (tenders) and evaluating these on the basis of one or more selection criteria'.² Often in the literature the term 'competitive tendering and contracting' (CTC) is used to describe the general trend in public and private sector management associated with outsourcing.

The above definition of outsourcing was formulated with the public sector in mind; hence the reference to 'agency'. With the substitution of 'company' for 'agency' it could be applied to the private sector. As for the rationale for outsourcing in the private sector, this is explained as follows:

¹ Industry Commission, *Report No 48 - Competitive Tendering and Contracting by Public Sector Agencies*, 24 January 1996, p xix. (Henceforth, *Industry Commission Report*)

² Ibid.

Company analysts in big firms often take a 'make or buy' decision, judging whether it is better for the company to build (or do) something with their own workforce, or to purchase it from outside. Traditionally, this has often been done with materials, parts, machines and so forth. Now...it is being done with services and knowledge work. It has become possible to outsource practically anything, and companies are moving to do just that in many areas which are not their 'core business', that is, those areas of special skills which define their uniqueness. It has become especially popular to outsource activities which require specialized skills, such as data processing.³

The rationale for competitive tendering and outsourcing (CTC) in the public sector has been explained in these terms:

The adoption of CTC essentially represents a switch towards market discipline in the delivery of services, involving greater separation between client/purchaser and provider/producers, coupled with a formal 'contractual framework' which establishes those dimensions of performance - principally price and quality - which form the basis of the transaction.⁴

In the private and public sector alike, the bottom line is the claim that outsourcing saves money.

3. PUBLIC SECTOR OUTSOURCING IN AUSTRALIA

3.1 Background to public sector outsourcing

In the last two decades, businesses have been reviewing and restructuring their operations in response to a changing world economy. Many firms have responded to these pressures by concentrating on their core functions and 'farming out' their ancillary activities to external service providers. Activities which have been contracted out in this way have included legal and accounting services, catering, security, cleaning, building or equipment maintenance, and information technology.

In the 1970s and 1980s many governments began to re-evaluate their role, and to examine which activities governments should be engaging in, and how they should be carried out.⁵ Faced with growing demand for government services in a time of economic uncertainty, governments began to look for ways to increase efficiency. Practices from the private sector, such as outsourcing, were introduced on a substantial scale into the public sector. The

³ WD Engelke, 'Outsourcing perspectives - part 1', <http://www.hsv.com/writers/engel/sou1.htm>

⁴ S Domberger and C Hall, 'Contracting for public services: a review of antipodean experience' (1996) 74 *Public Administration* 129 at 130.

⁵ Ibid at 129.

United Kingdom, United States and New Zealand were in the forefront of these reforms, and Australia quickly followed suit. The range of government activities which have been contracted out in Western countries include building and equipment maintenance, cleaning, catering, prison management, information technology, telecommunications, waste management, mail services, printing, training, legal services, security, library services, property management, policy advice, payroll and accounting services, economic forecasting, determining or administering welfare entitlements, auditing, recruitment, collecting revenue, health care, home and community care, and transport.

The Commonwealth Government and most State governments have implemented formal policies and guidelines on competitive tendering and contracting. During the 1980s and 1990s Australian State governments have increased their use of CTC, especially in the areas of information technology, cleaning, building maintenance, library services, legal services, recreation services and auditing.⁶

Outsourcing is not new; private and public sector bodies have always purchased some outside goods and services. What marks the recent developments as a change from past practices is the comprehensive application of competitive tendering and contracting to a very wide range of government activities: the 'emphasis on wholesale contracting as a management philosophy'.⁷ Few areas of the public sector have escaped examination for their suitability for competitive tendering or contracting. In some respects, the enthusiasm of governments for competitive tendering and contracting has surpassed that of the private sector. For example, it has been claimed that nearly 40% of the public sector in Australia are outsourcing over half of their total information technology services, compared to 15% in the private sector.⁸

Government enthusiasm for contracting out has to a large extent been a result of the influence of economic theory on public sector management. While the immediate impetus for the reforms was budgetary pressure and the need to reduce government spending, there was also a strong theoretical drive to model government more along the lines of the private businesses. The general move to a more entrepreneurial focus for government came from **public choice theory**. Public choice theorists argue that government officials, like all rational individuals, are self-interested and seek to maximise their personal income and

⁶ S Rimmer, 'Competitive Tendering and Contracting: Theory and Research', *Australian Economic Review*, 3rd Quarter 1994, pp 80-81.

⁷ G Hodge, 'Time to tally social and political price of outsourcing', *The Australian*, 7/5/97.

⁸ S Cullen, 'Outsourcing Survey, Exploding the Myths: Recommendations for Decision Makers', *Thought Leadership Series*, Ernst and Young, Melbourne 1994, cited in M Graham and H Scarborough, 'Information Technology Outsourcing by State Governments in Australia', (1997) 56 *Australian Journal of Public Administration* 30.

influence.⁹ Officials will therefore strive to gain as large a budget and as many staff as possible, regardless of the actual needs of efficient administration. Government decision-making is said to be prone to ‘capture’ by those with a vested interest in the decisions, such as bureaucrats and interest groups. These behaviours lead to excessive growth of the state and distorted allocation of resources.

To combat this tendency towards inefficiency and capture of government policy making, it is argued that policy advice should be separated from service delivery. Policy advice would then no longer be distorted by agencies with a vested interest in maintaining and expanding their service delivery functions. Service delivery can then be subjected to competitive tendering and contracting. Competition for service contracts will, it is argued, tend to reduce the cost to government of providing the services, because a commercially-motivated operator will have a financial incentive to minimise the costs of the operation. This competitive discipline is absent in the public sector. In this model, the role of government is to develop policy and to monitor service delivery contracts.

Contracting out is also supported by **agency theory**. Agency theory analyses how to structure the relationship between the principal (in this case, the government purchasing the service) and the agent (the person providing the service, whether in-house employees or external contractors) so that agents will meet their obligations to the principal and not act in their own interests. From agency theory comes the notion that a contractual relationship between purchaser and provider, rather than an employment relationship, may frequently be the best way to obtain the optimum performance from the provider. This is done by rigorously specifying in the contract the outputs to be provided, and providing clear performance incentives and penalties for providers.

Influenced by these theories, governments have developed comprehensive, formalised processes for offering for tender, or contracting out, the provision of many goods and services. In-house bids by the public servants currently providing the service are generally allowed, and often encouraged. Governments also commonly use ‘**market testing**’ as a tool to encourage efficiency. Market testing is the practice of comparing the internal costs of service delivery (or the in-house bid price) against the costs of externally sourced service delivery.

While most governments promote competitive tendering, some governments have introduced **compulsory competitive tendering**, making it mandatory for some activities to be put to tender. For example, since 1988 the UK Government has required local councils to put out to tender several functions such as refuse collection and cleaning.¹⁰ In Victoria

⁹ This and the following two paragraphs are drawn from J Alford et al, ‘The Contract State’, in J Alford and D O’Neill, *The Contract State: Public Management and the Kennett Government*, Centre for Applied Social Research, Deakin University, 1994 pp 14-16.

¹⁰ *Local Government Act 1988* (UK); S Rimmer, ‘Competitive Tendering and Contracting: Theory and Research’, n 6, p 84.

the local councils must allocate 50% of their total expenditure through CTC.¹¹ An example at the federal level in Australia is the requirement that new construction and most road maintenance work funded from federal roads grants to the States and Territories must be subject to tender.¹²

It should be noted that outsourcing is only one of a number of programs that have been implemented since the 1970s at various levels of government in order to reduce spending and increase efficiency. Reforms involving the transfer of activities to the private sector include: service management contracts; licensing or franchising the activity; contracting out; corporatisation; and privatisation.¹³ 'In-house' reforms include: benchmarking; best practice analysis; managerialism; performance measurement and budgeting; systems analysis; total quality management; and re-engineering.

3.2 Outsourcing policies

Commonwealth: The change in Australia's approach to public sector management at the Commonwealth level began in the 1970s with the recommendations of the Coombs Royal Commission on Australian Government Administration.¹⁴ The move towards introducing competition to the public sector has been reinforced by subsequent government reports such as the Hilmer Report¹⁵ and the Competition Principles Agreement endorsed by the Council of Australian Governments in 1995. A range of Commonwealth services provided to the public are already contracted out at present, including some employment assistance programs, children's and disability services, veterans' hospital services, counselling services for Vietnam veterans, and rural postal services.¹⁶ The Commonwealth Government is currently negotiating the contracting out of its information technology requirements. In 1996 it was estimated that the Commonwealth public sector contracted approximately \$8 billion of services.¹⁷

¹¹ *Local Government Act 1989* (Vic) Part 9 Division 3.

¹² *Australian Land Transport Development Act 1988* (Cth).

