

# Contracting Out: Promise and Performance

John Quiggin\*

## Abstract

*In this paper, it is argued that the benefits of competitive tendering and contracting have been overestimated, and that many of the apparent benefits actually reflect transfers rather than efficiency gains. Moreover, if arrangements for competitive tendering and contracting yield an inappropriate allocation of risk, such policies can reduce welfare rather than enhancing it as is commonly claimed. A number of case studies are presented to illustrate the latter proposition. Finally, some recommendations are presented for improvements in policy with respect to competitive tendering and contracting.*

## Introduction

The practice of contracting with private firms for the provision of public services is a very old one. For example, the transport of convicts to Australia was undertaken primarily by private contractors. However, the First Fleet was effectively a public venture, being under the direct control of Governor Philip, while the Second Fleet was controlled by the contractors, paid on a fixed rate per convict. As a result of the incentive to skimp on food and medical attention, around a quarter of the convicts in the Second Fleet died, and half were unfit for work when they arrived (Clark 1962), whereas the death rate for the First Fleet had been minimal. Subsequent tightening of contractual terms reduced death rates, but also increased costs.

---

\* School of Economics, Australian National University. The author would like to thank Nancy Wallace for her helpful comments and criticism.

In broad terms, the history of convict transportation has been repeated in more recent experiments with competitive tendering and contracting. In the initial rounds of contracting, private firms have offered to deliver public services at a price far below the cost of public provision. As a range of hidden costs and problems have emerged, contractual terms have been tightened. The results have included improvements in performance, but also the loss of many of the financial savings that originally motivated the move to contracting.

The recent upsurge in private provision of public services began in the early 1980s under the Thatcher government in the United Kingdom. The Thatcher government imposed compulsory programs of competitive tendering and contracting on central government agencies and local governments. A similar approach was adopted by the Kennett government in Victoria and by the Howard government. Other governments have undertaken extensive contracting out without adopting a comprehensive program of this kind.

The adoption of systematic programs of competitive tendering and contracting has been encouraged by claims that such programs will generate substantial savings in the cost of providing public services. A commonly-cited estimate, due originally to Domberger, Meadowcroft, and Thompson (1986, 1987) is that average costs will be reduced by 20 per cent. In some cases, such as that of the outsourcing of Commonwealth government information technology, budgets have been reduced in anticipation of cost savings.

In this paper, it is argued that the benefits of competitive tendering and contracting have been overestimated, and that many of the apparent benefits actually reflect transfers rather than efficiency gains. Moreover, if arrangements for competitive tendering and contracting yield an inappropriate allocation of risk, such policies can reduce welfare rather than enhancing it as is commonly claimed. A number of case studies are presented to illustrate the latter proposition. Finally, some recommendations are presented for improvements in policy with respect to competitive tendering and contracting.

### **Contracting out and outsourcing**

The increase in support for the policy of contracting out for the provision of public services is also closely related to the increasing popularity of the corresponding practice of 'outsourcing' in the private sector. In both the

public and private sectors, policies of contracting out or outsourcing have been adopted for a number of reasons.

First, there has been a general shift towards the belief that organisations should focus on the achievement of a single 'core objective' or a small number of such objectives, and should, as far as possible, avoid responsibility for peripheral activities. This belief contrasts with the ideas of the 1960s and 1970s when 'conglomerate' corporations, with subsidiaries engaged in many different industries, were seen as a way of achieving diversification, and when government agencies typically sought to pursue very broad definitions of 'the public interest'.

Second, improvements in understanding of the allocation of risk have led to a desire to organise contractual relationships in a way that yields better management of risk. Where specific operational risks can be distinguished from the general operations of an organisation, contracting may provide an appropriate way of managing those risks.

Last, but not least, there has been a desire to reduce the core workforce of public and private sector organisations. In part, this reflects a change in fashions, as 'downsizing' rather than 'empire-building' has come to be seen as the mark of a good manager. More importantly, many organisations have found it difficult, because of legal restrictions and concerns about morale, to reduce wages and conditions for core employees. Contracting out or outsourcing has enabled corporations to replace core employees with contract employees who receive less favourable wages and conditions and to increase competitive pressure on the remaining core employees.

