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***CONTRACTING OUT GOVERNMENT SERVICES:
LESSONS FROM THE PRIVATE SECTOR***

BY

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Abstract

Diverse motivations induce private sector decision-makers to contract out rather than to produce in-house: economies and diseconomies of scale and scope, the competitive environment, and organizational diseconomies. But private sector firms also attend to *the costs of managing contracting out*. In contrast, public sector authorities have paid inadequate attention to the costs of the contracting out process, especially those involved in monitoring contractor compliance. Although this essay supports contracting out of government services to the private sector as a vital tool in the hands of public sector authorities, it argues that government production might be more efficient than outsourcing when contracting costs in general and monitoring costs in particular overwhelm the cost-savings that might otherwise accrue from contracting out.

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CONTRACTING OUT GOVERNMENT SERVICES: LESSONS FROM THE PRIVATE SECTOR

Jonas Prager

Contracting out has become a popular method of simultaneously reducing government expenditures and improving the efficiency of government services.¹ Apparently, the dual aims of economy and efficiency have been attained to the satisfaction of most government decision-makers, which in turn has spurred on new contracting out initiatives.² Such structural changes in government operations can be highly beneficial and deserve to be emulated. However, expanding reform presupposes that these innovations have been properly evaluated and their limits thoroughly understood. Unfortunately, in the case of contracting out the benefits have been trumpeted loudly while its weaknesses have been muted. To some

¹ Both Morley and Pack find slight growth in municipal use of contracting out between 1982 and 1987 or 1988. See Elaine Morley, "Patterns in the Use of Alternative Service Delivery Approaches," in The Municipal Year Book (Washington, D.C.: International City Management Association, 1989), p. 38 and Janet Rothenberg Pack, "The Opportunities and Constraints of Privatization," in William T. Gormley, Jr. (ed.), Privatization and Its Alternatives (Madison: University of Wisconsin Press, 1991), p. 298. The starkly contrasting conclusion of Savas, estimating a U.S. annual growth rate of 4.5 percent between 1982 and 1988, is based on an arithmetic error in Morley's Table 4/6; his 1982 average counts only government contracting out to the private sector. See E.S. Savas, "Privatization and Productivity," in Marc Holzer (ed.), Public Productivity Handbook (New York: Dekker, 1992), p. 82. The slow growth in contracting may be as much supply-determined -- lack of private sector providers, legal impediments, etc. -- as demand-generated.

² See, for example, the wide-ranging recommendations of the Lauder Commission (Privatization of New York: Competing for a Better Future -- A Report of The New York State Senate Advisory Commission on Privatization (January, 1992)) for privatizing and contracting out such New York State activities as airports, bus service, housing, and off-track betting. Such recommendations are not limited to the U.S. See, for example, the British White Paper Competing for Quality: Buying Better Public Services (London: Her Majesty's Stationery Office, 1991), CM 1730, which declares contracting out to be a major objective of both the national and local authorities.

extent, this imbalance reflects from the absence of a systematic treatment of the advantages and hence the limits of outsourcing. This article, which supports outsourcing as a vital financial tool in the hands of government authorities, examines contracting out in a private sector context to determine the sources of its alleged cost-savings.³ This will facilitate abstracting the essential lessons that can be transferred from the private sector to the public sector. One conclusion will emerge quite clearly: Contracting out is not a panacea. Indeed, at times, outsourcing, instead of stemming the flow of budgetary red ink, will intensify the hemorrhage.

I. Contracting Out in the Private Sector

A business firm can acquire the resources it needs for producing its output by producing them itself, by acquiring them from the marketplace on an ad hoc basis, and by turning to designated suppliers. The firm will typically buy an input on the market when that resource is not unique and is readily available at acceptable prices. However, the options narrow to contracting out versus self-production when the firm anticipates supply constraints, unacceptable pricing, or unique specifications. It is this constrained choice -- produce in-house or contract out -- that needs to be understood.

In fact, no private business firm is so integrated that it produces all the resources it uses. Companies typically contract out for physical inputs, intermediate or component products, and services used in producing the few goods or services in which the firm specializes. Furthermore, because the typical business firm is geared up for undertaking a

³ The present article builds and expands upon my "Contracting Out: Theory and Public Policy," Journal of International Law and Politics (forthcoming, 1993).

limited number of primary activities, secondary functions are relegated to outside contractors. Finally, firms rely on contractors rather than permanent staff and facilities to meet temporary needs.

These generalized statements can be easily illustrated with a simple service provider such as an automobile repair facility. The master mechanic who owns a typical small shop repairs vehicles with the assistance of a few mechanics. Parts supplies are normally obtained on an as-needed basis from a few distributors, relying on the competitive local parts market. But outsourcing is routine as well. It might be resorted to when demand overwhelms the facility's capacity. And the shop might contract out activities that require special skills and equipment such as wheel alignments or transmission repairs.⁴ Other contract relationships stem from secondary functions, in this case running the business side of the operation in an office equipped with machinery that is prone to malfunction, such as a service contract with a xerox or computer repair service. So, too, will the shop have a contract with a health maintenance organization to cover the medical outlays of the owner and staff. Finally, outside architects and construction crews will manage plant modernization plans and their execution. So, too, will the retained attorney handle the occasional legal brief and the accountant file the periodic tax forms.

This illustration, however, begs the "contract out versus in-house production" question. Why does the shop not expand its capacity to handle overflow? Why doesn't it

⁴ Although such contracts may be informal, an implicit contract that builds on a long-lasting relationship based on mutual trust may be treated for all practical purposes as a formal contract.

acquire its own personnel and equipment for specialized repairs? Why does it not internalize equipment repair and legal and tax issues? The intuitive response that it's cheaper to contract out than to do it in-house is inadequate, for it leaves unanswered the crucial question: Why? We need to understand the economic and, as will soon become clear, the organizational constraints that underlie the internal versus external production decision. We turn first to the economics.