¹³ G Hodge, *Contracting out Government Services: A review of international evidence*, Montech Pty Ltd 1996 p 2; M Trebilcock, 'Can Government Be Reinvented?' in J Boston (ed), *The State Under Contract*, Bridget Williams, Wellington 1995

¹⁴ Royal Commission on Australian Government Administration, 1976.

¹⁵ F Hilmer, M Rayner and G Taperell, *National Competition Policy*, Report of the Independent Committee of Inquiry into competition policy in Australia, 1993 AGPS, Canberra.

¹⁶ Administrative Review Council, *The Contracting Out of Government Services*, Issues Paper, AGPS, February 1997 pp 2-3.

¹⁷ *Industry Commission Report* p 3.

The Commonwealth Coalition Government generally favours opening the public sector to competition. In December 1996 the Minister for Finance, the Hon John Fahey MP, announced that public service managers would be 'required to systematically review their responsibilities and assess the costs and effectiveness of these activities.' This review process will include consideration of whether the use of competitive tendering and contracting or other performance improvement tools would enable government services to be delivered better.¹⁸ In May 1997 draft guidelines on competitive tendering and contracting were issued.¹⁹ A review is to be undertaken in 1998-99 to determine how well new approaches to delivering government services have been adopted and implemented.

New South Wales: In 1992 the former Coalition Government issued a vision statement, *Facing the World*, setting out its commitment to providing value for money to the people of New South Wales. Promoting effective competition was seen as a way to achieve this. Under this policy, all areas of government were open to consideration for contracting, including the traditional core or operational functions and services of each organisation.²⁰ The first guidelines for competitive tendering and contracting in NSW were issued in 1991.²¹ In the same year the NSW Government announced the use of contracting out would be extended for a wide range of functions.

In 1993 a survey was conducted in NSW of all budget sector agencies and several Government Trading Enterprises.²² The survey aimed to quantify the extent of contracting activity in the NSW public sector. It identified contracts with an annual value of over \$540 million. In 1994, the value of contracts increased to over \$1.07 billion.²³ A 1995 survey of contracting in the NSW public sector found that in 1994-95 the combined value of NSW government contracts was over \$1.48 billion.²⁴ The survey found that the activities with the highest value of contracting expenditure were transport services (\$375.5m), property

¹⁸ 'Competitive Tendering and Contracting', Media Release 37/96, Minister for Finance, 11/12/96.

¹⁹ *Exposure Draft: Competitive Tendering and Contracting: Guidance for Managers*, Commonwealth of Australia, May 1997.

²⁰ S Domberger and C Hall, 'Contracting for public services', n 4, p 131.

²¹ *Competitive tendering and contracting out: Guidelines*, NSW Premier's Department, Office of Public Management, 1991.

²² S Domberger, S Farago, C Hall, E Li, *Competitive Tendering and Contracting in the NSW Budget Sector: the 1993 survey findings*, Working Paper 11-93, University of Sydney, Graduate School of Business.

²³ CTC Research Team, *Competitive Tendering and Contracting in the NSW Budget Sector: 1994 survey findings*, NSW Treasury, December 1994

²⁴ S Brown, S Domberger and C Hall, *Contracting of services in the New South Wales public sector: the 1995 survey findings*, CTC Research Team, Graduate School of Business, University of Sydney.

management (\$190.3m), cleaning (\$171.2m), contract staff (\$155.3m) and building maintenance (\$149.3m).

Another survey was conducted in 1996.²⁵ This survey, which warned that several aspects of the survey differed from those in previous years, found that the reported expenditure on contracting in the budget sector was \$1.762 billion in 1995-1996. The five contracted services with the largest expenditure were health and welfare (\$547m), transport (\$352m), property (\$255m), training and education (\$197m), and information technology (\$85m). Together these services accounted for more than 80% of the total contracting expenditure for 1995-96. The average saving resulting from contracting was found to be approximately 19.6% in 1995-96, based on a restricted sample of contracts. Appendix A contains the executive summary of the 1996 survey and a table showing annual contracting expenditure by service.

The New South Wales Labor Government retains a strong emphasis on CTC, but the protection of public sector employment is also a stated priority.²⁶ Tendering is not compulsory, but agencies are motivated to obtain savings from contracting out by allowing them to retain any savings to put towards their core functions. The Government has taken the view that the available evidence clearly shows that the benefit of contracting arises from the application of competition, not from whether the private or public sector undertakes the function.²⁷ The Government's 1997 Service Competition Guidelines state that:²⁸

- ℓ All Government agencies are to incorporate market testing and contracting reviews as part of their formal business planning.
- ℓ Progress will be monitored through an annual survey and select post-implementation audits will be undertaken both to check that policy is being followed and to keep the appropriateness of policy under ongoing review.
- ℓ In-house providers will be given every opportunity to compete on equal terms with external contractors.
- ℓ The Office of the Council on the Cost of Government will act as a research and information provider to assist agencies in planning their market testing and contracting initiatives.

²⁵ *Contracting for Services in the NSW Public Sector: 1996 Survey Findings*, New South Wales Treasury Research & Information Paper TRP 97-2, February 1997.

²⁶ New South Wales Budget Information 1995-96, Budget Paper No. 2, pp 7.12-7.13.

²⁷ Ibid.

²⁸ *Service Competition Guidelines*, Service Competition Project Advisory Committee of the Council on the Cost of Government, 1997 p 5.

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- ℓ In implementing the policy, the pursuit of best value for money, rather than the adoption of a particular means of achieving that end, is the essential factor. The most appropriate means can only be determined after case-by-case assessments.
 - ℓ Market testing under this policy means testing in-house performance against what the market place can offer, but this does not necessarily mean seeking competitive tenders. The option of inviting tenders should only be considered where efforts to improve in-house performance have not realised clear potential for substantial benefits.

The NSW Government has issued guidelines setting principles and objectives for agencies undertaking competitive tendering and contracting:

- ℓ *Service Competition Guidelines* (Service Competition Project Advisory Committee of the Council on the Cost of Government, 1997)
- ℓ *Competitive Tendering Guidelines* (Department of Local Government, 1997)
- ℓ *Contracting for Services - The Probity Perspective* (Independent Commission Against Corruption, 1995)

Victoria: The Victorian government's policy is to expose government funded activities to competition wherever possible. Competitive tendering and contracting guidelines were first issued in 1992. New guidelines were issued in 1996.²⁹ The contracting out of public sector functions is not compulsory for Victorian government agencies, although local government councils are required to subject 50% of their activities to competitive tendering.³⁰ However, it is government policy to encourage the competitive contracting out of functions wherever possible. In-house bids are rare and not encouraged. The government's policy is that it should only directly provide those services for which markets do not exist or cannot be created.³¹

Western Australia: The Western Australian Government encourages agencies to review all activities to assess their suitability for competitive tender. Private sector bids are preferred to bids from government agencies unless government bidders possess unique expertise or are the only source of supply.³² The WA Government developed competitive tendering guidelines for use by its agencies in 1994 to assist agencies evaluate their

²⁹ Victorian Department of Treasury and Finance, *Outsourcing and Contract Management Guidelines*, 1996.

³⁰ *Local Government Act 1989* (Vic) Part 9 Division 3.

³¹ *Industry Commission Report* p 428.

³² Western Australian Office of the Premier *Circular to Ministers No 46/93*; Western Australian Office of the Premier *Circular to Ministers No 46/94*.

options.³³ The Government has stated that:

There will be compelling reasons for some core agency activities to be carried on in-house and not opened to tender. Generally, they will be excluded from competition for reasons of public interest, such as strategic functions and those where there would be unacceptable risks. These may include areas whose main service is to provide policy advice to government, certain regulatory and emergency functions, and essential services to the independent arms of government - ie. the executive, and parliamentary services, and judicial functions. Functions within agencies which entail matters of public policy advice or analysis, financial or contractual management and the like may still be required.³⁴

South Australia: The South Australian Government has developed competitive tendering and contracting out guidelines for the public and private sector. There is no predetermined commitment to contract out any particular functions. Agencies are expected to consider in-house bids, but ensure that comparisons between in-house and external bidders are on an equal basis.³⁵ The South Australian Government has outsourced all its information technology and processing to a US-based company, EDS.

Guidelines on submitting and assessing tenders include: *All About Contracting Out* (South Australian Department of Premier and Cabinet, June 1995); and *A Guide for Tendering Practices* (to be published shortly by Services SA).

Queensland: Although the Queensland Government has a detailed purchasing policy which applies to all service contracts, it has not issued comprehensive guidelines on CTC. Under the Government's procurement policy, government agencies are required to specify quality assurance systems based on internally recognised quality system standards.³⁶

Competitive Service Delivery policies are implemented where appropriate. It is up to individual agencies to determine to what extent Competitive Service Delivery should be used. The Government's Information Policy Board has a policy on purchasing information technology which aims to increase the benefits to agencies and develop the information technology industry in Queensland.