Contracting out, then, is undertaken for both good and bad reasons. This paper focuses primarily on the dangers of inappropriate contracting out.

## **Costs and benefits of contracting out**

### *Estimates of budget savings*

The primary motive for contracting out the provision of public services to the private sector has been the desire to reduce public expenditure. Most contracts have been designed to achieve such savings and in some cases, such as the outsourcing of information technology (IT) services by the Commonwealth government, agency budgets have been cut in anticipation of projected cost savings. As is discussed below, the Commonwealth IT outsourcing program failed to achieve the projected savings.

In Australia, the most widely-used estimate of the cost savings associated with contracting out has been that, on average, the cost of providing public services will be reduced by 20 per cent as a result of contracting out.

This estimate is derived mainly from the work of Domberger and his co-workers, and has been employed by the Industry Commission (1996) and other government agencies.

Other studies have suggested that, when the costs of tendering and contract management are taken into account, and if there are no changes in wages and conditions as a result of contracting out, the average cost saving from contracting out will be less than 20 per cent in most cases (Paddon 1991, 1993). Paddon criticises the work of Domberger and cites British estimates that the average cost saving was around 7 per cent.

In evaluations of the benefits of contracting out, it has normally been assumed that budgetary savings arise from improvements in efficiency. Estimates of net social benefits are considerably smaller if savings are supposed to arise from other sources, such as reductions in wages or service quality.

### *Service quality*

There are both political and economic reasons to expect that contracting out will be directly associated with quality reductions. First, governments frequently use contracting out as a cover for deliberate reductions in the quality of service, designed to cut costs. It is more politically attractive to implement reductions in service quality at the time of contracting out than to reduce service quality first, then to call for tenders for the provision of service at the reduced quality level.

Second, the incentives for private contractors are clearly to provide the minimum service specified in the contract. Hence, if any services previously provided are not specified in the contract, or if there is room for interpretation regarding the quality of service required, it is reasonable to assume that the minimum quality will emerge. Instances of this kind are examined in the case studies presented below. This point raises serious problems for governments seeking to evaluate the performance of contracting out. If the measures of service quality used in the evaluation are the same as those used in the contract specification, the evaluation will be biased in favour of a positive assessment. This point is illustrated with respect to the Job Network, discussed below.

Most international and Australian studies of contracting out of public services have found that service quality deteriorated (Ascher 1987; Evatt Research Centre 1990; Rimmer 1993; Egan, Montesin and Adena 1995; Fraser 1997). Savas (1977) found no evidence of statistically significant change. The Industry Commission (1996) cited a number of Australian

studies finding that service quality either improved or remained unchanged. However, nearly all of these studies came from a single group of researchers affiliated with the consulting group CTC Consultants, which took a leading role in the promotion and implementation of competitive tendering policies in New South Wales.

### *Wages*

In both the private and public sectors, outsourcing has been used as a device to reduce wages. Although the Industry Commission (1996) found no systematic pattern of wage reductions following contracting out, the ACTU submission to the same inquiry found a number of cases where wages were reduced.

Further evidence can be found in a number of decisions of the Industrial Relations Court preventing employers from reducing wages and conditions as a result of contracting out. The very existence of decisions of this kind is evidence that, in their absence, at least some employers would seek to reduce conditions.

### *Conditions of employment*

Even more than with reductions in wages, contracting out has been associated with changes in the conditions of employment designed to increase output per worker. Such changes are commonly referred to as the removal of 'restrictive work practices'. Most official evaluations of contracting out have proceeded on the assumption that such changes involve a mutually beneficial increase in flexibility and productivity.

Flexibility of employment arrangements is often discussed in terms that suggest that flexibility is unambiguously desirable. In reality, flexibility in employment is, for most purposes, a zero-sum commodity. The greater the flexibility available to the manager, the less there is for the worker and *vice versa*. From the employer's point of view, the most flexible employee is one who is permanently on call, but is paid only when called upon to work. Obviously, such employees have essentially no flexibility in managing their own time.

