



BEST PRACTICE GUIDELINES FOR CONTRACTING OUT GOVERNMENT SERVICES

Contracting out government services is one of the principal market-type mechanisms applied in OECD Member countries. Its use is increasing in virtually all Member countries, as the evidence is fairly clear that contracting out can lead to efficiency gains, while maintaining or increasing service quality levels. These guidelines identify the key success factors for achieving the benefits of contracting out.

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SECURE TOP MANAGEMENT INVOLVEMENT AND ENCOURAGE RE-ENGINEERING

- Contracting out should be integrated with the overall corporate strategy of the organisation. It requires the active leadership of top management if it is to achieve its full potential. The ownership and oversight of the contracting out exercise should therefore rest with the very top of the organisation.
- Contracting out should not involve a mechanistic consideration of contracting out existing tasks or processes. Rather, it should be used as an opportunity to re-evaluate both the rationale for existing tasks and the processes used to carry them out. These re-engineering benefits can only be reaped with top management involvement.
- Contracting out can lead to tensions within organisations. There may also be resistance to contracting out by some in the organisation. Active top management involvement is essential in preventing, or resolving, these internal impediments to contracting out.

When the City of Indianapolis decided to contract out the operations of its international airport, the Mayor took personal leadership of the project. It was one of the many projects where he had decided to apply the principles of competition to the provision of government services. Under the direct management of its board of directors, the Indianapolis Airports Authority then began the process of soliciting proposals to run the airport. This high-level commitment is one of the key factors responsible for the success of the project.

From United States Case Study

FOCUS ON STAFF ISSUES

- It should be recognised that contracting out is not only a financial and performance issue; it is also a people issue. It is essential to demonstrate a high degree of sensitivity in this area.
- Staff are inevitably concerned by contracting out. These concerns are caused in large part by the uncertainty that the contracting out exercise can create for them. While the process requires proper analysis, it must proceed rapidly in order to minimise any period of uncertainty for staff.
- It is of primary importance to consult staff immediately when an activity is being considered for contracting out, to deal with them honestly and frankly, and to keep them informed at every step of the way, both individually and as a group. As some staff may feel uneasy about asking questions, a confidential box (or similar) should be established where staff can drop questions anonymously with the answers then being posted for all to see.
- Similarly, the relevant trade unions should be consulted immediately when an activity is being considered for contracting out and kept up to date on developments.

When the Inland Revenue Department contracted out its information technology function, it immediately recognised staff worries about their future, and adopted a number of approaches to keeping them informed and responding to their concerns including: establishing a confidential telephone inquiry line, issuing newsletters and information bulletins, providing question-and-answer booklets and one-on-one meetings with individual staff. Consultations were opened with the trade unions at an early date as well. The Inland Revenue requests regular reports from the contractor on the progress of its former staff. These show that the staff is enjoying better career prospects at one of the world's leading information technology firms than they did previously working in the information technology department at the Inland Revenue.

From United Kingdom Case Study

SPECIFY SERVICE REQUIREMENTS IN TERMS OF OUTCOMES OR OUTPUTS

- Service requirements should be specified in terms of outcomes or outputs, not inputs. This means specifying *what* the activity is, not *how* the activity is to be performed. Operational flexibility is essential for the contractor to be innovative in performing the activity, and thereby securing efficiency gains. These outcomes or outputs should be specified as fully as possible, and include appropriate service quality measures.
- Consideration should be given to the applicability of incentive payments in the contract, either by structuring payments in such a way that they are contingent on the achievement of certain levels of service, or by offering bonus payments for achievement of service levels above a pre-defined baseline.

When Australia decided to contract out its case management services for the unemployed, the contracts were specified in terms of finding a job (or full-time education) for the unemployed. That was the desired outcome, and the contracts were framed around that. This was backed up by the payment schedule to the contractor. Fees are paid in two parts: an initial fee after the case manager and the client have developed an agreed "return to work" strategy, and a second fee based on achieving a successful outcome. The outcome fees are paid after the client has completed 13 consecutive weeks in employment or full-time education. This aims to create an incentive for case management organisations to attract clients and successfully place them in employment or training.

