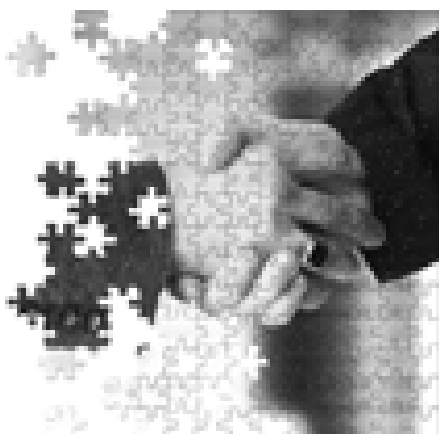
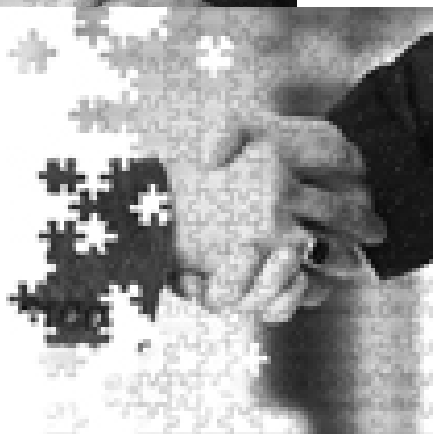
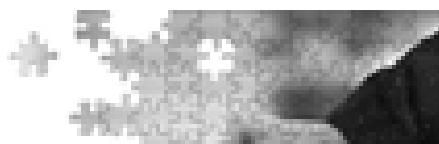
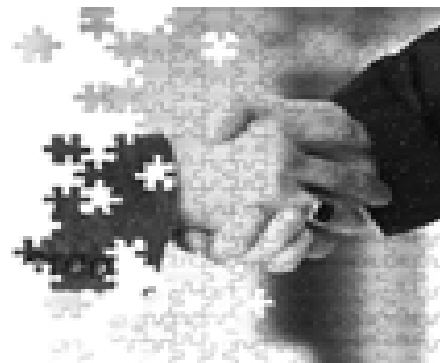
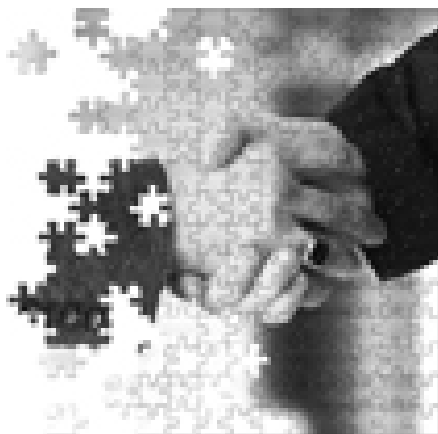


SUSTAINING SERVICES FOR FUTURE GENERATIONS: SUMMARY REPORT



**An Economic Analysis of
Shared Services and
Outsourcing in Australian
Local Government**

1. INTRODUCTION

Australian local government faces several daunting challenges. By far the biggest problem resides in ensuring the continued financial sustainability of local councils and somehow overcoming massive funding difficulties involved in tackling the local infrastructure backlog. A much less acute problem lies in ongoing concerns over the operational efficiency of local councils in service provision by local government policy makers.

In general, three main structural reform approaches have been adopted to improve the operational efficiency of Australian local councils:

Forced amalgamation: With the sole exception of Western Australia, all Australian state governments have relied on structural reform by means of forced mergers to improve the operational efficiency of local councils, despite the demonstrated failure of previous amalgamation episodes to improve municipal efficiency.

Shared service arrangements: A spate of recent national and state inquiries has dismissed council mergers as a viable policy option and instead proposed that shared service arrangements between cooperating local councils represented a much better way of improving council efficiency. Common shared service arrangements in contemporary Australian local government include Regional Organisations of Council and Strategic Alliances between cooperating councils.