More generally, the productivity gains derived from the removal of 'restrictive work practices' are typically the result of an increase in unpaid working hours and in the pace and intensity of work. The main source of efficiency gains explicitly noted by Domberger, Meadowcroft and Thompson (1986) is the replacement of fixed 'task and finish' payments with piecework rates. Productivity gains from such changes in payment

schedules will arise primarily from increased effort. Ganley and Grahl (1988) cite a number of cases of increases in working hours or reductions in working conditions associated with the contracting out of garbage collection.

The Industry Commission (1996) argues that it is impossible to distinguish between increases in work intensity arising from contracting out and general changes in the labour market. This kind of obfuscation is, unfortunately, typical of the analytical approach adopted by the Industry Commission in its evaluation of microeconomic reform. A more intellectually honest statement of the position would be that contracting out is one of a number of strategies adopted by private and public sector employers to increase the intensity of work and enhance the flexibility of employers at the expense of employees.

### *Cost shifting*

Cost shifting between levels of government has been a common practice for many years, but the emphasis on cost minimisation associated with competitive tendering and contracting creates new incentives for cost shifting. An obvious way of minimising costs at one level of government is to make extensive use of services provided by another level of government on a free or subsidised basis.

Another source of cost shifting is tax evasion. The opportunities for evasion and avoidance are increased by contracting out. Public sector wage employees have less 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. The evidence reported in Tanzi (1982) indicates that evasion is insignificant among government employees and highest in the small business sector.<sup>1</sup>

### *The allocation of risk*

The appropriate allocation of risk is a crucial element of successful contractual relationships of all kinds. In a well-designed contract, risks, and the associated rewards, are allocated to the party best able to manage those risks. This point may be illustrated by considering a construction project. Under a fixed-price contract, the builder bears the risk of any unanticipated cost increases, and receives the benefit of any unanticipated cost savings. By contrast, under a 'cost-plus' contract, these risks are allocated to the customer. In general, the allocation of risk under the fixed-price contract is

superior, because the builder has more capacity to manage risk associated with the construction process.

Contracting out is likely to be beneficial in cases where risks peripheral to the core concerns of a government agency can be transferred to a contractor who is well-placed to manage those risks. On the other hand, poorly designed contracts can leave governments, and ultimately the community, in the position of bearing high risks while receiving no return. Examples illustrating both possibilities are discussed below.

### Case studies

In this section, a number of case studies are presented. In the majority of cases, contracting out was partly or completely unsuccessful. It is not claimed, however, that the case studies are a representative sample. Rather the object is to illustrate potential strengths and weaknesses of contracting out. As with Tolstoy's happy and unhappy families, successful examples of contracting out have similar characteristics, while unsuccessful examples are each unsuccessful contracting process illustrates different possible reasons for failure.

#### *Road contracting*

Experience of various contracting arrangements in the construction of roads and other public infrastructure projects illustrates the benefits of an appropriate allocation of risk and the costs of an inappropriate allocation. As has been noted above, the central principle is that risk should be allocated to the party best able to manage it.

It is important to distinguish between different sources of risk. In transport infrastructure projects, three types of risk are important: systematic economic risk; project-specific risk; and network risk. In general, project-specific risk is best allocated to the enterprise undertaking the project, typically a private contractor, and network risk is best allocated to the party responsible for the network as a whole, normally the government. The debate over systematic risk remains unresolved, but the large difference between the rate of return required by holders of private equity and the rate of return at which governments can borrow provides a *prima facie* case for allocating the systematic risk associated with ownership of the project after construction is completed to the government (Grant and Quiggin 2002).

Before the 1980s, public infrastructure projects were frequently undertaken by public works departments using their own employees, or by private

contractors hired on a 'cost-plus'. The effect was that project-specific risk was borne by the buyer, in this case, the citizens of the relevant jurisdiction.

During the period of microeconomic reform, most public projects have been undertaken by private contractors chosen through competitive tendering. The typical contract has been based on a fixed price, sometimes with adjustments for early or late completion, but with no adjustment for unexpected cost increase. The result is that project-specific risk is borne by the contractor. Relative to the previous system, this is an unambiguous improvement in risk allocation.