From Australian Case Study

MONITOR PERFORMANCE AND FOSTER CO-OPERATIVE RELATIONSHIPS

- Contracting out an activity does not diminish, in any way, the responsibility of the organisation for the performance of that service. This is especially relevant when that service is being provided to a third party.
- The organisation should regularly and formally monitor the performance of the contractor to ensure that the performance standards stated in the contract are fulfilled. When performance information originates from the contractor, it should be audited to ensure its accuracy.
- Although contracting out involves a formal contractual relationship, both parties need to recognise their mutual dependence and thus their mutual interest in developing a co-operative relationship rather than an adversarial relationship.
- The contract should incorporate provisions regarding contractor non-performance, dispute resolution mechanisms and the smooth hand-over of the activity to another contractor.

When the National Hospital in Copenhagen contracted out its building cleaning services, a system of performance monitoring was put in place. The hospital established a group of controllers to ensure that the work performed by the contractor was in accordance with the provisions of the contract. Unannounced quality checks are made 40 times per month. No such independent reviews had previously been conducted.

From Danish Case Study

When the Turkish Ministry of Finance contracted out its catering operations, it ensured that they were regularly monitored against the output-based quantity and quality standards stated in the contract. If they are not in conformity with the terms of the contract, the contractor is warned and fined for the first two violations. If the violation is repeated for a third time, the contract is terminated and the contractor's guarantee fee is not returned. The Ministry of Finance has never had to make recourse to these enforcement mechanisms.

From Turkish Case Study

ENSURE VALID COMPARISONS

- It is important when considering proposals for contracting out that all alternatives, which may include continued in-house provision, be comprehensively evaluated. This involves considering both the costs and outcomes or outputs, including comparative quality. All risks should also be systematically assessed. This includes the risk of dismantling in-house capabilities and possible dependence on a single supplier.
- A thorough costing of the present activity should be conducted and used as a benchmark for evaluating contracting out proposals. This involves identifying all costs related to the activity that is to be contracted out. These include not only the direct costs of the activity, but also its share in overhead costs and such non-cash costs as depreciation and cost of capital. The treatment of the present activity for taxation purposes also needs to be taken into account.
- If the present activity can be restructured in such a way as to offer improved performance, then this should be similarly costed and used as the benchmark for evaluating contracting out proposals.
- If contracting out an activity will incur a liability for severance payments, then this should be identified as a separate item recognising the one-off nature of such payments.

When the New Zealand Audit Office contracted out many of its audit functions, careful attention was paid to determining the cost of its services for comparison with private sector providers. The financial management reforms undertaken in New Zealand in recent years were of great assistance in this respect. All costs are reported on full accrual-basis, thus reflecting depreciation charges; and include a capital charge to reflect the cost of capital employed. This enabled the reported cost of producing audit services by the public sector to be directly compared with the price charged by private sector providers.

From New Zealand Case Study

EVALUATING IN-HOUSE BIDS

- An in-house bid occurs when the staff presently performing an activity bids against an outside contractor for an activity being considered for contracting out.
- In-house staff are often in the best position to identify opportunities for work process improvements. Their bid should be judged on the basis of these improvements.
- In-house bids should in all respects be treated the same as outside bids. Special care needs to be taken to ensure that the costing of the bid is complete, i.e. that it incorporates all items of cost faced by private sector contractors. The costing should be reviewed by an independent organisation to verify its accuracy. In-house bidders should also fulfil any accreditation and certification requirements imposed on an outside bidder.
- A winning in-house bid should be awarded to the staff on the basis of a formal document that obligates the staff to meet the terms of their bid. The performance of in-house staff should be monitored using the same processes and criteria used for outside contractors.
- The criteria used for deciding whether to permit an in-house bid should be clear and specific.