Tasmania: Although the Tasmanian government does not have a formal policy on contracting, it is a fundamental tenet that where services are provided more efficiently by

³³ Western Australian Public Sector Management Office, *Competitive Tendering and Contracting: Guidelines for Use by Agencies*, Ministry of Premier and Cabinet, 1994.

³⁴ Ministry of the Premier and Cabinet (WA), *Competitive Tendering and Contracting Manual*, July 1995, Process Guidelines p 6.

³⁵ *Industry Commission Report* p 431.

³⁶ *Ibid* pp 429-430.

the private sector, government should withdraw from direct provision. General tendering guidelines have been issued for departments. In-house bids are costed on an equal basis with external tenders. However, the government does not encourage in-house bids.³⁷

4. EMPIRICAL FINDINGS ON THE BENEFITS AND COSTS OF OUTSOURCING

4.1 Methodological and other considerations

As with all research in the field of economics and the social sciences generally, empirical findings relating to outsourcing tend to be the subject of methodological debate, as well as other considerations. Some of these points of debate are worth noting before the main findings of the empirical research are set out. General issues to note are as follows:

- ℄ A relevant question refers to the source of funding for any study, a consideration of considerable importance where the outcomes of the research are of intense interest to certain groups. Graeme Hodge notes that ‘the vast majority of studies did not report the source of funding’. He continues, ‘the consequence of this is that without this information, there is no way of determining...whether the source of funding appears to have had any influence over the study results obtained’.³⁸
- ℄ Allied to the above is a concern that, as in many fields of research, a relatively small number of researchers have come to dominate the study of outsourcing. This appears to be the case in Australia, where there is a core of researchers whose names crop up time and again in any literature search. A number of possible issues may flow from this: one could be a concern that some or all these researchers are, for want of a better term, part of the ‘outsourcing industry’; another is that they will tend to reproduce the kinds of findings with which their names are associated in a professional sense; following this, it may be that bureaucracies will tend to contract out research work to those with a known predisposition in the field. On the other side, it could also be the case that the study of outsourcing will attract those who oppose it on ideological grounds, with a view to debunking the assumed ‘myth’ of its cost-saving potential. Or it may be that some commentators will come to it out of antipathy to change or what they see as the pursuit of fashionable ideas.
- ℄ Pursuing this theme, Hodge found that the kind of research which had been undertaken was influenced by the disciplines to which the researchers belonged. Most of the research was by economists, he noted, adding that ‘it is little wonder that the “dimensions of performance” covered in the studies...seem to be almost

³⁷ Ibid pp 432-33.

³⁸ G Hodge, *Contracting out government services*, n 13, p 16.

entirely “economic”³⁹. On the other side, those looking at the issue from disciplines which tend to emphasise social welfare considerations will tend to consider such factors as: wage reductions; increased work intensity; reduced service quality; cost-shifting; and the abandonment of community service obligations.⁴⁰

- ℓ A similar point, going to the problems of emphasis and bias in research, can be made with respect to the ideological predispositions informing research in this field. Originally, at least, outsourcing was associated with the wave of New Right thinking in political economics, often associated with privatisation.⁴¹ To an extent, the ongoing debate and research on outsourcing reflect deeply opposing viewpoints on market-oriented economic philosophies.
- ℓ Many of the key studies in this field are based on questionnaires. It may be the case that those managers who are associated with the introduction of outsourcing in their organisations will have an incentive to portray its implementation in a positive light. The opposite may also apply. In any event, the general point is to further emphasise the scope for bias in research findings.

More particular methodological issues include:

- ℓ Many of the studies have focused on such things as garbage collection and cleaning services and the question is asked whether results from these fields can be extrapolated to a more comprehensive program of outsourcing.⁴² The ‘20% rule’ for savings through outsourcing associated with the earlier work of Domberger et al related to the outsourcing of such services in the UK. Hodge comments: ‘More recent work led by Domberger has broadened the applicability of the cost savings notion. These later Australian studies have been undertaken across several levels of government, and remarkably, have again pointed to cost savings of around 20%, for a whole range of different services’.⁴³
- ℓ This raises the difficulties involved generally in making meaningful comparisons between different service types, a problem which is exacerbated when these

³⁹ Ibid, p 17.

⁴⁰ J Quiggin, ‘Competitive tendering and contracting in the Australian public sector’ (1996) 55 *Australian Journal of Public Administration* 49.

⁴¹ N Deakin and K Walsh, ‘The Enabling State: the Role of Markets and Contracts’ (1996) 74 *Public Administration* 33.

⁴² J Quiggin, ‘Competitive tendering and contracting in the Australian public sector’, n 40, p 53.

⁴³ G Hodge, *Contracting out Government Services*, n 13, p 27.

comparisons are cross-national in nature.⁴⁴ Generally, the differences between various economies and political structures are said to have ‘major consequences that need to be taken into account’.⁴⁵

℄ In fact, on the question of the reliability of the available statistics, the Industry Commission comments: ‘Even within the same country and level of government, estimates of the cost savings from the contracting of particular services vary widely. For example, Domberger, Farago, Hall and Li (1993) estimated the cost savings achieved by the NSW Government from contracting building maintenance services in its budget sector, were in excess of 50 per cent. However, using the same methodology the following year for the entire NSW public sector, the cost savings were estimated to be less than 10 per cent’.⁴⁶

℄ At this stage few studies have been able to investigate whether cost savings from outsourcing are similar over the short and long run.⁴⁷

℄ A common argument is that not all costs are included or accurately measured in the research. For example, the Industry Commission Report said it shared the concern expressed by the Public Sector Research Centre⁴⁸ and the Evatt Research Centre to that effect, with the latter organisation stating that ‘research of the apparent cost savings of contracting out has been overly simplistic’.⁴⁹ Indeed, the Industry Commission went on to say that ‘very few’ of the studies used to compile evidence of the cost impacts of outsourcing had attempted to include all of the relevant costs. It warned, ‘The evidence which follows should be viewed in that light’⁵⁰ and added ‘In that respect, the cost savings and increases reported here can only be treated as estimates of the true results’.⁵¹ Of particular concern to the Commission was that the ‘transition, transaction and internal management costs’ of outsourcing should be

⁴⁴ *Industry Commission Report*, p 534.

⁴⁵ M Paddon, *The real costs of contracting out: re-assessing the Australian debate from UK experience*, Public Sector Research Centre, December 1991, p 4.

⁴⁶ *Industry Commission Report*, p 534.

⁴⁷ *Ibid*, p 136 and p 535.

⁴⁸ The PSRC submission is reproduced in *Australia’s Contracting Public Services*, edited by M Paddon and R Thanki, PSRC 1995. A methodological critique of the questionnaires used in the surveys of contracting activity in the NSW and WA public sectors is found at pp 18-21.

⁴⁹ *Industry Commission Report*, p 125.

⁵⁰ *Ibid*, p 127. In fact the Commission tried to mitigate these omissions by various means, including conducting a case study of its own.

⁵¹ *Ibid*, p 139.

included in calculations.⁵² Dr Meredith Edwards, Deputy Secretary, Department of Prime Minister and Cabinet, has observed, 'Overall, evidence on the size of transaction costs is poor'. She notes, too, that in some cases the measurement of the effect of outsourcing on the quality of the service provided can face substantial problems. The contrast is made between quality of outcome in a field like refuse collection, which may be relatively unproblematic, and home care where it is much harder to specify the quality required and to monitor its achievement.⁵³

- ℄ The empirical studies reviewed by the Industry Commission used three different methodologies, each of which had its own strengths and weaknesses. The first method involved *before and after surveys*, where the advantage is that the estimated changes in costs are based on a sample of contracts, often across a number of agencies. One example is the 1993 study of Domberger et al. It is said that one problem with this methodology is that 'for the cost comparisons to be accurate, comprehensive data is required before and after contracting' and it is noted that data on past costs is often difficult to obtain. The second method involved *cross-section surveys*, where a comparison is made between agencies which do and do not use outsourcing. The Industry Commission notes that the approach is appealing from a theoretical perspective, but that in practice 'some of the required data for these studies is difficult, if not impossible to obtain and proxy variables are often used as a result. Omitting important variables or using inappropriate proxies, can reduce the reliability of the estimates'. The third method involved *case studies*, the main advantage of which is 'their scope to take full account of all or most of the costs provision'. Their disadvantage is that they are of 'limited value when the objective is to estimate the average or typical cost savings from contracting'; thus, 'care must be taken in drawing general conclusions from individual case studies'.⁵⁴

4.2 Some empirical findings

The Industry Commission's survey of the empirical findings: Bearing these and other considerations in mind, the Industry Commission's findings in relation to costs included:⁵⁵

- ℄ While there are instances where costs have increased through its use, CTC can and generally does reduce the ongoing costs of agencies' service provision. 75% of surveyed Australian and overseas empirical studies found that CTC reduced the ongoing costs of service provision. Savings ranged from 10 to 30% in over half the services studied. The savings from CTC can vary widely and do not appear to be

⁵² Ibid, p 134.