There have also been a significant number of projects in which infrastructure is, at least nominally, privately-owned and operated. In some cases, referred to as Build, Own, Operate and Transfer (BOOT) schemes, ownership is to be transferred to the public sector on the expiry of a contractual term. Although popular because they appear to provide 'something for nothing', BOOT schemes and, more generally, partial private ownership of network infrastructure, involve a misallocation of risk, and therefore higher costs than a system of competitive contracting based on a fixed price (EPAC 1995; Industry Commission 1996).

As the example of infrastructure projects shows, appropriate use of competitive tendering and contracting can generate efficiency gains. However, where the design of contracts is based on the desire to shift costs off-budget, as the case of BOOT schemes, these gains are unlikely to be realised.

There are many examples of BOOT schemes that have failed to generate an appropriate allocation of risk. In the case of the Sydney Harbour Tunnel project, the transfer of risk to the nominal private owner was so minimal that the Auditor-General concluded that the tunnel was effectively publicly owned. In other cases, such as the CityLink scheme risk has been transferred at very high cost. The construction costs of the scheme have been estimated at \$2 billion, but the present value of the associated tolls is around \$4 billion, implying a risk premium of up to \$2 billion.

### *School cleaning services in New South Wales*

Until 1992, cleaning of NSW government schools was undertaken for the NSW Education Department by the Government Cleaning Service (GCS). During 1992 and 1993, cleaning was provided on the basis of a mixture of competitive tendering, with the GCS competing against private firms, and non-tendered services provided by the GCS. The majority of contracts

awarded under competitive tendering went to three major contractors, Berkeley Challenge, Menzies International, and Tempo Services.

This episode of contracting out is of particular interest because it formed the basis of one of the few peer-reviewed studies to find that contracting out was associated with maintenance or improvement of service quality. Domberger, Hall and Li (1995), analyzing data collected by CTC Consultants, concluded that contracting out of school cleaning services in New South Wales yielded substantial cost savings with no reduction in service quality.

There is a striking contrast between the findings of Domberger, Hall and Li (1995), and those of a review of cleaning services undertaken following a change of government in New South Wales, which led to an upgrading of service specifications. In reporting the results of the review to State Parliament, the Minister for Education, Mr. Aquilina, described it as 'damning' and stated that 'school cleaning specifications were inadequate for young children, with grit and grime trampled into carpets because of insufficient vacuuming, food preparation areas in canteens left uncleaned and dust and shavings left to build up in woodwork rooms' (*Daily Telegraph*, 22/9/95, p. 14).

The results claimed by Domberger, Hall and Li (1995) are also inconsistent with those of surveys of school principals (Egan, Montesin and Adena 1995) and of school cleaners themselves (Fraser 1997). Fraser and Quiggin (1999) report evidence that contractors manipulated the assessment process, requiring unpaid extra work in the leadup to scheduled visits by inspectors.

Although contracting out of cleaning services has frequently produced budgetary cost savings, there is no real evidence of efficiency gains. It seems likely that, in most cases, savings are realized through reductions in wages and service quality.

### *SA Water and the 'Big Pong'*

In 1995, the operations of the South Australian sewerage and water supply system, owned by a corporatised government enterprise, SA Water, were contracted out to United Water, a consortium of the British Thames Water Company and the French Compagnie General des Eaux. The contractors reduced expenditure on maintenance, accelerating a trend that had begun during the process of corporatisation of SA Water.

In April 1997, the main sewage treatment works at Bolivar, 18 kilometres north of Adelaide, failed. For the following three months the entire

metropolitan area was subject to foul sewage odours, creating universal annoyance and widespread health problems. A subsequent audit found that the failure was the result of 'action to reduce biofilter odour production and operating and maintenance costs' (Hartley 1997). The problems were eventually rectified, but the cloak of commercial confidentiality routinely adopted by the South Australian government in relation to contracting out made it impossible to determine how the costs were divided between United Water and the South Australian community.