When the Dutch Tax and Customs Administration decided to contract out its printing services, it emphasised extensive consultations with all stakeholders. Involving all parties in the process at an early stage led to a balanced solution that was widely accepted. Staff members participated in the working group established to develop further the contracting out proposal. This working group recommended that no decisions be taken until a detailed Social Plan was developed for dealing with each affected staff member. All staff were either offered new positions with the contractor, reassigned to other positions within the organisation or offered outplacement training and related services. Given this Social Plan, the unions agreed with the decision to contract out the printing services.

From Dutch Case Study

FOSTER COMPETITIVE MARKETS

- Competitive supplier markets are key to achieving the benefits of contracting out. The government should foster competitive markets by recognising that its contracting out practices can play a major role in the development of markets for the relevant services.
- This relates especially to the scope and duration of contracts. At either extreme, contracts may be so small and short that they do not stimulate interest, or so large and lengthy that only the largest suppliers can participate. Consideration should therefore be given to bundling various services into attractive “packages” that can be contracted out as a single activity, or, conversely, splitting an activity among more than one contractor in order to foster competition. A judgement has to be made each time, but it should explicitly take account of its competitive impact.
- Avoiding over-specification in contracts is also important for fostering competitive markets. If the objective is specified, rather than the operational aspects of an activity, the market may be encouraged to develop its own proposals and solutions.
- Contracting out is part of the procurement function. It should be recognised that participating in the bidding process involves substantial time and resources on the part of the bidders. To the extent that this process can be simplified and shortened, a greater number of valid bidders are likely to participate.

When the Icelandic government decided to contract out residential treatment homes for children with behavioural and emotional problems, it was unknown whether there were any potential contractors willing to provide these services. The government was, however, determined to see if it could extend its competitive tendering policies to a core social functions such as this. The government publicised this widely and took out advertisements in leading newspapers soliciting interest from the private sector. The response was overwhelming. A competitive private sector market has now been established where none existed before, and almost all residential treatment homes have now been competitively contracted out.

From Icelandic Case Study

DEVELOP AND MAINTAIN THE NECESSARY SKILLS

- Effective contract management requires a new set of skills for many government organisations. Recruitment and staff training policies need to take account of this.
- Organisations that contract out activities need to maintain their knowledge of the market and their technical knowledge of the activity. This is imperative in order to be able to communicate with the contractor on equal terms, and to be in a position to effectively tender the activity again. This is especially relevant in the case of contracting out complex activities.
- It can be considered inappropriate to assign responsibility for the contract management function to staff members formerly responsible for in-house production, especially if they were part of an unsuccessful in-house bid.
- It should be recognised that contracting out involves a learning process, with knowledge gained through the contract management phase enabling subsequent tendering of the activity to be carried out more effectively.

When Mexico started contracting out its network of national highways through toll-based private finance initiatives, it encountered difficulties. The volume of traffic on the highways was less than estimated, the quality of the highways constructed was higher than that actually required, and the length of the contracts was too short. Other problems were identified as well. These problems are viewed as “areas of opportunity,” and have been studied in-depth by those responsible for the management of the contracts. Subsequent tendering will incorporate the lessons learned.

From Mexican Case Study

About this Policy Brief

At their 1995 Annual Meeting, Senior Budget Officials requested the PUMA Secretariat to undertake a study of contracting out practices in Member countries in order to identify key success factors for achieving the benefits of contracting out.

The Secretariat was assisted by a Panel of Experts in preparing these Guidelines. As part of their work, Panel members prepared case studies of specific activities that had been contracted out in their respective countries. These case studies are being published by the OECD as *Contracting Out Government Services - Case Studies*. The Guidelines were reviewed and endorsed at the 1996 Annual Meeting of Senior Budget Officials and were subsequently approved at the Fall 1996 Meeting of the Public Management Committee.

It should be emphasized that the purpose of the Guidelines is not to identify which activities should be contracted out, but rather to identify best practices for evaluating whether government services should be contracted out and how the process can best be managed once the decision to contract out has been made.

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