The economics of production. The efficiency-enhancing quality of specialization is a fundamental tenet of economics. Specialization, whether of labor or capital, facilitates optimal utilization of inherent or acquired traits, saves time by focusing on a limited number of tasks, encourages job mastery, and spurs on innovation. Hence, two individuals who each specialize in a particular task can produce more output from the same volume of inputs than can the two when each divides his time between both tasks. And if they produce more output from the same amount of resources, then it's equally true that the same amount of output would require less input. In other words, specialized production is more efficient. So, the repair facility benefits by acquiring at lower cost the various services it contracts out to the transmission shop, the business equipment service specialist, and the attorney and accountant.

However, further reflection finds even this response incomplete. First, by focusing on supply, it ignores the role of demand. On the one hand, demand can be inadequate to take full advantage of the indivisibilities of production technology or, on the other hand, too large, so that existing facilities are inadequate. Will specialization be sensible in the former case? Why not expand in the latter? Second, this example suggests that functional specialization is inconsistent with output diversity. Yet, our everyday experience points to

many firms that successfully integrate specialization and variety. Many automotive repair facilities do provide comprehensive care without contracting out. Moreover, automotive repair chains employ corporate house counsel and handle in house all routine tax matters. It's not improbable that equipment will be repaired internally.

A more complete response would recognize the pervasiveness of economies of scale and scope. Too small often leads to higher costs because scale economies cannot be realized. The firm must then decide whether to exit entirely from this line of business, to cut back internal operations and contract out, or to undertake complementary activities to achieve economies of scope that compensate for its inadequate economies of scale. Yet, bigger is often better when efficiency is the issue. Large scale production tends to drive unit costs down. For a variety of reasons, a larger repair facility can operate more efficiently than can a smaller one.⁵ Its larger capacity would not only preclude contracting out routine repairs, but would also perform the repairs at a lower unit cost. In other words, contracting out is a more cost-effective alternative for a small firm that cannot take advantage of economies of scale and scope. But the firm need not consider outsourcing when it is sufficiently large to take advantage of the productive efficiencies that accompany economies of scale and scope.

Even the large firm, however, may find outsourcing advantageous. Both economies of scale and economies of scope have limits. Although these economies will differ from industry to industry and will change as technology changes, at some point bigger and/or more diversified is no longer cheaper. One can thus visualize two large, diversified plants that

⁵ See, for example, Jonas Prager, Applied Microeconomics: An Intermediate Text (Homewood, IL: Irwin, 1993), pp. 232 - 233.

have each exhausted their respective economies of scale and scope. They each produce in house those goods or services they produce most efficiently and contract out with the other for those goods or services they could provide only at higher cost.

The organization of production. This economic explanation for the contracting out decision is itself deficient. It fails to answer a question first posed by Coase: Why isn't the entire economy run by a single firm?⁶ Coase wonders: What will prevent a single body of owners, once having discovered the plant size that optimizes the economies of scale and scope, from simply cloning such plants repeatedly until a single firm was responsible for the economy's entire output? In other words, contracting out would never be necessary. When seen from the ownership point of view, all production would be internal even though it would be allocated to different production facilities and sites.

Coase's solution diverges from classical microeconomic theory by introducing an organizational constraint. He asserts that such an immense firm will simply be unmanageable. Complex business organizations, with their layers of bureaucracy not only drive costs upward, but stifle reactions to more nimble competitors.⁷ Indeed, just as

⁶ Ronald Coase, "The Nature of the Firm," Economica iv (1937), pp. 386 - 405. This article has been reproduced in many compilations, among them Oliver E. Williamson and Sidney G. Winter (eds.), The Nature of the Firm: Origins, Evolution, and Development (New York: Oxford University Press, 1991), pp. 18 - 33.

⁷ The 1991 downsizing and reorganizing of IBM resulted from the mammoth computer firm's inability to respond flexibly to the challenge of competitors in the personal computer segment of the market. Smaller computer firms had come to dominate that segment, which IBM had neglected in favor of the market for giant mainframes. In a belated admission of its error, IBM split off its PC operations into a separate subsidiary with substantial independence from IBM corporate headquarters.

technological constraints limit optimal plant size, so, too, does organizational complexity limit optimal firm size.⁸ The diseconomies of coordinating operations of an industrial behemoth will more than offset the production cost savings resulting from scale and scope economies. Consequently, a firm will cease expanding operations whenever it reaches either an economic or organizational constraint. Breaching that barrier, which will differ for each industry and for each firm, leads to higher costs, so that it will be more cost-effective to contract out needed inputs or services.

The role of competition. Efficiency in production need not coincide with low cost to the customer. Economic theory suggests that competition among producers strengthens the bargaining power of the purchaser. The transmission specialist will more likely relent and pass on the cost savings when the repair facility owner has the option of turning elsewhere. Indeed, the absence of market competition among suppliers may induce firms to consider in-house production even when the product or service is available from a contractor whose own costs are lower than theirs.

Simply put, business firms contract out when it's not cost-effective to produce internally. That itself hinges on the technology of production, the efficiency of its organizational structure, and the degree of market competition. And because of these

⁸ The M-form (multidivisional) corporation, with a decentralized corporate structure making independent divisional decisions and a corporate staff charged with interdivisional coordination, reduces some of the organizational complexity. See Alfred D. Chandler, Jr., Scale and Scope: The Dynamics of Industrial Capitalism (Cambridge: Harvard University Press, 1990), especially pp. 43 - 45. However, even that has limits, as is amply demonstrated by the disintegration in the 1990s of many of the U.S. conglomerates formed only a few years earlier.

ingredients are variable, the contracting out decision must be continuously reviewed rather than neglected once made.

Some examples. That small firms such as the repair shop or a medical office contract out is apparent to all. Less evident is the extent of contracting out among U.S. business giants. The absence of data forces us to rely on apparently convincing anecdotal evidence. Thus, no manufacturer of large commercial aircraft produces all of its components; most are contracted out. Boeing, for example, considers itself essentially a design and assembly outfit. It contracts out the vast majority of its planes' structure and parts, and its contractors subcontract further. The same applies to the automobile industry, although the various manufacturers differ in the degree of outsourcing and are themselves currently in a state of flux. In the 1991 General Motors' restructuring, for example, outside contractors were designated to provide many of the parts heretofore produced internally.⁹ L.A. Gear, a sneaker manufacturer that in the 1980s expanded into the apparel business, retrenched in late 1991 by eliminating apparel design and distribution to focus attention on its core sneaker business. In a variation of outsourcing, it would henceforth license other clothing manufacturers to use its logo.¹⁰

Fortune 500 business firms contract out services as well as components. To cite a few examples, McDonnell Douglas contracted out all of its computer and telephone services to

⁹ This example highlights the flexible boundary between internal production and contracting out.