An important implication is that it is necessary to look at the actual rather than the nominal allocation of risk. As Sheil (2000) points out, the bargaining position of the contractor in cases of this kind is greatly enhanced by the fact that governments cannot, in the end, walk away from their responsibilities for the provision of adequate infrastructure services, whatever contractual arrangements they may make.

### *The Job Network*

The Commonwealth Employment Service (CES) was established as a result of the White Paper on Full Employment (Commonwealth of Australia 1945). As such, the CES was an embodiment of a public commitment to full employment. Despite the persistence of high unemployment since the economic crises of the early 1970s, it was not until the election of the Howard government that this commitment was officially abandoned.

In 1998 the CES was replaced by a system of competitive outsourcing referred to as the 'Job Network'. Under the tendering process, government, private and community organisations submitted bids to provide labour market services to groups of unemployed workers, classified in terms of need indicators such as the duration of unemployment. Success in tendering depended on willingness to meet tightly specified goals at low costs.

The results of this shift were entirely predictable. By providing sharp financial incentives to meet specified goals, the government greatly increased the probability that those goals would be met. According to the most recent evaluation (Department of Employment, Workplace Relations and Small Business 2001, p. 90):

Preliminary data on efficiency (unit cost and cost-per-outcome) indicate that the cost of assistance under Job Network is well below that of the assistance delivered under Working Nation and, in aggregate terms, less than the unit cost of assistance in the early 1990s ... on the basis of preliminary net impact estimates and lower costs, Job Network appears to be delivering better value for money than the previous labour market assistance arrangements.

The same evaluation was effectively reproduced in an assessment by the Organisation for Economic Co-operation and Development (OECD) (2001). This assessment reflected the dependence of the OECD on information supplied by national governments. However, the OECD noted the failure of the Job Network to reduce long-term unemployment, a point played down by the Australian government.

The problem with schemes based on competitive tendering is that the specified goals rarely respond exactly to social needs or even to the objectives of policymakers. A competitive tendering framework encourages service providers to meet the specified goals in the most cost-effective manner possible.

At best, the sharpening of incentives encourages service providers to abandon any aspects of their service not encompassed in the goal specification. For example, grant-funded charitable providers of services to the unemployed might offer counselling and assistance for a range of family-related problems, drug dependence problems and so on. Under an incentive based system with competitive tendering, such services can only be offered to the extent that they are cost-effective in meeting the goal of obtaining employment, or if they are specifically included as part of the service specification.

A second outcome of competitive incentive systems is 'cream-skimming' or 'cost-shifting'. Service providers face a strong incentive to seek out clients (the cream) whose needs can be met at relatively low cost compared to others in the same payment class. Meanwhile, high-cost clients are diverted to residual 'providers of last resort', or receive no service at all. Cream-skimming and cost-shifting have been a common outcome of case-mix funding schemes for health-care providers.

At worst, competitive incentive systems promote the search for opportunities for arbitrage, that is, for the design of systems which yield a positive profit with no net effort. In the case of the Job Network, for example, a payment was offered for successfully placing a client in employment defined as a job of at least 15 hours employment over a period of no more than 5 consecutive days. Under the rules of the scheme, the requirements for this payment could be satisfied by a service provider who simply hired the client themselves at a cost less than the payment for a 'successful outcome'. According to a Senate inquiry, precisely this strategy was adopted by one of the largest service providers, Leonie Green & Associates (Commonwealth of Australia 2001).

### *Commonwealth Serum Laboratories*

The case of the Commonwealth Serum Laboratories involved a combination of privatisation and contracting out. Until 1994 the Commonwealth Serum Laboratories fulfilled a range of public functions, the most important of which was the manufacture of plasma and other blood products using blood donated to the Australian Red Cross Blood Transfusion Services. In that year, the company, renamed CSL was privatised, and given a 10-year contract to supply the Commonwealth government with blood products.

The sale price of \$300 million was superficially attractive, in view of the fact that the profits of the Commonwealth Serum Laboratories had always been modest. However, as was observed by Hamilton and Quiggin (1995), closer examination revealed a different picture. Just prior to the privatisation, the Commonwealth government had funded a new blood fractionation plant and other equipment upgrades at a cost of \$200 million, leaving net proceeds of only \$100 million.