⁵³ M Edwards, 'Competition and the public sector' (October 1996) No 81 *Canberra Bulletin of Public Administration* 31 at 33-34.

⁵⁴ *Industry Commission Report*, pp 526-528.

⁵⁵ Ibid pp 125-184.

strongly related to the type of service considered.

- ℓ From the little that is known of the magnitude of the costs associated with transition, contract management and internal management, the evidence suggests that, in most cases, there would still be net savings from CTC.
- ℓ The savings appear to be significant regardless of whether an in-house or external bid wins.
- ℓ The available evidence suggests that cost savings continue to be realised over time relative to the cost prior to contracting, but may vary (up or down) from those obtained initially.
- ℓ The available evidence suggests that most of the savings from CTC do represent efficiency gains from better management and work practices, access to a wider knowledge base, skills or technology, and better use of equipment.
- ℓ The evidence suggests that transfer costs (associated with the claim that efficiencies are gained under outsourcing by such factors as lower wages and reduced conditions of work) are generally a small proportion of savings made through CTC.
- ℓ There are examples of reductions in wages and conditions but these often reflect different awards in the public and private sectors or general labour market trends.
- ℓ Competition or the threat of competition is a major driver of savings.
- ℓ CTC will generally lead to a significant reduction in public sector employment, which is likely to be offset by some increase in overall employment.
- ℓ To date, women, people from a NESB and those in jobs requiring little training appear to have been the most likely to lose their jobs as a result of CTC.

Hodge's survey of the empirical findings: Hodge's review of the evidence relating to CTC in the public sector was undertaken for the Local Government Research Foundation of South Australia. The survey suggests the following findings with respect to the impact of outsourcing on the economic performance of public sector agencies:⁵⁶

- ℓ The empirical evidence on cost savings from outsourcing is 'by no means unanimous'. At the same time, the 'weight of evidence' supports the notion 'that on average the unit costs of services is reduced through competitive tendering of public services'.

⁵⁶ G Hodge, *Contracting out Government Services*, n 13, pp 26-29.

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- ℓ Where savings are reported, they appear to occur across a wide range of possible arrangements - outsourcing from the public to the private sector, from one public sector body to another, or from public sector to in-house production teams.
 - ℓ The role of competition cannot be overstated, with some US research finding that even the threat of competition can stimulate the same level of savings as outsourcing itself.
 - ℓ It appears that savings are greatest through contracting outside the organisation, with these being achieved mainly through greater workforce flexibility.
 - ℓ Several cost savings issues remain uncertain. For example, do the cost savings measured on individual contracts actually result in lower overall costs to government and, with reference to local government, the lowering of overall costs through rate reductions to the community? There is a 'worrying lack of evidence' to support the claim that outsourcing reduces costs overall to government. Hodge adds: 'Indeed, the recent US review of Martin and Stein⁵⁷ and the Australian review of Albin⁵⁸ actually found evidence of the opposite. Both of these reports found that the cost savings through contracts were not passed on to the community but were apparently absorbed through greater numbers of management positions and other rewards to the organisation'.
 - ℓ Hodge reported the finding in the research of the UK Centre for Public Services⁵⁹ that direct reductions in costs to government flowing from outsourcing were outweighed by greater unemployment costs. 'Few other reports on this issue were found'.
 - ℓ In relation to the social costs of outsourcing, citing the work of Escott and Whitfield⁶⁰ and Stein⁶¹, Hodge noted that contracting out 'certainly appears to lead to fewer people employed and to a greater impact on minority groups'. He found

⁵⁷ D Martin and R Stein, 'An Empirical Analysis of Contracting Out Local Government Services', *Privatizing the United States Justice System: Police, Adjudication, and Corrections Services from the Private Sector*, McFarland & Co, 1993.

⁵⁸ S Albin, *Bureau Shaping and Contracting Out: The Case of Australian Local Government*, Public Policy Discussion Paper 29, Australian National University, 1992.

⁵⁹ Centre for Public Services, *Calculation of the National Costs and Savings of CCT*, Research Paper, Supplement to the Gender Impact of CCT in Local Government, Equal Opportunities Commission, United Kingdom, 1995.

⁶⁰ K Escott and D Whitfield, *The Gender Impact of CCT in Local Government*, UK Equal Opportunities Commission, Research Discussion Paper No.12.

⁶¹ L Stein, 'Privatisation, Workforce Cutbacks and African-American Municipal Employment', (1994) 24 *American Review of Public Administration* (1994) 181.

the Industry Commission conclusion that 'there are likely to be overall increases in employment' to be 'nothing short of surprising'.

- ℓ The monitoring and supervision costs associated with outsourcing are rarely measured. Also, where estimates do exist they tend to vary considerably, from around 3% up to as high as 20%. Hodge comments that 'The lack of this type of information puts in doubt the accuracy of service delivery cost savings estimates under contracting'.
- ℓ As far the long term cost benefits of outsourcing have been measured, it is suggested that, while these tend to reduce over time, that trend is not to the 'extent of fully evaporating the savings'.
- ℓ On the issue of whether outsourcing results in a decline in service quality, Hodge comments that 'An array of possible findings is found in the literature'. His own view is that 'lower costs do not usually get accompanied by detrimental changes to service quality levels'.

5. ADVANTAGES OF OUTSOURCING

5.1 Cost savings

The primary argument in favour of outsourcing is that services can be purchased by the government for less money than it would cost the government to provide them. Contractors may be able to provide services at a lower cost through:

- ℓ the use of greater management or labour productivity;
- ℓ the use of skills or technology which the government agency does not have;
- ℓ economies of scale;
- ℓ more efficient use of capital and assets; or
- ℓ greater innovation or flexibility in providing the service.⁶²

It is claimed that competitive tendering and contracting generally leads to reductions in service costs, often resulting in savings in the order of 20%.⁶³ The Industry Commission

⁶² *Industry Commission Report*, p 140.

⁶³ S Domberger and C Hall, 'Contracting for Public Services' n 4; S Domberger and S Farago, 'Competitive tendering and the performance of government trading enterprises in NSW', Graduate School of Business Working Paper Series 01-94, University of Sydney 1994.

took the view that tendering and contracting generally lowers the ongoing costs of agencies' service provision. It found that most of the savings result from efficiency gains, and not from simply transferring costs from one group to another.⁶⁴ A review of empirical evidence by Hodge stated that the 'weight of evidence appears to support the notion that on average the unit costs of services is reduced through competitive tendering of public services. Many of the empirical studies having strong research design integrity support the notion that contracting saves costs'.⁶⁵

The private sector is said to be generally able to work more efficiently than the public sector because public servants are not directly subject to market pressures to perform as efficiently as possible. Public sector agencies are responsible to the electorate only through political means; there is no direct fiscal performance measurement such as the share price by which the performance of the managers of publicly listed companies is reflected.⁶⁶ Private contractors may also be subject to penalties clearly specified in the contract for failure to perform their contractual obligations. Disciplining or dismissing public sector employees for performance failures may be more difficult than terminating a service contract or enforcing contractual sanctions.

5.2 Accountability

Accountability involves a capacity by some person or institution to call an authority into account, in the sense of having to answer for its conduct; and a responsible authority or person with a duty to answer and explain such conduct.⁶⁷ It is argued that competitive tendering and contracting can increase the accountability of government agencies by forcing them to specify clearly the objectives of the service and the responsibilities of the service providers, making it easier to identify who is responsible for different aspects of the service. The process of contract specification and the establishment of objective performance criteria may make it easier to measure the performance of the organisation delivering the service. Moreover, as a result of improving the level of information on performance and the opportunity to replace the service providers, the capacity to impose effective sanctions against poor performers increases.⁶⁸

Addressing concerns that CTC may reduce the accountability of government for the contracted services, the Industry Commission considered that it can be introduced in a way

⁶⁴ *Industry Commission Report* p 15.

⁶⁵ G Hodge, *Contracting out Government Services*, n 13, p 26.

⁶⁶ M Trebilcock, 'Can Government Be Reinvented?', n 13, p 7.

⁶⁷ G Doern, *Political Accountability and Efficiency*, Ottawa Government and Competitiveness School of Policy Studies. Queens University, Discussion Paper Series 93-20, Ottawa, p 4.