¹⁰ See "L.A. Gear to Farm Out Apparel Business, Consolidate Facilities and Cut Workers," The Wall Street Journal, November 25, 1991.

IBM, while Eastman Kodak outsourced its computer support services to IBM and Businessland. British Petroleum outsourced a divisional finance department to Arthur Andersen, the accounting firm. Mobil Oil contracts out refinery maintenance, while AT&T farms out its credit-card processing. Pitney Bowes, Xerox, and Ameriscribe contract with U.S. businesses of all sizes for copying, faxing, and mailroom facilities.

That contracting out appears widespread among U.S. private sector businesses is certainly consistent with the theoretical framework suggested in the previous paragraphs. That the public sector can apply some of these general principles surely follows. But it is worthwhile to turn first to a further implication of the analysis.

II. Managing Contracting Out

The private sector not only undertakes outsourcing but manages it. After all, outsourcing is merely a phase of the production process that is not performed in house. And just as the private firm does not neglect in-house production efficiency, so does it not ignore the costs of contracted out inputs. There is one fundamental difference, however. The firm's managers exert direct control over the firm's assets and employees; the relationship is hierarchical and authoritarian. The firm's control over contractors is more indirect and subject to the parties' interpretation of the contractual arrangement. That opens up a range of problems emphasized in a different context by Oliver E. Williamson. Rejecting the fundamental assumption of classical microeconomic theory -- that individuals act rationally and are fully informed about all alternatives -- Williamson insists that in practice people are

both "less competent in calculation and less trustworthy and reliable in action."¹¹ Because of this bounded rationality, individuals cannot possibly know everything that needs to be known nor can they resolve all problems that demand resolution. Moreover, economic actors behave opportunistically; they are characterized by Williamson as being "self-interest seeking with guile."¹² In essence, transactions occur between individuals whose own agendas will not always coincide. They fall prey to what economists have called "asymmetric information," where one party is, by the nature of the relationship, better informed about its actions than is the other. The transmission specialist may, for example, install parts that are rated to last 20,000 miles instead of the 30,000-mile rating part contracted and charged for, a distinction that may never be traced back to the specialist's doorstep. No contractual arrangement can resolve this asymmetry, for as Williamson notes, contracts between economic actors cannot specify all possible contingencies. Nor if they could, would it always be cost-effective to be so precise. The firm's defense lies partly in the proper choice of contractors and partly in monitoring them appropriately.

The choice of contractor. Selecting a contractor is often a complex process.

Competition among contractors plays a key role, since the most efficient manner of choosing a contractor is through a competitive bidding process. Yet, collusion among bidders is a real danger, since the incentive structure of competitive bids is designed to benefit the contractee

¹¹ Oliver E. Williamson, Economic Organization: Firms, Markets and Policy Control (New York: New York University Press, 1986), p. 140.

¹² Ibid.

at the expense of the bidders.¹³ Competition cannot be taken for granted; in its absence, the gains from contracting will be diminished, if not dissipated entirely.

Multiple awards, where a number of bids are accepted, reduces although it doesn't eliminate the incentive to collude. This method, used by U.S. automobile manufacturers among others, has the additional attraction of permitting comparative performance assessments. But it is often not possible, nor is it always desirable. Contract administration costs increase directly with the number of contractors employed. Also, client leverage over contractors varies directly with the dependence of the contractor on the client, implying fewer but larger contracts. Japanese automotive corporations, for example, tend to minimize the number of contractors, enabling them to work intensively with their contractors. Indeed, despite the formal contractor-contractee relationship, a case can be made that de facto, Japanese automobile manufacturers and their contractors function as a vertically-integrated production organization.¹⁴

Contract design -- cost-plus contracting versus incentive contracting -- also plays a

¹³ Even the potential winning bidder may gain from a collusive arrangement, since both the contract award is higher and the cost of bidding is lower. Moreover, bidding competition is subject to the "winner's curse," which asserts that the winner will most likely have overpaid. See Richard H. Thaler, The Winner's Curse: Paradoxes and Anomalies of Economic Life (New York: The Free Press, 1992), Ch. 5.

¹⁴ See Imai, Ken-ichi and Itami, Hiroyuki, "Interpenetration of Organization and Market: Japan's Firm and Market in Comparison with the U.S.," International Journal of Industrial Organization 2 (December 1984): 294 - 297. Imai and Itami note that although the member firms of the Japanese keiretsu share long-term relationships, each retains the ultimate right to abandon the organization. They imply, however, that this option is rarely exercised.

vital role as do award criteria. The cost-plus contract invites "moral hazard," since the contractor's incentive to hold down costs is eroded. On the other hand, incentive contracts shifts risk onto the contractor. Although contractors profit from productivity improvement, they may also lose when increased costs beyond the contractors' control turn up. The added risk absorbed by the contractor will be reflected in higher costs to the contractee.¹⁵

Not always will a firm award the contract to the lowest-cost bidder. Such considerations as past record, reliability, and capacity are also taken into account. Although the objective standard is lost when the contracting administrators are permitted flexibility, the avoidance of "low balling" -- untenable low bids that will later be reopened -- as well as the weeding out of poor potential and actual performers suggests that total contracting costs will be lower in the long-run. However, flexibility also opens up the possibility of corrupting the bidding authority, a danger that cannot be easily dismissed.¹⁶

Monitoring contracts. The letting of a contract ultimately gives way to contract compliance, which is evaluated through monitoring. Contract monitoring should be viewed

¹⁵ Assuming that for any particular contract the contractor is more risk-averse than is the contractee, a circumstance that is likely when the contractor relies more heavily on the contractee than vice versa, risk-shifting from the latter to the former raises total costs. See R. Preston McAfee and John McMillan, Incentives in Government Contracting (Toronto: University of Toronto Press, 1986), Ch. 3.