More importantly, the contract with CSL was exceptionally favorable to the private shareholders and exceptionally unfavorable to the public. Using evidence available at the time, Hamilton and Quiggin estimated that the contract involved annual payments \$50 million in excess of those made to the publicly owned Commonwealth Serum Laboratories.

As it turned out, these estimates were conservative. According to the Australian National Audit Office (1995), the payments required under the Plasma Fractionation Agreement were to total around \$1 billion between 1994 and 2004, or about twice as much as estimated by Hamilton and Quiggin.

Moreover, subsequent dealings with CSL exposed the difficulties of underfunded public servants seeking to negotiate with a profit-oriented monopoly supplier. As was shown by the Australian National Audit Office, the Commonwealth Department of Health was outmanoeuvred. In particular, CSL was effectively able to double-count depreciation of the fractionation plant, which was, as noted, a gift from the Commonwealth government. Moreover, despite the claim that public ownership was too risky, the deal with CSL left the public bearing most of the risks associated with a blood products business (such as possible exposure to litigation over Creutzfeld-Jakob disease, a blood-borne virus) while receiving none of the returns.

As the generosity of contract arrangements has become apparent, the share price of CSL has soared. The float, at a price of \$2.30 was heavily oversubscribed by foreign buyers, but Australian purchasers were somewhat less eager. Following the release of the Auditor-General's report the price rose to \$5, as it became apparent that CSL had an effective licence to

print money. Since 1999, the price has risen to \$35, valuing the entire business at \$7 billion. Some of this increase reflects acquisitions and income-earning possibilities from the group's pharmaceutical products. However, the valuation is underwritten by the monopoly rents extracted from the public under the outsourcing contracts negotiated by the Keating and Howard governments.

The attempted defence of the CSL privatisation offered by Johns (2001) sheds some light on the policy thinking behind this unsatisfactory outcome. As Parliamentary Secretary to the Minister for Health, Housing and Community Services, Johns was largely responsible for the privatisation. He is now employed by a right-wing 'think tank', the Institute of Public Affairs. As Johns correctly observes:

The critics' argument is that the Commonwealth will be paying out \$45 million per year more for the life of the ten-year agreement than it would have, had CSL remained in Commonwealth ownership. Is this accusation sustained by the facts?

This rhetorical question appears to promise a negative answer. In fact, Johns concedes that:

A government which was unwilling and unable to run CSL as a private company could not expect to recoup a present value from assets that were improved after they were sold. *Of course, the basis for much of that improvement rested in the preparation of CSL for sale, in particular the new fractionation plant and the corporatization process. It may also be true that the Commonwealth could have struck a better bargain with CSL on the price of plasma products and the assignment of depreciation at the Broadmeadows plant.* (emphasis added)

To put the matter more bluntly, the Keating government's unwillingness to invest in an important public asset led to a situation where the public made a \$200 million gift to private shareholders, negotiated a deal to give the same shareholders at least another \$1 billion, and still ended up bearing nearly all the risk associated with the activity in question. Johns attempt defence does not overturn the conclusion of Walker and Walker (2000) who awarded it the Wooden Spoon for Australia's worst privatisation. The poor outcome reflected the combination of an underpriced public float and a mismanaged contracting arrangement.

### *Commonwealth IT outsourcing*

Contracting for the provision of Commonwealth public services, already extensive under the Hawke-Keating Labor government was accelerated

under the Howard government, following the recommendations of the National Commission of Audit (1996). Under the *Financial Management and Accountability Act 1997*, systematic 'market testing' of all activities undertaken by Commonwealth agencies, beginning with corporate services, was required to determine whether the relevant services could be provided more cheaply by the private sector.

This general commitment was deemed inadequate in the case of information technology (IT) services. A commitment to outsource all such services was reflected in the establishment of the Office of Asset Sales and Information Technology Outsourcing (OASITO) within the Department of Finance. This group, which also had responsibility for supervising market testing and a range of asset sales including the partial privatisation of Telstra and the sale of Commonwealth office buildings,<sup>2</sup> imposed a centralised outsourcing process.

