Costing the Alternatives:

Evaluating Outsourcing Options

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Topics

- Setting the context
- The vantage point of the presentation
- An introduction to costing concepts
- Transactions costs
- The issue of contracting
- A final word on competition

Setting the Context

Policy Bias & Cost Accounting

- Cost accounting is based on choices about the nature of costs and their relative importance.
- These choices in turn are rooted in the social and political values of the decision makers who define which costs matter and which do not.
- It is important to bear this in mind as we consider the relative efficiency of outsourcing.

The Vantage Point of this Presentation

- Economics as a subset of Political Economics
- Cost minimization for taxpayers. (assumes equal quality)
- Time Frame: medium term (up to 10 years)
- Organizational Frame: Models the "make-buy" decision of private for profit firms.

U.S. Government Policy Goal

"In the process of governing, the Government should not compete with its citizens. The competitive enterprise system, characterized by individual freedom and initiative, is the primary source of national economic strength. In recognition of this principle, it has been and continues to be the general policy of the Government to rely on commercial sources to supply the products and services the Government needs."

Cost accounting is based on choices about the nature of costs and their relative importance.

Source: http://www.whitehouse.gov/omb/circulars/a076/a076.html

The myth of competitive savings

"The government spends billions of dollars every year for commercial services provided by government employees. **Competition** (*emphasis added*) can easily result in savings of an average of 30 percent, whether government employees or private sector employees ultimately do the work. At the Defense Department, a survey of the results of hundreds of competitions done since 1994 showed savings averaging 42 percent."*

* http://www.cfo.doe.gov/me2-1/a76/WhatYouAlways.pdf

An Introduction to Costing Concepts

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The Elements of Costs

- Contract costs are the offerer's price.
  - A quasi-hard number. (*The cost overrun problem*)
- Fully allocated costs are the costs avoided by outsourcing + an estimated cost allocation for operations overhead and general and administrative overhead.
  - A quasi-hard number for the avoidable costs and a softer one for the allocated costs
- Avoidable costs are the costs no longer incur as a result of outsourcing.
  - A quasi-hard number.
- Transactions costs are the costs of managing the outsourcing operation
  - (*A <u>very soft</u> number, but often the most important one in the entire exercise*)

The Fundamental "Make-Buy" Decision Inequalities – Private Sector

- If AC > CC + TC; "Buy"
- If AC< CC + TC; "Make"
  - AC = Avoidable Cost
  - CC = Contract Cost
  - TC= Transactions Cost

The Fundamental “Make-Buy” Decision Inequalities under A-76

- If FAC > CC + TC; “Buy”
- If FAC< CC + TC; “Make”
    - FAC = Fully Allocated Cost
    - CC = Contract Cost
    - TC= Transactions Cost
- FAC is by definition always greater than AC.
    - *A-76 uses a baseline 12% differential for allocated overheard costs.*

Please Note: The central importance of transactions costs

- Even if CC<AV (or CC< FAC), outsourcing is not necessarily less expensive.
  - The crucial factor is TC, which is the hardest cost to estimate *ex ante*.
  - In the decision process, organizations need to think carefully about TC.
- Outsourcing <u>always</u> either succeed or comes to grief on issues of TC.

Two Approaches to Comparative Cost Accounting

Fully Allocated Cost Accounting (FAC) requires that when we estimate the cost of a government function, we include not only an estimate of the actual costs of that activity but an allocation for the overhead of the agency that is responsible for that activity.

Avoidable Cost Accounting (AC) requires that we compare the costs avoided through contracting to the costs of the contract (CC) plus the costs imposed on the organization by the act of outsourcing.

Transactions Costs: In Depth

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Transaction costs are <u>the</u> core issue in outsourcing.

- Transactions costs include:
  - The costs of administration of the contract bidding process.
  - The costs of contract management and supervision.
- They are difficult to estimate but real and significant.
- Typically when a contract fails it is because of the transactions costs (Often perceived as a “hassle factor” or an “aspirin factor.”)

Forms of Transactions Costs

- Information Costs – Lack of or unequal information between parties to a transaction (information asymmetry)
- Agency Costs – Divergence in mission between principal and agent
- Coordination of complex set of contractors
- Costs of Shirking – The employment contract
- Opportunism – Parties act with self interest
- Costs of Uncertainty – Lack of knowledge about future conditions
  - Risk Premiums
  - Insurance Costs
- Adverse Selection – The worst comes first
- Moral Hazard – Conflict of interest
- Costs of Compliance
  - Costs of measuring performance
  - Detecting Violations
  - Imposing Penalties
- Costs of Imperfect tools of Measurement

Transaction Cost Economics

- TCE focuses on 3 factors in determining the desirability of outsourcing
  - Frequency of transactions
  - Uncertainty about the quality of deliverable output
  - The degree of asset specificity involved in the transaction
- Behavioral assumptions of TCE
  - Parties act with bounded rationality. (Information is far less than perfect)
  - Parties act with self-interested guile in contracting situations.

The TC Rule

- When the frequency of transactions is high;
- When the ability to judge the quality of contractor output is difficult;
- When the assets needed to complete the mission are highly specialized
- The transactions costs of outsourcing will generally drive an organization to make rather than buy.

The Issue of Contracting

Transaction Costs & Contract Structure

- Contracts in general take 1 of 3 forms
  - Complete or classical contracts
  - Incomplete contracts
  - Relational contracts

Complete Contracts

- Products are clearly specified and easily evaluated.
- There is no expectation of an ongoing relationship.
- There is easy of entry and exit into the market for the product.
- Points of contract law are clear, adjudication, if any, is on facts. (Hence TC of enforcement are low)
- Examples:
  - Paint the building
  - Repair the plumbing
  - Construction (more complex but still complete)

Incomplete Contracts

- Long term relationship between the parties (either measured in multiple years or open ended)
- Product quality is not easily evaluated
- Control over expensive assets is a factor in the relationship
- Frequent interaction between the parties is required
- Contract exit incurs high transactions costs as well as financial ones
- Forms of 3rd party governance such as arbitration are required

Examples of Incomplete Contracts

- Protective services(Police, Fire, Security)
- Incarceration
- Health (Mental & Physical)
- Economic Development
- Education

In general most contracts for mid to long term arrangements in which results are not easily measured are incomplete.

Relational Contracting

- Occurs when the parties to a contract share an organizational mission.
- Parties depend on one another to achieve the shared mission.
- Occurs in all sectors private-for-profit, not-for-profit and public sector.

Examples of Relational Contracting

- Just-in-Time Production - Private Sector
  - Toyota
  - Bennetton
- Public Sector
  - IFS Indianapolis Fleet Services
  - Dual track social service contracts (public provision and not-for-profit provision)

A Final Word on Competition

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What's competition got to do with it?

- Competition must be considered in a dynamic as opposed to static context.
- It is an unstable market situation
  - Buyers love it; sellers hate it.
  - Sellers work to undermine competition
- Once work is outsourced, government's ability to carry it out rapidly deteriorates. Work rarely if ever comes back in-house.
- Competition, especially in situations of incomplete contracting, and dissolution of government competence, tends to dissolve into oligopoly, duopoly and monopoly.
- Absent stable competition (a rare event) the general assertion that outsourcing always saves money is always a highly questionable concept
- Relational contracting is antithetical to competition.

Thank You

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