⁶⁸ *Industry Commission Report* p 85.

which enhances the capacity to achieve redress where information is available on performance standards and on the results of monitoring, and where there are a number of providers between whom purchasers and clients may choose. Redress may also be enhanced by making customer satisfaction part of performance standards.⁶⁹

5.3 Better work and management practices

CTC is said to be associated with substantial improvements in management and work practices.⁷⁰ One consequence of improved productivity is that fewer people may be needed to perform a given activity. Putting operations up for tender requires management to assess what work they do, how they do it, whether it should be done at all, and if so, who should do it:

The availability of outsourcing also forces organisations to evaluate the effectiveness of their internal structures, including cost structures. CTC requires agencies to look closely at the level of service desired, the specifications and the level of quality. This can assist in driving improvements to in-house providers.⁷¹

Outsourcing their operations allows managers to devote their time and resources to strategic issues, rather than focusing on day-to day operations. In the words of Osborne and Gaebler, leading proponents of the move to a smaller, entrepreneurial public sector, the role of governments should be 'to steer, not row'.⁷² In other words, public servants should concentrate on making policy, not on implementing it.

Public sector budgeting is also thought to be improved by CTC, since financial estimates of expenditure are easier to determine. This occurs because contractors must meet legally binding contracts with specified costs. Financial risks to government can also be reduced by CTC, as contracting out can lead to lower levels of capital investment by the public sector, and the sharing of risk with private contractors.⁷³

5.4 Access to greater knowledge, skills or technology

The Industry Commission concluded that competitive tendering and contracting can provide cost savings and other benefits by encouraging innovative solutions through access to a

⁶⁹ Ibid p 99

⁷⁰ Ibid p 14.

⁷¹ Department of Local Government, *Competitive Tendering Guidelines*, January 1997 p 3.

⁷² D Osborne and T Gaebler, *Reinventing Government*, Addison-Wesley Publishing Company Inc, 1992.

⁷³ N Barnes and B Dollery, 'An Economic Evaluation of Contracting Out and Competitive Tendering in Australian Local Government', (1997) 15 *Urban Policy and Research* 115 p 121.

wider knowledge base, new ideas and new technology.⁷⁴ Contractors may be able to offer specialist expertise and sophisticated technical solutions which a government agency may not be able to afford or maintain using its own resources.⁷⁵ Contracting out a function can give governments access to the latest plant and equipment, while saving them the costs of buying their own assets of this sort. It also saves the costs of training and employing specialist staff whose skills may only be required occasionally.

5.5 Better use of capital and equipment

It is argued that competitive tendering and contracting can produce savings due to more efficient use of capital or access to economies of scale. Winning tenderers, whether external or in-house, have an incentive to use capital more efficiently than internal providers, and may have access to economies of scale not available to internal providers. Benefits to government from outsourcing include avoiding the cost of up-front purchases of equipment, reduced administrative overheads, improved maintenance standards, sharing of risk of equipment failure, and intangible costs savings resulting from standardisation of machines, and increased reliability and productivity of new equipment.⁷⁶

Savings also arise from not having to maintain a permanent capacity to complete infrequent tasks. Under-used resources can be disposed of or leased, leading to sale receipts and savings on maintenance. The Industry Commission concluded that the available evidence indicates that competitive tendering and contracting can produce savings due to the more productive use of capital.⁷⁷

5.6 Better service quality

The Industry Commission reported that it had received evidence that competitive tendering and contracting provides an opportunity to improve the quality of service delivery. Improvements can arise from:

- ℄ a better understanding of quality requirements through formal specification;
- ℄ greater flexibility in choosing the service providers, which allows agencies to use providers that specialise in the particular service; and
- ℄ a greater focus on service quality and standards by contractors because of the threat

⁷⁴ *Industry Commission Report* p 145.

⁷⁵ *Ibid* p 4.

⁷⁶ *Ibid* p 143.

⁷⁷ *Ibid* p 143.

of losing a contract.⁷⁸

Another argument is that private contractors often have a greater awareness of client needs, and more incentive to develop innovative methods of delivering services. Outsourcing can therefore lead to a greater focus on the needs of the client, and result in better or quicker responses. The Industry Commission noted that although the results of studies on quality of contracted services vary, many studies have found either no evidence of quality deterioration, or an improvement. For example, the Commission reported that in the City of Stonnington, in Victoria, an in-house team won a contract to run the city's maternal and child health services after offering an enhanced service including extending opening hours, developing new programs and offering enhanced facilities.⁷⁹

The Industry Commission concluded that the contracting agency's approach to the competitive tendering and contracting process is an important determinant of the impact that CTC has on service quality. Based on the evidence presented to it, the Commission considered that:⁸⁰

- Ⓒ improvements in quality can occur as a result of better specification of the service, improvements in monitoring and the ability to access external expertise; and
- Ⓒ agencies can largely avoid any unplanned reductions in quality that derive from failure in the tendering process (including inadequate specification of the service required and inappropriate contractor selection) and poor contract management (including insufficient performance monitoring).

5.7 Greater flexibility

The Industry Commission concluded that competitive tendering and contracting has increased flexibility for agencies by allowing them to choose between different means of service delivery, and to change rapidly the resources devoted to particular ends. Outsourcing may also increase an agency's ability to introduce changes to practices and policies, or to bring in new technology.

5.8 Industry and regional development

Another argument in favour of outsourcing is that it can result in the creation and growth of markets traditionally supplied exclusively by public agencies, with significant flow-on effects for industries and regions.⁸¹ Outsourcing may encourage a growth in small businesses

⁷⁸ Ibid p 105.

⁷⁹ Ibid p 110.

⁸⁰ Ibid p 117.

⁸¹ Ibid p 201.

that pick up work from the public sector. Some governments have deliberately used their market power in an attempt to secure benefits to particular kinds of industry or businesses. For example, a government may include local industry development requirements in contracts with large multi-national companies.

The Industry Commission stated that competitive tendering and contracting, and government purchasing more generally, has had a significant impact on industries and regions in several ways, including:⁸²

- ℓ Increasing industry capabilities - action by governments to put service delivery to tender has provided new market opportunities for private enterprise. Access to these markets has given private contractors an opportunity to develop new capabilities and skills to meet the demands of government purchasers.
- ℓ Increasing industry competitiveness and export potential - increased industry capability from a particular procurement can improve the competitiveness of the firm that wins the contract and the industry that it competes in. Access to government business can improve the prospects of such firms in export markets. Further, obtaining government contracts can be seen as official endorsement of suppliers, which can be important for winning business in overseas markets.
- ℓ Industry structure - contracting programs may give small and medium-sized enterprises an opportunity to expand their operations. The large sums involved in government contracts can also encourage multinational firms to locate offices in Australia, and bring new technology, knowledge and expertise with them that is passed on to Australian firms. Concerns have been expressed that government contracts are being won by a disproportionate number of multinational companies, limiting the opportunities for small and medium sized enterprises to develop. However, it has been noted that large contractors generally engage smaller firms by subcontracting or employing previous public employees.
- ℓ Regional development - some councils in rural and remote areas have addressed the possible adverse impacts of competitive tendering and contracting on local communities by using contract specifications to ensure the employment of local resources and the promotion of local development. For example, in the outsourcing of information technology for the Victorian Public Transport Corporation and VicRoads Corporation, information technology industry development objectives and commitment to increase employment in Ballarat was a key consideration in tender evaluation.⁸³

⁸² Ibid pp 201-210.

⁸³ M Graham and H Scarborough, 'Information Technology Outsourcing by State Governments in Australia', (1997) 56 *Australian Journal of Public Administration* 30 pp 35.

5.9 Fewer industrial relations issues

Many private sector firms outsource blue-collar work in order to avoid problems of labour rigidity, demarcation disputes and restrictive work practices.⁸⁴ Outsourcing can be a means of limiting an agency's involvement in industrial relations issues, as the contractor bears the responsibility of managing its employees and dealing with the relevant unions. The same considerations apply in the public sector, where contracting out could be used to increase the flexibility of the service purchased.

6. DISADVANTAGES OF OUTSOURCING

6.1 Accountability

There is an argument that outsourcing can reduce the Government's accountability to the public for its actions. Government activities become less transparent in a number of ways:

- ℓ the line of accountability becomes extended and less certain, making it difficult for affected parties to determine who is responsible for the delivery of the service;
- ℓ for services where it is difficult to allocate precise responsibility, the introduction of an additional person provides greater scope to shift the blame, making it difficult to seek redress;
- ℓ governments may refuse to make public the details of contracts on the basis that they are 'commercial in confidence', thereby preventing the public from assessing the terms on which services are contracted out, and the costs involved;
- ℓ where services are contracted to the private sector, individuals may not have access to the administrative law mechanisms and remedies that safeguard the interests of persons affected by government actions (such as an Ombudsman or freedom of information, or rights to privacy).⁸⁵

Hodge reports, 'Recent experience in Victoria...has highlighted the closure of avenues which have traditionally been available to the community for enquiry into areas central to government accountability. The unavailability of information has been justified on the grounds of this now being "commercial-in-confidence"'.⁸⁶ In South Australia, several parliamentary select committees established to monitor some major outsourcing contracts

⁸⁴ J Benson and N Ieronimo, 'Outsourcing decisions: Evidence from Australia-based enterprises', (1996) 135 *International Labour Review* 59 p 71.