In announcing the initiative, the government projected savings of \$1 billion over seven years. As the Senate Committee on Finance and Public Administration (2001), notes, the IT outsourcing program was driven predominantly by the desire to achieve cost savings, with little concern for the achievement of appropriate contractual relationships.

The central element of the process was the aggregation of units of governments into 'clusters' in order to deliver economies of scale from aggregating services within and across budget-funded agencies. Thus agencies were not only forced to undertake tendering, but were deprived of any real control over the process.

Following intense public criticism of the program, the government commissioned a review of the program (Humphry and Richard 2000), which found that savings had been substantially overestimated, and that the needs of specialised agencies such as CSIRO were not properly taken into account. In response, the government removed OASITO from control of the process. A number of partially completed tendering processes were abandoned and responsibility for outsourcing returned to individual agencies.

Despite these changes, many of the fundamental defects in the process remained unresolved (Senate Finance and Public Administration Committee 2001). The fundamental difficulties arise because competitive tendering has been imposed by a mandate from central government rather than being adopted where appropriate by individual agencies.

## **Policy implications and recommendations**

A number of policy recommendations follow from the analysis and case studies presented above:

- Decisions on the use of contracting should be made by agencies with direct responsibility for service provision, in consultation with service consumers and employees.
- Agencies undertaking contracting out should maintain sufficient in-house expertise to guarantee that contractual provisions yield appropriate benefits to the community and that those provisions are implemented. The cost of this in-house expertise should be included in any assessment of options for contracting out.
- Contractors should be required to maintain wages and conditions equivalent to those in force prior to contracting out.
- Contractors should have the same public accountability requirements, including Freedom of Information, as public service providers. Where appropriate, rights to claim commercial confidentiality should be waived, as part of the contractual conditions.
- Contracts should be drawn up with the aim of making provision of the previously existing quality of service the default standard. Where reductions in service quality are proposed they should be specified explicitly.
- A Consumers Charter or similar mechanism should be provided to allow consumers of public services to seek remedies in cases where service quality is reduced without an explicit decision process.
- Quality assurance procedures in contracting out should be enhanced to ensure that all contractors guarantee compliance with taxation, workers compensation and related obligations.
- Residual risks borne by the community should be evaluated and the cost of those risks included in any evaluation of contracting out.

## **Concluding comments**

The employment of private contractors to provide public services is a long-standing practice. Appropriate use of competitive tendering and contracting can improve the efficiency of public service provision and the allocation of risk.

However, the recent popularity of contracting out as a policy has given rise to numerous instances of inappropriate, poorly designed and poorly implemented contracting out. In many cases, the benefits of budgetary cost savings have been outweighed by losses in wages, reductions in working

conditions and reductions in the quality of service. Competitive tendering and contracting should be undertaken only on a case-by-case basis, and only after an assessment that takes account of all relevant costs and benefits.

## Notes

- 1 This is, of course, what would be expected given the incentives and opportunities faced by different members of the community, and not a reflection on their inherent honesty or otherwise.
- 2 The performance of OASITO with respect to asset sales has also been the subject of vigorous criticism, the main theme of which has been that assets.