¹⁶ Corruption appears unavoidable whenever the decisions of one or a few individuals can determine the wealth of others, especially when the former do not directly share in the fruits of their selection. Contracting out, however, is not unique. The in-house production alternative to outsourcing normally involves procurement of resources by firms' purchasing agents. They are equally susceptible to being suborned despite the National Association of Purchasing Management's code of ethics, which unequivocally declares that "members shall not use their authority or office for personal gain."

primarily as a preventive, not punitive function, so that the most effective monitoring uncovers no discrepancies between the contract provisions and the actual results. Since monitoring entails additional costs,¹⁷ but not monitoring can even be more expensive, firms aim at an optimal monitoring arrangement.

It is useful to distinguish between financial monitoring or auditing and technical monitoring, which is concerned with physical specifications. Both are straightforward in principle. Financial monitoring is designed to make sure that contractors are paid only as mandated by the contract. Auditors sample the document trail to disallow inappropriate charges.¹⁸

Technical monitoring refers to comparing the quantity and quality of product or service delivered against contract specifications. In truth, quality control is endemic to internal production as well. But it takes on extra cogency when the product is obtained from a contractor who has a stake in dissembling.¹⁹ The contractee's staff samples the goods

¹⁷ Costs may be explicit as in those cases where outside auditors are hired to monitor contracts. But costs are incurred even if such monitoring is done internally with existing staff and resources. Cost calculations in the latter case are more complicated, since, for example, employee time must be allocated between monitoring and other tasks. But they cannot be ignored.

¹⁸ Two issues need to be explored in this context. First, auditing serves not only to check on contractors, but also on the contractee's staff. Audits stand to uncover both error and fraud. Second, insofar as all contracts are incomplete, the contractee faces an asymmetric incentive set. When in doubt, the contractor asks for payment. At best, the request can be rejected. The auditing function is needed to clarify the grey areas, and so reduce the contractor's incentive to charge for questionable items.

¹⁹ A profit-maximizing contractor may be viewed analogously to a potential criminal. In both cases, the rational principal will weigh the benefits of performing the act -- product shading or outright theft -- against the probability of being

delivered, and in many instances inspects even prior to delivery. It is not unusual for members of the client's quality control staff to be physically located at the contractor's site.

Quality control requires greater monitoring efforts in some instances than in others. Product quality is normally simpler to monitor than service quality, because product specifications tend to be more precise. More intense monitoring is called for when the contracted good is vital and service disruption has substantial deleterious consequences. Similarly, monitoring is needed more when the contractor's incentive and ability to cheat is powerful. Hence, the cost of monitoring can be significant.

Recognizing the necessity to manage contracting out leads to perceiving its limits as well. Contract administration requirements may well give birth to a contracting bureaucracy in the contractee. Moreover, "coordinating a gaggle of subcontractors is often more time-consuming -- and costly -- than managing in-house manufacture of the parts in question."²⁰

A major new conclusion now emerges. In addition to the motives mentioned earlier for in-house production -- production economies, organization economies, and the absence of competition among potential contractors -- contracting out is inappropriate when the combined contract price and the cost of the contract management exceed the cost of in-house production.

apprehended and the consequences of being found out. Monitoring increases the probability of being discovered, and so reduces the incentive to cheat.

²⁰ The Economist (August 31, 1991, p. 56) based on an unpublished study by the Boston Consulting Group.

III. Government Sector Inefficiency

It is important to dispell a myth about public sector efficiency before applying to the government sector the lessons of private sector outsourcing. The idea that public sector provision is inherently less efficient than private sector supply rests upon the absence of the the profit motive in government activities. It is buttressed not only by popular experience of public sector inefficiency, but by evidence that purports to demonstrate the accuracy of the conventional wisdom.

The role of the profit motive. The drive to efficient production in the private sector is clearly related to the profit motive. A private supplier will minimize costs, for the cost-savings accrue to the firm's owners. That cannot be presumed for the public sector; cost-savings do not accrue to public servants. This contrast is thought to create an efficiency gap in favor of private enterprise.

This distinction is exaggerated for two reasons. First, motivation need not take the form of monetary rewards. Second, one may question the presumption of pervasive efficiency-inducing incentives in the private sector.

Surely monetary rewards stimulate goal achievement. But clearly they are not the only, and, in many instances, the primary incentives. Power, prestige, and "public service" motives cannot be ignored. Many individuals are willing to sacrifice the monetary rewards offered by the private sector for the power attainable in government positions. That certainly is one, if perhaps a cynical motive to explain the substantial pay cuts taken by many who enter and indeed compete to join government service. The French and Japanese civil service are two outstanding examples of the prestige incentive; their social status is totally

uncorrelated with their salaries. And surely altruism remains a force to be reckoned with in the United States. People do feel a responsibility to their communities, and turn to the public sector as a means to improving the lot of their neighbors.²¹ On a more mundane level, even the pecuniary rewards of public sector employees, broadly-considered, may be equivalent to private sector remuneration. The financial package that is offered by the public sector, encompassing pay, fringe benefits, opportunities for promotion, and job security may provide no less of an incentive than that paid by the private sector.²²

Thus, the issue of public versus private sector efficiency cannot lie in different attitudes toward pecuniary motivation. The willingness to address the bottom line can be identical whether the incentive is profit or an equally potent nonfinancial motivator.

Second, profit should not automatically be correlated with efficiency in the private sector.²³ Much depends on the institutional structure of the private sector firm. The critical distinction here is between an owner-operated enterprise and a firm characterized by a

²¹ Many of the highest-ranking graduating students of the most prestigious law schools seek judicial clerkships, positions with such top-level government agencies as the State or Justice departments, or with federal prosecutors for the opportunity, visibility, responsibility, and challenge offered them. They certainly could earn double or more at corporate law firms.