⁸⁵ *Industry Commission Report*, pp 85-86. The report synthesises the views of the Public Sector Research Centre and others.

⁸⁶ G Hodge, *Contracting Out Government Services*, n 13, p 30.

have experienced considerable difficulty in obtaining information about the terms and operation of the contracts. The Executive Government refused to make available some of the contracts to the committees on the basis that they were commercially sensitive.⁸⁷

In its submission to the Industry Commission, the ACTU cited the conclusion of the 1993 evaluation of Commonwealth public sector reform that 'Services involving substantial accountability, privacy or control issues or discretion in decision making by government may best be retained in-house'.⁸⁸

What happens if a person receiving a service suffers loss as a result of a contractor's actions? Contract law usually prevents the person taking action directly against the contractor, because only a party to the contract (that is, the government agency or the contractor) can take legal action to obtain a remedy for breach of the contract. If the relationship between the contractor and the government agency is not clearly defined, then the agency, the contractor and their respective insurance companies can all deny liability for a problem. The Commonwealth Ombudsman has commented that

'... the rules associated with contracting out are muddy, contradictory, or not yet written, and when it comes to issues of accountability and redress there is a new twilight zone. It is this blurring between public accountability and commercial remedies (through, for example, contracts and/or common law) that needs to be carefully considered in the contracting context because current redress mechanisms cannot cover all the situations and questions being raised.'⁸⁹

The Administrative Review Council thoroughly considered the issues surrounding the accountability of the Commonwealth government for outsourced services in its issue paper, *The Contracting Out of Government Services*. The issues paper discussed available public and private remedies under Commonwealth law for persons affected by the actions of contractors. It also considered whether there is a need for additional remedies. The Council identified four possible approaches to providing service recipients with remedies against problems with contracted services:

1. Modify existing law to ensure that service recipients can exercise legal rights on their own account against contractors.
2. Create new legal rights so that:
 - i. service recipients can take action against the Government (leaving the Government to recoup any costs from contractors);

⁸⁷ K Towers, 'Crisis looms on \$600m contract', *The Australian*, 12/4/96. Eventually a compromise was reached that the Government would provide summaries of the terms of the contracts to the committees; however, only one such summary was ever provided. The select committees have been dissolved due the State election.

⁸⁸ M Paddon and R Thanki (eds), *Australia's Contracting Public Services*, n 48, p 87.

⁸⁹ Commonwealth Ombudsman, *Annual Report 1996-1997* p 59.

- ii. service recipients can seek redress through a new complaint-handling mechanism established by statute; and/or
 - iii. service recipients (and possibly groups which represent them) can obtain information about the service.
3. Require contractors to establish complaint-handling mechanisms and to provide access to information about the service.
4. Make available or modify existing administrative law mechanisms so that they can be used to deal with complaints by service recipients about services provided on behalf of Government by private contracts.

6.2 Loss of privacy

Contracting government functions (in particular, information technology and data processing) to the private sector leads to concerns that information about individuals is held by organisations that are not bound by rules as to the use of personal information. The Federal Privacy Commissioner has submitted that outsourcing has the 'side-effect of lowering the level of privacy protection that otherwise attaches to personal information given to, or acquired by Commonwealth agencies'.⁹⁰ The Commonwealth Ombudsman has observed that:

The transfer of control of databases from the public sector to private contractors provides a number of potential commercial opportunities. In most cases, citizens give personal information to government agencies, and permission has not been sought or obtained to allow commercial use of personal information which was collected on government databases. Complaints about the actions of contractors will not be reviewable under the current public accountability mechanisms, unless the jurisdiction of the Ombudsman and Privacy Commissioner is extended to cover such functions.⁹¹

6.3 Confidentiality issues

The argument is developed that, at least with respect to certain areas of work calling for high levels of mutual trust and confidentiality, that outsourcing cannot hope to match the kind of service delivered by long-term employees. The example of librarians in law firms is one that is used to illustrate the point, where it is said that 'To invite outside library employees into a law firm - employees with uncertain tenure and frequent turnover - is to

⁹⁰ Parliament of the Commonwealth of Australia, House of Representative's, Standing Committee on Legal and Constitutional Affairs, *In Confidence*, AGPS 1995, p 162. The Commonwealth Parliament's Senate Finance and Public Administration Committee is currently preparing a report on the contracting out of government services.

⁹¹ Commonwealth Ombudsman, *Annual Report 1996-97* p 67.

incur risks that no firm should consciously take'.⁹² The same argument can apply to many areas of work in the public service.

6.4 Collusive tendering and related issues

Contracting out involves a risk that potential suppliers will engage in collusive tendering. In May 1995 the ICAC said it 'frequently receives complaints about contracting for services', many of which focus on one or more of the following characteristics: the lack of a competitive selection process; the selection of contractors who had prior relationships with the purchaser; and allegations of partiality.⁹³ The Commonwealth Ombudsman has also reported an increasing number of complaints received relating to the procedures used by government departments and agencies in letting tenders.⁹⁴ In Victoria, serious concerns have been raised about irregularities and cover-ups in the tender process for the metropolitan ambulance service's dispatch system.⁹⁵ Indeed, according to Hodge several international studies suggest that corruption is 'almost inevitable' where services are contracted out: 'A string of corruption cases within the contracting process in the US Defence Department demonstrate that even with processes having been streamlined over several decades, with close media scrutiny and with increased professional attention, the risk of corruption is ever present'.⁹⁶ The risk of corruption may escalate as long-term relationships are developed between public service agencies and service providers.

Even where no dishonest practices are involved, the point is made that 'incumbent contract-holders often have a considerable advantage at renewal time over their competitors'.⁹⁷ There is a risk that governments that lock in to long-term contracts with a single contractor may find, at the end of the contract, that they have lost any real ability to change contractors or to bring the functions back in-house. The government agency may no longer have the knowledge and expertise in the area necessary to negotiate a contract with another company, or to take on the functions itself.⁹⁸

⁹² R Stone, 'Confidentiality, outsourcing and the library', <http://library.ljextra.com/out.html>

⁹³ ICAC, *Contracting for Services: The Probity Perspective - A Corruption Prevention Project*, May 1995, p 2.

⁹⁴ Commonwealth Ombudsman, *Annual Report 1996-97* p 68.

⁹⁵ 'Ambulance 'conspiracy' under police investigation', *The Australian*, 9 July 1997; 'Privatised ambulance deal 'veiled in secrecy'', *The Australian*, 14 June 1997; 'State admits backing Intergraph boss', *The Australian*, 5 June 1997.

⁹⁶ G Hodge, *Contracting Out Government Services*, n 13, p 30.

⁹⁷ MJ Trebilcock, 'Can Government Be Reinvented?', n 13, p 13.

⁹⁸ S Davies, 'Enthusiasm outweighs results', *Australian Financial Review* 23/8/96 p 26. See also M Lacity and R Hirschheim, *Information Systems Outsourcing: Myths, Metaphors and Realities*, John Wiley & Sons, 1993; M Lacity and L Willcocks, *Best Practices in*

A government can also find itself 'locked in' to a particular contractor if the contract provides for the private operator not only to operate, but also to build or own the facilities in question. Where the assets are highly specialised and costly, it will be unlikely that at contract renewal time there will be other private bidders with alternative facilities.⁹⁹ If the government agency loses the capacity to engage another contractor, the benefits of competition for the contract are eroded.

6.5 Loss of control

Outsourcing can result in public agencies losing the control they need to have over their suppliers. This may result from a loss of sufficient in-house expertise to oversee the process of contract management, including the capacity to assess and monitor each contractor's work. In relation to the American experience of contracting out, it has been said that 'Too often in recent years, federal agencies have not retained adequate in-house expertise, thereby placing themselves at the mercy of potentially opportunistic contractors'.¹⁰⁰ The danger is that public agencies will become too dependent on the expertise and information held by the contractor, in which case control will pass to the private contractors who may pursue their own interests as against the public good.¹⁰¹

It has been argued that contracts in the US 'continually place federal officers in the uncomfortable position of being responsible for the programme they do not really control...Instead of a hierarchical relationship between the federal government and its agents, what exists in practice is a far more complex bargaining relationship in which the federal government has the weaker hand'.¹⁰²

The issue of loss of control as a result of outsourcing also arises in the context of changes in government policy. Where an agency contracts out a service, it is tied by the terms of the contract if it later wishes to alter that service. The agency will have to attempt to renegotiate the contract, incurring extra expenses, or wait for the term of the contract to expire.

6.6 Quality

The claim is made that CTC is often associated with reductions in quality of service. Quiggin noted in this regard that all the foreign studies cited in the Industry Commission's Draft Report 'are unanimous in finding that quality reductions predominate'. He added, 'All

Information Technology Sourcing, Oxford Executive Research Briefings, Templeton College, Oxford 1996.

⁹⁹ M Trebilcock, 'Can Government Be Reinvented?', n 13, p 15.