## References

- Ascher, K. (1987) *The Politics of Privatisation: Contracting Out Public Services*, Macmillan Education, Basingstoke.
- Australian National Audit Office (1995) *The Sale of CSL, AGPS*, Canberra, The Auditor-General. Audit Report No. 14, 1995-96.
- Clark, C.M.H. (1962) *A History of Australia: From the Earliest Times to the Age of Macquarie*, Melbourne University Press, Melbourne.
- Commonwealth of Australia (1945) *Full Employment in Australia*, Commonwealth Government Printer, Canberra.
- Commonwealth of Australia (2001) *Report of Enquiry Arising from Senate Estimates Hearings on 4-5 June 2001 into Matters Concerning Job Network*, AGPS, Canberra.
- Department of Employment Workplace Relations and Small Business (2001) *Job Network Evaluation, Stage two: Progress Report*, AGPS, Canberra.
- Domberger, S., Doyle, G. and Hall, C. (1996) *Competitive tendering and contracting: a response to the critics*, CT02-96 April, CTC Research Team, Graduate School of Business, University of Sydney.
- Domberger, S., Hall, C. and Li, E.A.L. (1995) 'The determinants of price and quality in competitively tendered contracts', *Economic Journal* 105 (433), 1454-70.
- Domberger, S., Meadowcroft, S. and Thompson, D. (1986) 'Competitive tendering and efficiency: The case of refuse collection', *Fiscal Studies* 7 (4), 69-87.
- Domberger, S., Meadowcroft, S. and Thompson, D. (1987) 'The impact of competitive tendering on the costs of hospital domestic services', *Fiscal Studies* 8 (4), 39-54.
- Domberger, S., Meadowcroft, S. and Thompson, D. (1988) 'Competition and efficiency in refuse collection: a reply', *Fiscal Studies* 9 (1), 86-9.
- Economic Planning Advisory Commission Private Infrastructure Task Force (1995), *Final Report*, AGPS, Canberra.
- Egan, J.T., Montesin, H.J. and Adena, M.A. (1995) *NSW Teachers Federation School Cleaning Services Survey 1994*, February, INSTAT Statistical Data Analysts (INSTAT Australia Pty Ltd).

- Evatt Research Centre (1990) *Breach of Contract: Privatisation and the Management of Australian Local Government*, Pluto Press, Sydney.
- Fraser, L. (1997) Impact of contracting out on female NESB workers: case study of the NSW government cleaning service, Ethnic Communities' Council of NSW Inc.
- Fraser, L. and Quiggin, J. (1999) 'Competitive tendering and service quality', *Just Policy* 17, 53-7.
- Ganley, J. and Grahl, J. (1988) 'Competition and efficiency in refuse collection: a critical comment', *Fiscal Studies* 9 (1), 80-5.
- Hamilton, C. and Quiggin, J. (1997) *The privatisation of CSL*, Australia Institute Report No. 4, Canberra.
- Hartley, K. (1997) *Independent Audit of the Bolivar Wastewater Treatment Plant to Determine the Causes of a Major Odour Event*, Uniquet Limited, St Lucia.
- Humphry and Richard (2000) *Review of the Whole of Government Information Technology Outsourcing Initiative*, Commonwealth of Australia.
- Industry Commission (1996) *Competitive Tendering and Contracting by Public Sector Agencies*, AGPS, Melbourne.
- Grant, S. and Quiggin, J. (2002) 'The equity premium and the discount rate for public projects', *Economica*, forthcoming.
- Johns, G. (2001) 'Confessions of a Privatizer: The Privatization of CSL Ltd', Institute of Public Affairs, Privatisation Briefing, May.
- National Commission of Audit (1996) *Report to the Commonwealth Government*, AGPS, Canberra.
- Organisation for Economic Co-operation and Development (2001) *Innovations in Labour Market Policies: the Australian Way*, OECD, Paris.
- Paddon, M. (1991) *The real costs of contracting out: reassessing the Australian debate from UK experience*, Discussion Paper No. 21, Public Sector Research Centre, University of NSW, Sydney.
- Paddon, M. (1993) *Competitive tendering and contracting out in British local government, 1979-92*, Discussion Paper No. 30, Public Sector Research Centre, University of New South Wales, Sydney.
- Rimmer, S.J. (1993) *Aspects of competitive tendering and contracting in local government administration* (PhD thesis), April, University of New England.
- Savas, E. (1977) 'An empirical study of competition in municipal service delivery', *Public Administration Review* Nov/Dec, 717-24.
- Senate Committee on Finance and Public Administration (2001) *Re-booting the IT agenda in the Australian Public Service – Final report on the Government's information technology outsourcing initiative*, Parliament of Australia, Canberra.
- Sheil, C. (2000) *Water's Fall: Running the Risks With Economic Rationalism*, Pluto Press, Sydney.
- Tanzi, V. (1982) *The Underground Economy in the United States and Abroad*, Blackwell, Oxford.
- Walker, B. and Walker, B.C. (2000) *Privatisation: Sell Off or Sell Out? The Australian Experience*, ABC Books, Sydney.