²² See J. Norman Baldwin with Quinton A. Farley, "Comparing the Public and Private Sectors in the United States: A Review of the Empirical Research," in Ali Farazmand, Handbook of Comparative and Development Public Administration (New York: Marcel Dekker, Inc. 1991), p. 29. In their summary (p. 35), they write: "Public employees, especially federal employees, enjoy greater compensation and job security than private employees."

²³ See my "Is Privatization a Panacea for the LCDs? Market Failure versus Public Sector Failure," The Journal of Developing Areas, 26 (April 1992): pp. 306 - 307.

separation between ownership and management. To be sure, the owner of an owner-operated firm has a strong incentive to pursue efficient operation. After all, the cost-savings accrue directly to the owner. Profit-driven motivation weakens significantly when a firm is professionally managed, for then the principal-agent conflict surfaces. Although the agent -- the professional manager -- is expected to pursue the policy goals of the principal -- the owners -- the agent's personal agenda need not coincide with that of the principals. Even when the latter establish an incentive structure for the agent that is congruent with their interests, the two need not correspond. Moreover, reconciliation is not costless. Hence, one cannot assume that efficiency is a critical operating goal merely because a firm is privately-owned.

The evidence. The overwhelming evidence that private ownership is more efficient than public enterprise need not be taken at face value.²⁴ In fact, many public enterprises are as efficient as are private sector companies. (Or, perhaps more accurately, many private sector enterprises are as inefficient as are their government counterparts.) The differences in cost structure stem less from an inherent weakness in the public sector than in its operating environment. Surely it is no surprise that government-operated activities are inefficient when

²⁴ Ibid., pp. 305 - 309, and the sources cited there. See also Baldwin with Farley, who summarize: "Private organizations are frequently, but not consistently, more cost-efficient and productive than public organizations." (p. 35, italics added.) Boardman and Vining's conclusion is somewhat stronger -- "large industrial MEs [mixed enterprises] and SOEs [state-owned enterprises] perform substantially worse than similar PCs [private corporations]" -- but not inconsistent with Baldwin with Farley. See Anthony E. Boardman and Aidan R. Vining, "Ownership and Performance in Competitive Environments: A Comparison of the Performance of Private, Mixed, and State-Owned Enterprises," Journal of Law and Economics xxxii (April 1989): 26.

public policymakers deemphasize efficiency as a goal of the public sector, when management is not provided with sufficient flexibility to pursue efficiency goals, and when the incentive structure of the public sector either is neutral toward or even discourages cost-saving. The issue is not inherent inefficiency as much as a lack of political will to establish efficiency as a high-level priority of government operations.

Low-cost provision by a government agency may be possible on a conceptual plane but be impossible politically.²⁵ If so, contracting out becomes a second-best option. Even then, however, outsourcing will not be the universal remedy. Some types of government operations will be more amenable to contracting out, others less so. The criterion becomes: Will contracting out prove even more costly than inefficient government provision of specific services? It is here that the lessons of the lessons of business outsourcing can be applied.

IV. Contracting Out of Government Operations

Lesson transfer is relatively straightforward when the government sector is engaged in commercial operations such as public transportation and garbage collection. It is less obvious but exists nevertheless even when public sector activities are noncommercial such as policing or the administration of justice.

Scale economies. A private firm relies on contractors when it is either too small or too large to take advantage of optimal scale, provided, of course, that the contractor can reap the benefits of scale economies and pass them down to the client. That applies equally well to government entities, and suggests that certain types of services in appropriate circumstances

²⁵ See my "Contracting Out: Theory and Policy," pp.

should be candidates for outsourcing. Thus, a central crime laboratory, with experienced technicians and specialized technology, is not likely to be efficiently utilized by a small, low-crime community. Similarly, a municipal hospital or waste disposal plant with high-tech equipment makes little sense without a substantial patient or garbage throughput. And a computer service bureau can handle a variety of operations that may not be worthwhile for the small-scale municipal agency.

However, the picture is radically altered whenever the operating scale rises to the point where the same economies can be achieved in-house as through contracting out. Even prior to that, however, contracting out may not be appropriate should there also be:

Scope economies. Sometimes an operation may be too small to achieve high levels of efficiency, yet can be combined with a second activity that uses similar inputs. Municipal street maintenance crews can be trained to drive snow plows as needed and even to handle infrequent calls for rescue and first aid services. In a small community, hospital-based social workers need not be limited to their hospital patients. They can handle the social predicaments of dysfunctional families, home-bound senior citizens, drug-addicted teenagers, alcoholics, and so on. Perhaps the jack of all trades is the master of none. But when masters of all trades are financially unsupportable, the jack of all trades is surely more cost-effective!

Contracting out needs to be placed on the table whenever the government entity cannot take advantage of the economies of scale or scope. Contractors may themselves be able to supply a broad range of services to a larger number of users, and so take advantage of economies of scale and scope. Such, for example, is the case with Rural Metro, the well-known company that provides fire protection and fighting services to a number of localities,

many of which do not believe themselves capable of taking advantage of scale economies. They all benefit from sharing the low-cost operation of Rural Metro.²⁶

An important caveat must be introduced here. Contracting out does not necessarily imply outsourcing to the private sector. A large public sector entity can achieve scale and scope economies just as easily as a privately-owned firm. That's one reason why the Los Angeles County Sheriff serves about half of the cities in Los Angeles County.²⁷

Contracting out is also cost-effective in the presence of diseconomies of scale and scope. This is not due to large public sector demands that would lead to excessively large public service facilities -- a larger than optimal asphalt plant, for example. That issue can be resolved by replicating optimal scale/scope size -- two or more optimal-sized asphalt plants. The barrier to improved efficiency revolves around

Organizational economies. While most municipalities are small and can be managed relatively easily, many urban governments and especially those associated with megalopoli may simply be too large and complex to be effectively managed. Contracting out permits the government authorities to focus on their most critical operations and relegate the remainder to contractors. This might involve contracting out entire departments or agencies, such as preschool education, community health services, foster care, and waste disposal.