¹⁰⁰ J Boston, 'Inherently Governmental Functions and the Limits to Contracting Out' in J Boston (ed), *The State Under Contract*, Bridget Williams, Wellington 1995 p 105.

¹⁰¹ Ibid, p 89.

¹⁰² L Salamon, cited in N Deakin and K Walsh, 'The Enabling State, n 41, p 42.

but one of the Australian studies finding mixed or favourable results come from a single research group and the same method seems to have been applied in each case. These studies are more properly regarded as separate parts of a single study'. For Quiggin there are *a priori* reasons to expect outsourcing to be associated with quality reductions. Among other things, he says that the 'incentives for private contractors are clearly to provide the minimum service specified in the contract'.¹⁰³ A recent report commissioned by the Ethnic Communities Council of NSW found, on the basis of interviews with 45 former NSW Government Cleaning Service employees, that three-quarters of the cleaners interviewed believed that the quality of their service had declined, with most believing there was no longer enough staff or time to do the work properly.¹⁰⁴

Ensuring that outsourcing does not diminish the quality of government services may be a problem where it is difficult to identify performance indicators that measure the quality of the services. Many public sector services are complex and have multiple objectives, involving political and policy judgments which are difficult to specify.¹⁰⁵ Even where simple activities are involved, there may be problems in measuring the performance of contractors:

It is easier to operate market-based contracting approaches for simple repetitive services than for complex professionally based activities, but there are difficulties even for simple services. It is fairly easy to see whether refuse has been collected, but much more difficult to tell whether vehicles have been serviced properly. In the case of services such as health and social care it is often difficult to make any statement about the detail of the service that is to be provided, and contracts tend to be written in very general terms. The purchaser is often dependent on the provider for knowledge of what has been done, or even what should be done, so that information becomes a key battleground in service management...¹⁰⁶

There is a concern that contracts will tend to provide for performance assessment on the basis of easily ascertainable 'process' measurements (such as the number of items supplied) rather than by assessing factors which are more difficult to measure (such as the quality of

¹⁰³ J Quiggin, 'Competitive tendering and contracting in the Australian public sector', n 40, p 52.

¹⁰⁴ L Fraser, *Impact of Contracting Out on Female NESB Workers: Case Study of the New South Wales Government Cleaning Service*, Ethnic Communities Council of NSW Inc, 1997 p 45.

¹⁰⁵ Monagle T, 'Looking Before Leaping: Contracting Out Australia's Public Services', (1995) *Just Policy* No 3, 20 p 22.

¹⁰⁶ N Deakin and K Walsh, 'The Enabling State', n 41, p 37.

the items).¹⁰⁷

6.7 Financial costs

A 1991 review of UK research suggested that the additional costs imposed by outsourcing, including what are known as ‘transaction costs’ (such as the costs associated with negotiating and managing a contract, and providing for redundancy or retrenchment of staff), have been significantly underestimated. The average cost savings, at about 6%, are far more modest than the estimates suggested in the leading Australian surveys where the ‘20% rule’ seemed to apply. Also, the apparent savings differ substantially between different services and that, as a result, generalising figures from one kind of service to another can be dangerous. It has been said that the variation of experience up to 1991 among Local Councils in the UK indicates that ‘individual authorities are almost as likely to experience increases in costs...’.¹⁰⁸

The Industry Commission itself conceded that ‘There is limited evidence on the magnitude of transition, contract management costs and internal management costs. The majority of studies examined would have overestimated any cost savings from CTC because of omission of transition and management costs’.¹⁰⁹

6.8 Sources of saving - transfers

A general argument is that while outsourcing may reduce the budgetary costs of a given agency, this does not necessarily imply that there is an equivalent net social welfare gain. This is because costs reductions may reflect transfers, which are said to ‘involve donors giving something of value to recipients without being fully compensated’.¹¹⁰ Transfers arise from such sources as reduced service quality, wage reductions and the abandonment of community service obligations.¹¹¹ In its response to the Industry Commission Report, the

¹⁰⁷ L McGuire, ‘Service Delivery Contracts: Quality for Customers, Clients and Citizens’ in G Davis, B Sullivan, and A Yeatman (eds), *The New Contractualism*, MacMillan Education Australia Pty Ltd, 1997 p 115.

¹⁰⁸ M Paddon, *The real costs of contracting out: re-assessing the Australian debate from UK experience*, PSRC 1991, p 12.

¹⁰⁹ *Industry Commission Report*, p 136. The report goes on to say: ‘However, the evidence of the likely size of any omitted cost suggests that their inclusion will not alter the conclusion that in most cases contracting reduces the costs of service provision for public agencies’. The NSW Department of Local Government has noted in this respect that ‘there is a growing body of evidence indicating that cost savings from competitive tendering may, in some cases, be illusory or have at least been exaggerated’: NSW Department of Local Government, *Competitive Tendering Guidelines*, January 1997, p 4.

¹¹⁰ *Industry Commission Report*, p 147.

¹¹¹ J Quiggin, ‘Competitive tendering and contracting in the Australian public sector’, n 40, p 49.

ACTU said that, in its view, ‘much of the claimed “savings” from CTC relate to job loss or transfers from one group to another’.¹¹² According to the ACTU, ‘When savings have been achieved through contracting out, it has been largely through the reduction of numbers of jobs and/or working conditions, particularly of the lowest paid.’¹¹³

The Industry Commission conceded that, ‘in practice, it is difficult to initiate reform without making someone worse off’.¹¹⁴ A number of ways in which savings from outsourcing may arise from transfers were identified: (i) transfers from employees through reduction in wages and conditions, or increases in effort; (ii) transfers from one level of government to another through ‘cost-shifting’; (iii) transfers from governments and tax payers due to tax evasion; or (iv) transfers from clients through reductions in the level or quality of services.¹¹⁵

Specifically on the issue of the potential for tax evasion, Quiggin comments that the opportunities for evasion and avoidance are increased by contracting out. He adds ‘Public sector wage employees have fewer opportunities for evasion than any other group of income earners. By contrast, contractors and their employees are in a very good position to evade taxes, especially if, like cleaners and garbage collectors, they work non-standard hours’.¹¹⁶

6.9 Employment effects

Outsourcing raises concerns that it results in an overall loss of jobs. In its submission to the Industry Commission, the Ethnic Communities’ Council of NSW added that female employees and employees of NESB pay a high price when government services are outsourced. Studies in Britain and the US were cited in support of this conclusion.¹¹⁷ The Industry Commission agreed (in part at least) stating that ‘to date, women, people from NESB, low-skilled and blue-collar workers appear to have been disproportionately affected by CTC’. It added that ‘To an extent, CTC is therefore exacerbating the difficulties that these particular employees have traditionally faced in the labour market’.¹¹⁸ These results are apparently confirmed in the recent report on outsourcing commissioned by the Ethnic

¹¹² ACTU, *Industry Commission Report on Competitive Tendering and Contracting by Public Sector Agencies - ACTU Analysis*, October 1996, p 11.

¹¹³ M Paddon and R Thanki, *Australia’s Contracting Public Services*, n 48, p 104.

¹¹⁴ *Industry Commission Report*, p 150.

¹¹⁵ *Ibid*, p 147.

¹¹⁶ J Quiggin, ‘Competitive tendering and contracting in the Australian public sector’, n 40, p 53.

¹¹⁷ M Paddon and R Thanki eds, *Australia’s Contracting Public Services*, n 48, p 231. UK research undertaken by the Equal Opportunities Commission and others is also cited in support of this argument by the NSW Department of Local Government, *Competitive Tendering Guidelines*, January 1997, p 5.

¹¹⁸ *Industry Commission Report*, p 183.

Communities Council of NSW.¹¹⁹

Competitive tendering and contracting also raises concerns that it leads to reductions in wages and conditions of employment. Responding to the Industry Commission Report, the ACTU said that 'The Commission acknowledges that contractors tend to use greater number of casual and part-time workers. This contributes to the reduction in employment conditions, since casual workers are not entitled to annual leave, sick leave, maternity leave etc'.¹²⁰ The Commission has suggested that this use of contract and part-time workers may 'reflect general labour market trends rather than being due to the use of CTC'.¹²¹ Again, the recent report commissioned by the Ethnic Communities Council of NSW seems to confirm the view that the outsourcing of cleaning services in NSW has resulted in increased workloads, as well as increases in levels of unpaid work and workplace injuries.¹²²

7. WHAT SHOULD BE OUTSOURCED?

As would be expected, there is no widespread agreement on what kinds of services should be contracted out. The Industry Commission commented that while most would accept that functions such as law-making, coercive powers and governance are properly the province of government, there is little consensus beyond this point.¹²³

Opinions on which services should be subject to competitive tendering and contracting are often shaped by a person's theoretical perspective on matters such as: which areas of government operations are of such public importance that they should only be carried out by those under the direct control of the elected government; which areas of government should not be carried out with a view to generating profit; in which areas markets cannot provide an acceptable level of service while catering to public interest objectives; the importance of privacy protection or accountability mechanisms in the provision of government services, and so on. These are inherently subjective issues. Another approach to the limits of outsourcing is the view that a government agency's 'core competencies' should be identified and protected from outsourcing, in order to protect the agency's

¹¹⁹ L Fraser, *Impact of Contracting Out on Female NESB Workers: Case Study of the New South Wales Government Cleaning Service*, Ethnic Communities Council of NSW Inc, 1997.