²⁶ See Scottsdale Rural/Metro Fire Department, A Perspective on Progress (1991). The text of the Rural/Metro contract with Scottsdale, Arizona can be found in John A. Rehfuss, Contracting Out in Government: A Guide to Working with Outside Contractors to Supply Public Services (San Francisco: Jasssey-Bass, 1989), pp. 155 - 157.

²⁷ Rehfuss, pp. 234 - 242.

Alternatively, the authorities might outsource specific activities that cut across a number of departments such as vehicle repair, building maintenance, computer service operations, compliance with city codes, and meal services. The public authority receives a share of the cost-saving that accrue to the contractors, each of which specializes in providing the activity and each of which avoids organizational paralysis.

The role of competition. Purchaser power is strengthened and cost-savings are largely passed on when competition characterizes the market for the service to be contracted out. The ability to solicit bids from competitive contractors depends on a number of variables. The reputation of the local authority, gained in the treatment of its past contracts and contractors, fair and timely payment, and smooth resolution of differences in contract interpretation play a role.²⁸ So, too, does contract size. Large-scale projects are likely to attract more bids than small-scale ones, as the potential profits justify investing resources in preparing and submitting bids. For the same reason, the longer the tenure of the contract, the greater the number of bids. Yet, even in the best of circumstances, multiple bids cannot be assured. There may simply not be more than one or at best a few potential providers.²⁹

²⁸ Note, however, that poorly managed contracts may well increase the number of bidders, who see the possibility of increased profits at the expense of the public authority.

²⁹ A survey by The New York Times of some 22,500 bids to New York City during fiscal 1989 and 1990 found 6 percent by number and 3 percent by value attracted only one bidder. Data limitations precluded discovering how many bids attracted two competitors. See "Without Competing Bids, New York Pays the Price," February 19, 1991, pp. A1 and B4. That the lack of competitors is not unique is borne out by DeHoog's in-depth study of contracting out in Michigan. See Ruth H. DeHoog, Contracting Out for Human Services: Economic, Political, and Organizational Perspectives (Albany: State University of New York Press, 1984),

The flexibility of government authorities vis-a-vis contractors is more constrained than is that of the private sector firm. Transparency and fairness are high priorities of good government, but basically irrelevant in interfirm relations. Hence the public sector bidding process must be structured to assure access to all potential bidders (e.g., adequate time, sealed bids). Moreover, the contract award must be perceived by all as fair; legal steps can be initiated if the rules are not adhered to precisely. The private firm, of course, is free to diverge from its announced procedures. Indeed, private sector firms often use the bidding process is used to narrow down the number of potential suppliers. The firm then negotiates in camera with the remaining bidders, an option not open to the public sector contracting mechanism. Consequently, public authorities not only often face a more complex and costly bidding process but also a more time-consuming one. Anecdotal evidence points to extensive delays in project initiation merely because a losing contractor had tied up the government in the courts.

In truth, the bidding process does not guarantee competition or competitive results. Lowballing, although Savas does not believe it widespread,³⁰ cannot be ignored. Nor must the bidding authority assume away collusion merely because a number of bids were submitted.³¹ Permitting the government entity that had hitherto provided the service to bid

Ch. 4.

³⁰ P. 95.

³¹ Four hundred and seventy-five private garbage collectors pick up commercial solid waste in New York City. Yet city authorities do not believe this market to be competitive, the large number of companies notwithstanding. Instead, the industry is believed to be a cartel, with customers and routes allocated among the haulers and with outside entry virtually impossible. See The New York Times, March 5,

for the contract, a method used successfully on both the federal and local levels, can alleviate concerns about noncompetitive behavior.³²

Finally, the danger of accepting a single bid if that puts the public authority at the mercy of the contractor cannot be ignored. Contract cancellation provisions are critical, but will be of no use when the contractor defaults on a vital service. For example, contracting out emergency hospital services may be unwise even if it is financially sound. If the staff pulls out, the community is left in the lurch. There's much to be said in favor of parcelling out a contract among a number of providers. Not only does that permit service comparisons, but it furnishes an emergency reserve.

1992, pp. B1, B2. For more general remarks, see Robert W. Bailey, "Uses and Misuses of Privatization," in Steve H. Hanke (ed.), Prospects for Privatization: Proceedings of the Academy of Political Science, v. 36, no. 3, pp. 143 - 144, 148.

The 1992/93 contract bribery scandal in Italy revealed that competitive bidding for public contracts was a sham. "Alberto Zamorani, a Milanese who was arrested last year, said private companies collaborated to work out who would get which contract. 'They would just write their names on pieces of paper and draw them out from a hat,' he said. 'First one out would win the first contract, second one would win the second, and so on.'" Alan Cowell, "Broad Bribery Investigation Is Ensaring the Elite of Italy," The New York Times, March 3, 1993, pp. A1, 8. (Citation is on p. A8.)

³² See on the federal level the President's Commission on Privatization (Linowes Commission), Report (Washington, D.C.: Government Printing Office, 1988), p. 132 and David Osborne and Ted Gaebler, Reinventing Government: How the Entrepreneurial Spirit is Transforming the Public Sector (Reading, Mass: Addison-Wesley, 1992), pp. 76 - 78. This method has additional economic and political benefits. Workers and managers with hands-on experience may more easily identify efficiency-generating reforms than outsiders. Also, coopting the incumbents into the reform process reduces their resistance to change.

Monitoring. The public authority's involvement with the contractor does not cease once the contract has been let. Indeed, the most arduous and expensive part of the process may now be at hand. The auditing of the contracting out process requires professional staff, whatever the outsourced service. Technical monitoring may or may not require professionals, depending on the type of service contracted. Thus, a service that directly affects an interest group or even unorganized citizenry requires less bureaucratic concern and hence lower monitoring outlays from the authorities. Snow removal from streets, filling in road potholes, garbage pickup, library services, and public radio and television broadcasting are examples of services that the citizenry can monitor effectively, and so keep monitoring costs to a minimum. On the other hand, such government services as water fluoridation, building and highway construction, or education and health service quality need technically competent monitors to assure contract compliance.³³

Two further dangers need to be addressed: corruption and inefficient monitoring. To be sure, corruption has been documented frequently within the private sector. In fact, the known instances of contractors bribing monitors surely understates reality. Not all such illegal relationships are discovered, nor are all those discovered revealed to the public. Suborning of monitors is no less difficult to unearth in the public sector. Public authorities must first recognize the need to monitor the monitors and then devote resources for this

³³ Anyone can eyeball a bridge to see whether it's been completely repainted. But whether the contractor used the proper consistency of paint rather than mixing in more thinner -- as was the case in New York City (The New York Times, February 19, 1991, p. B4) -- requires chemical analysis, performed by skilled technicians using sophisticated equipment.

purpose.³⁴

In fact, monitoring public sector monitors is rare.³⁵ More disheartening, government authorities do not even efficiently monitor contractors themselves. In many instances, simply not enough monitoring is done. Furthermore, monitoring is inefficient for the very same reasons mentioned earlier in connection with general cost-inefficient government production. We examine each of these in turn.

The federal government's auditor of defense procurement, the Defense Contract Audit Agency (DCAA), is unique; it audits every sizable contract awarded by the Defense Department. Other federal agencies are less comprehensive monitors, although DCAA audits 90 percent of all for-profit contractors that involve more than one federal agency. Even then, the federal Office of Management and Budget reported as of September 30, 1991 a backlog of almost 13,000 audits, involving approximately \$160 billion, which would take from 3 to 5 years to complete.³⁶ Inadequate funding is one reason advanced.³⁷ An extensive survey

³⁴ On the other hand, the media is more likely to focus on public sector corruption than private sector bribery. Also citizens are more likely to be incensed by abuse of public power and thus be more likely to report it to the authorities. Finally, the penalties for violating public trust are apt to be heavier than for private sector abuse. The first two forces, however, are erratic, while the deterrent impact of the last takes effect only if the offenders are caught, which in itself depends on monitoring.

³⁵ Congress's General Accounting Office performs some monitoring of the monitors. For instance, the GAO recently criticised the Health Care Financing Administration for failing even to have a contract monitoring system and of consequent overpayment. See GAO, Medicare Claims (Washington, D.C.: U.S. General Accounting Office, December 1992), pp. 12 - 15.

³⁶ Executive Office of the President, Office of Management and Budget, Interagency Task Force Report of the Federal Contract Audit Process, December 3, 1992, pp. 5 - 6. The presence of independent Inspector Generals, whose

undertaken by interagency SWAT teams of 12 federal civilian agencies and departments in 1992 proved even more revealing.³⁸ Among its findings: "Monitoring contractor performance and costs is not emphasized."³⁹ "The review disclosed that seldom do agencies accomplish a reasonableness review of the direct costs submitted for reimbursement by contractors."⁴⁰ "At present, there is little incentive to civilian agency contractors to exclude unallowable costs from their submissions, while the possible benefits in terms of increased reimbursement are real."⁴¹ "...The current cost principle allows the costs of insurance to cover losses to the contractor's clients resulting from defects in the contractor's materials or

mandated task is monitoring of federal departments and agencies, has apparently not led to significant reform. See Paul C. Light, Monitoring Government: Inspectors General and the Search for Accountability (Washington, D.C.: The Brookings Institution, 1993).

³⁷ P. 2.

³⁸ Summary Report of the SWAT Team on Civilian Agency Contracting: Improving Contracting Practices and Management Controls on Cost-Type Federal Contracts, December 2, 1992.

³⁹ P. 11. The reason given is that "because bureau management concentrates on attainment of mission goals, the primary focus is on contract award and obligation of dollars to attain those goals." (*Ibid.*)

⁴⁰ P. 17. Such reviews seem to fall between the cracks. "The COTRs [Contracting Officer's Technical Representatives] review the adequacy of the technical requirements of the contract, but on cost reimbursement contracts seldomly [sic] evaluate the reasonableness of the cost to produce that product or service." (*Ibid.*)

⁴¹ P. 33. This "heads we win, tails we don't lose" stands in contrast to Department of Defense contracts. The DOD is authorized "to impose penalties on contractors who do not properly screen unallowable costs" from their payment requests. (*Ibid.*)

workmanship."⁴²

The monitoring situation at the state and local level is no better. Anecdotal evidence suggests that little monitoring is done.⁴³ Thus, Rehfuss, who personally surveyed city and county managers in 1986 found that only 25 percent could even estimate monitoring costs. Similarly, De Hoog concludes her study of human services contracting: "For the most part, the departments have not had adequate resources to monitor contractors and conduct periodic evaluations of their programs."⁴⁴ Rehfuss also notes that "many [jurisdictions] are not particularly interested in finding out."⁴⁵ Van Horn makes an even more discouraging point: "When pressed, few officials could supply any hard evidence that private contracting was cheaper than government service delivery."⁴⁶

The presumption of inadequate public sector monitoring of contractors cannot easily be refuted. More monitoring, however, is not the entire response. The authorities need to allocate their scarce monitoring resources better. That might require less monitoring of some activities and more of others. Unfortunately, as Wilson has noted, we do not even know whether the monitoring performed by the paradigm of government monitoring agencies, the

⁴² P. 47. In other words, the government pays the insurance taken by contractors to protect themselves against faulty materials and workmanship, which, of course, removes any incentives for contractors to provide quality work.

⁴³ See Prager, "Contracting Out," p. .

⁴⁴ P. 133. See also Ch. 6.

⁴⁵ Rehfuss, p. 95.

⁴⁶ Carl E. Van Horn, "The Myth and Realities of Privatization," in Gormley, p. 271. This suggests that cost-saving is not always a priority in outsourcing decisions. See also De Hoog, Chs. 4, 5.

DCAA, is optimal.⁴⁷

The Non-Profits: A Digression. The private sector rarely contracts out to the not-for-profit sector; governments, however, do, especially for health and human services.⁴⁸ On the surface, such contracting out should not prove cheaper to the client agency, since the profit motive that drives efficiency is as irrelevant for the not-for-profits (NFP) as it is for the public sector itself. And although the lack of the profit motive should bring monitoring costs down, there's no reason to presume that the total costs of production by the NFP plus contract management costs will be lower than the total costs of government production.