¹²⁰ ACTU, *Industry Commission Report - ACTU Analysis*, n 112, p 14.

¹²¹ *Industry Commission Report*, p 176.

¹²² L Fraser, *Impact of Contracting Out on Female NESB Workers*, n 104. See also C Mayhew, M Quinlan and L Bennett, *The Effects of Subcontracting/Outsourcing on Occupational Health and Safety*, UNSW Studies in Australian Industrial Relations No.38, 1996.

¹²³ *Industry Commission Report*, p 245.

capacity to carry out its functions and to prepare strategies for its future directions.¹²⁴

On a practical level, the question as to what should be outsourced revolves around whether in a particular case outsourcing would achieve the desired outcomes of cost savings, increased efficiency and so on. Will the benefits of outsourcing outweigh the costs incurred? Addressing the question as to whether there are some government functions which are inherently difficult or inappropriate to contract out, the Industry Commission stated that it has not been able to find robust, generally applicable definitions of categories of services suitable for competitive tendering or contracting, or a consistent framework for deciding which services belong in which category. The Commission concluded that:

The lack of success in developing broad categories of services which are suitable or unsuitable for CTC indicates a more fundamental problem. There are a number of characteristics of some services which may make it more difficult to use CTC (such as privacy, accountability or consumer redress requirements), but it is difficult to define absolute restrictions. There will always be trade-offs between the costs and benefits of managing those issues internally and the costs and benefits of managing them through external providers... In addition, the risks involved and the external and internal management costs will be different for each service and each agency. Moreover, those costs will change over time. It is therefore extremely difficult to formulate broad categories of services or to nominate characteristics of services which will make them more or less suitable for CTC for a wide range of agencies. Such decisions need to be made on an individual basis.¹²⁵

The Industry Commission identified a range of factors which managers should consider when deciding whether a particular operation should be subjected to competitive tendering or contracting.¹²⁶ The New South Wales Service Competition Guidelines¹²⁷ also contain a table of factors to be considered when assessing the suitability of an activity for competitive tendering, reproduced below.

¹²⁴ C Hood, 'Which Contract State? Four Perspectives on Over-Outsourcing for Public Services', (1997) 56 *Australian Journal of Public Administration* 120 p 121.

¹²⁵ *Industry Commission Report*, p 251.

¹²⁶ *Ibid*, pp 258-259.

¹²⁷ *Service Competition Guidelines*, Service Competition Project Advisory Committee of the Council on the Cost of Government, 1997 p 11.

Factors relevant to the suitability of an activity for competitive tendering	The case for competitive tendering becomes stronger:
Future of the activity	the more certain that provision of the activity continues to be justified, and that it will not need to change substantially.
Statutory, legal, policy and practical constraints, including accountability and privacy issues	the more certain that the activity (or its major components) is free or can be freed of statutory, legal, policy or practical constraints on contracting.
Degree of risk	the lower the risks to all parties including the public, the Government and the contractor, taking account of risks during and beyond the term of the contract.
Clarity of need for users of the services	the more precisely the task can be specified in advance.
Importance of the means of service provision	the less there is a need to specify the method of service provision.
Ability to measure performance	the more accurately performance can be evaluated and quality assured.
Degree of competition	the more certain that a number of firms are able to genuinely compete.
Ease of replacement of contracts	the more certain that the agency will not be locked in to a monopoly provider; and the more readily an unsatisfactory contractor can be penalised or replaced without significant interruption to service provision.
Impact on essential skills and knowledge	the more certain that skills and knowledge essential for the agency to undertake its responsibilities would be retained.
Competence in contract management and administration	the greater the competence of the agency to manage the competitive and contract management processes for the activity.
Costs and benefits of competitive tendering and outsourcing	the greater the likely benefits exceed the likely costs.

8. CONCLUSION

Studies of outsourcing and competitive tendering have produced mixed results, indicating that outsourcing is not an instant cure for budgetary troubles. Nevertheless, it seems clear that in some situations outsourcing can produce significant cost savings with satisfactory outcomes. It is also clear that successful outsourcing and competitive tendering requires a great deal of preparation and work. The contracting agency must consider in detail what is appropriate for outsourcing, what is hoped to be achieved, the existing costs of providing the service, the potential cost savings and costs involved in outsourcing. A broader issue is whether the cost savings on individual contracts actually result in lower overall costs to government, taking into account all the costs of outsourcing, including the social costs. Ultimately it seems that outsourcing and competitive tendering, like many tools, are neither inherently beneficial or harmful: the effects of outsourcing appear to depend on how it is put into practice in individual cases.

APPENDIX A

Extracts from *Contracting for services in the NSW Public Sector: 1996 Survey Findings*, New South Wales Treasury Research and Information paper, February 1997

Executive Summary

This study reports on the results of the 1995-96 survey of contracting in the Budget sector of NSW Government. Of the 64 agencies in the Budget sector, responses were received from 61 agencies. Consistent with past practice, the survey was restricted to contracts with a minimum value of \$50,000 in order to simplify the task of responding to the survey.

The survey covered services undertaken within the public sector and excluded capital works, consultancies, and employment contracts. The sample of contracts surveyed included contracts that were current as at 30 June 1996, and those that operated during the 1995-96 financial year. Agencies responded to the survey over the three month period from July to September 1996.

Although several aspects of the 1995-96 survey differ from those in previous years, it was possible to compare the results with those of the 1994-95 survey by making the necessary adjustments. The key findings of the survey are summarised as follows:

- ℓ The reported expenditure on contracting in the Budget sector increased substantially from \$966 million in 1994-95 to \$1,762 million in 1995-96. This was also reflected in the number of contracts in operation, which increased from 13,852 in 1994-95 to 28,479 in 1995-96.
- ℓ The reported increase in contracting can be partly explained by the inclusion of 3,700 contracts by the Department of Health with Visiting Medical Officers, valued at \$264 million. Similarly, the expenditure of \$42 million by the Legal Aid Commission on 4,200 contracts referred to as assigned matters was also included in 1995-96. Both these items were not reported in the 1994-95 survey and have therefore not been included in the results for that year.
- ℓ Apart from the contribution of \$31 million on 219 first-time contracts in 1995-96, the remainder of the reported increase in contracting can be explained by more thorough reporting by the agencies, inclusion of contracts previously excluded, and improved methods of analysing the survey data.
- ℓ Ten agencies accounted for more than 90 percent of the total contracting expenditure and number of contracts that operated during the year.
- ℓ The agencies are planning a total of 341 new contracts valued at \$125 million for 1996-97.
- ℓ The five contracted services with the largest expenditure were health and welfare, transport, property, training and education, and information technology. Together they accounted for more than 80 percent of the total contracting expenditure for 1995-96.

- ℓ The average saving resulting from contracting was approximately 19.6 percent in 1995-96, based on a restricted sample of contacts.
- ℓ The average cost of managing contracts was 2.7 percent of the value of a contract.
- ℓ As in previous surveys, many respondent agencies nominated efficiency and effectiveness as primary reasons for contracting. An equally large number of respondents reported having successfully achieved these objectives following the implementation of contracting.
- ℓ Premature termination of contracts was not encountered frequently, representing only 0.32 percent of contracting expenditure (\$5.7 million) and 0.12 percent of the total number of contracts (34 contracts).
- ℓ Approximately 63 percent of contracts had durations greater than or equal to 1 year and less than 5 years. In addition, 15 percent of contracts were on-going, without a fixed term. Contracts for food and laundry services tended to have the longest duration, averaging 5.5 years.
- ℓ Almost half the contracts were based on schedule of rates pricing, with the remainder being divided approximately equally between total tendered price and annual tendered price contracts.
- ℓ Almost half the in-house staff affected by contracting were retained within the agency after contracts had been awarded. The remaining staff were either redeployed to other agencies, transferred to the contractor, or accepted voluntary redundancy.

Annual contracting expenditure and number of contracts

Contracting expenditure by service for 1995-96 and 1994-95 is shown in Figure 3.8. All services, except for transport, recorded increases in contracting expenditure in 1995-96. The large increases in contracting expenditure reported by the Department of Health and the Department of Community Services are reflected in the figures for health and welfare services. Similarly, contracting expenditure on transport services and training and education relate closely to the reported changes in contracting at the Department of Transport and TAFE Commission, respectively.