Ferris and Graddy suggest NFP use of volunteers instead of paid personnel and the availability of other funding sources as reasons that NFPs keep costs down.⁴⁹ However,

⁴⁷ James Q. Wilson, Bureaucracy: What Government Agencies Do and Why They Do It (New York: Basic Books, 1989), pp. 323 - 324. "In one case the army was required to spend \$5,400 to obtain fully competitive bids for spare parts that cost \$11,000. In exchange for the \$5,400 and the 160 days it took to get the bids, the army saved \$100." (p. 324.)

Ross has questioned the fraud deterrent effect of defense procurement monitoring despite DCAA auditing. He notes that "the risk of detection has been minimal because of the complexity of bookkeeping of Pentagon contracts and because one supplier may be simultaneously working on several contracts, making it possible to juggle charges between them." He admits that the situation has improved since 1982, when the Department of Defense's Inspector General formed the Defense Criminal Investigative Service, which is primarily concerned with investigating procurement fraud. See Irwin Ross, Shady Business: Confronting Corporate Corruption (New York: Twentieth Century Fund Press, 1992), Ch. 8, especially p. 113.

⁴⁸ See Morley, p. 38, Table 4/6.

⁴⁹ James Ferris and Elizabeth Graddy, "Contracting Out: For What? With Whom?" Public Administration Review 46, 4 (July/August 1986), p. 338. De Hoog cites instances where contracts were awarded to NFPs who could donate the 25 percent nonfederal contribution, which then triggered a federal subsidy for the remaining 75 percent. De Hoog, pp. 57 - 59.

volunteer use is hardly limited to the NFP sector. Morley notes increased intensity and breadth of volunteer usage by local governments over 1982 to 1988, and finds it the second most used (after outsourcing) alternative delivery mechanism.⁵⁰ Contract terms may well play a significant role. A cost-plus type of financial arrangement would be no less destructive to NFP efficiency than it would be to private sector firms. On the other hand, contracts that repay less than full costs and hence implicitly assume nonpublic funding of the remainder are cost-saving to the client agency. Such policies, however, merely shift resources; they do not improve overall economic efficiency.⁵¹ A more significant motivating element advanced by Ferris and Graddy to explain the use of NFPs rather than private sector contractors is concern with service quality. Specifying and then monitoring service quality is especially difficult in the health and human services area.⁵² Again, however, it is unclear why NFP delivery will provide better service quality than will the public sector. In short, it's difficult

⁵⁰ Pp. 39 - 40.

⁵¹ This is one instance where it's important to distinguish between cost-saving and efficiency. Although the government's budgetary picture is improved, there is no cost-saving to the average citizen who pays for the service either through taxes or through voluntary contributions. The same distinction can be made for mandated services, whereby the state imposes on municipalities certain services without providing funding. The state's financial picture is improved especially if these services were previously carried on the state's budget. But the municipalities' financial situation moves precisely in the opposite direction. Such cost redistribution does not improve the fiscal condition of the public sector as a whole.

⁵² James M. Ferris and Elizabeth Graddy, "Production Costs, Transactions Costs, and Local Government Contractor Choice," Economic Inquiry, xxix (July 1991), p. 550. A supporting anecdote: A U.S. Department of Defense study of treatment of federally insured military families in private psychiatric hospitals "found that many of the programs appeared to provide poor or dangerously deficient care." The New York Times, April 28, 1992, p. D1.

to conclude that contracting out to NFPs will lead to superior efficiency than will producing the service within the government sector.

Public sector decision-makers have yet to learn from the private sector the significance of managing outsourcing. Efficient monitoring, though costly, pays for itself by preventing overcharges and poor quality performance in the first place, by recouping inappropriate outlays, and by disallowing payment for inadequate performance. Government authorities must resist demands for privatizing through outsourcing until they internalize the need for contract management and actually devote to it the required resources. Contracts that demand complex monitoring that are likely to be inadequately or inefficiently monitored, even if sound on economic and organizational grounds, must be viewed skeptically. In such instances, government production would be less costly as the apparent savings from outsourcing are overwhelmed by monitoring and other contracting costs.

V. Conclusion

Contracting out of government services, in short, will neither reduce government outlays nor increase government efficiency unless the decision makes economic sense. To be sure, a government authority may decide that downsizing is a political, not financial or economic imperative. Or outsourcing may serve as a threat to weaken the power of an entrenched bureaucracy or labor union. Or it may improve the short-term budget picture. Yet, government authorities and especially public sector managers have a professional responsibility for addressing the long-term. This essay has suggested that contracting out is not a silver bullet. Long-term savings from contracting out will only prevail if a number of conditions coalesce.

1. Scale. Contracting should be considered when the contractee is either too small or too large to take advantage of optimal economies of scale, provided, of course, that the contractor can capture these scale economies.

2. Scope. Similarly, contracting is a viable option when the contractor can benefit from economies of scope while the contractee cannot.

3. Organization. An overgrown governance structure that can be made more efficient, flexible, and responsive by shedding some government responsibilities is a clear candidate for outsourcing. However, it is not axiomatic that any government structure is per se inefficient, inflexible, or unresponsive. Nor is contracting out the only alternative; structural reform should also be considered.

4. Competition. More of the cost-savings of outsourcing will be passed on to the client when the contractors -- including government entities -- compete for the contract. There's little if any advantage to be gained from turning over a public service to a private monopolist.⁵³

5. Managing contracting out. The costs of the contract process -- contract design, letting, and monitoring -- need to be properly calculated. Contracting out is inappropriate when the total costs of outsourcing -- contractor charges plus contract administration -- are greater than the costs of continued internal production.

⁵³ Public regulation of a private monopolist raises efficiency questions of its own. A government monopoly can be more efficient than a regulated private monopoly.

Government operations can be as effectively contracted out as can private sector activities. Government decision-makers must approach outsourcing just as private sector decisions do -- on pragmatic not ideological grounds. Some activities will be more cost-effective when contracted out, others will not. The continuing challenge to public sector authorities is to distinguish the former from the latter.