Outsourcing: In contrast to shared service models, alternative market-orientated approaches to local government service provision, such as outsourcing, contracting out, public/private partnerships and the privatisation of services, have also been proposed to improve operational efficiency. A new form of outsourcing, sometimes termed ‘transformational outsourcing’, also sold under the misleading title of ‘shared services partnerships’, is currently being marketed in Australian local government, especially in Queensland.

The distinction between shared services and outsourcing service provision to private firms is critically important against the background of current developments in Australian local government. For example, there has been a concerted effort by leading British corporations involved in local government service contracting in the United Kingdom, such as Capita, to persuade Australian local government that self-

styled ‘transformational outsourcing’ or ‘business process outsourcing’ somehow represents a *bona fide* ‘partnership’ between private for-profit providers and local councils in shared service provision rather than simply a traditional outsourcing arrangement.

A salient recent example of this persuasive effort was the UK Shared Services Study Tour organised by the Local Government Association of Queensland and Queensland Partnerships Group Shared Services in 2008, which hosted a party of Australian local government councillors and managers in an attempt to persuade them to adopt these ‘shared service’ partnerships. Efforts to market ‘transformational outsourcing’ arrangements as shared service models seem to have been focused most heavily on Queensland local government.

Against this background, the Australian Services Union commissioned New England Education and Research Pty. Ltd. to undertake a detailed analysis of shared services and outsourcing in local government which considered the arguments for these two alternative modes of local service provision, the various institutional forms they can take, their economic characteristics, and available empirical evidence on their outcomes. New England Education and Research Pty. Ltd. engaged Professor Brian Dollery to prepare a detailed report on shared services and outsourcing in local government, as well as a short discussion paper presenting the main findings of his Report. This paper represents a synoptic review of the Final Report prepared by Professor Dollery.

The paper is divided into five main parts. Section 2 provides a brief outline of the contents of the Final Report. Section 3 distinguishes between shared services in Australian local government and alternative outsourcing methods of providing local government services. Section 4 deals with shared services in local government by examining the rationale for this form of service provision, the various models that can be used and available empirical evidence. Section 5 considers outsourcing to the private sector as an alternative approach to shared services by considering the economic rationale for outsourcing, the different models of outsourcing, especially so-called Strategic Service Delivery Partnerships, and the existing limited empirical

evidence on outsourcing. The paper ends with some brief concluding on the main findings of the Final Report in section 6.

2. OUTLINE OF THE FINAL REPORT

The Final Report is divided into four main parts:

- Part A provides the background to the Report by considering recent trends in Australian local government, conceptual considerations which distinguish between *bona fide* shared service models and alternative market-orientated approaches to service provision, including outsourcing, contracting out, public/private partnerships and the privatisation of services, as well as outlining the aims and contents of the Report. Part A comprises chapters 1, 2 and 3.
- Part B focuses on shared services in local government by considering the theoretical rationale for shared services, alternative models of shared services, Australian and international empirical evidence on shared services in local government, flaws in the Local Government Association of Queensland (2006) appraisal of the outcomes of shared services, as well as recent initiatives by the Local Government Association of Queensland into vertical ‘shared service’ arrangements between the Association, its member councils, and commercial partners. Part B comprises chapters 4, 5, 6 and 7.
- Part C deals with the outsourcing of local government functions and services through commercial enterprises. Specific attention is focused on so-called ‘transformational outsourcing’, currently marketed as ‘shared services partnerships’ in Australian local government, particularly in Queensland. Part C comprises chapters 8, 9, 10 and 11.
- Part D outlines the conclusions reached in the Report. Part D comprises Chapter 12.

3. SHARED SERVICES AND OUTSOURCING IN LOCAL GOVERNMENT

The Final Report demonstrates that the main structural alternative to amalgamation resides in shared services in local government. A large number of Australian local councils have already embarked on shared service arrangements of various kinds. While the vast majority of these arrangements have occurred through institutional

arrangements between groups of councils acting in concert, a growing number have taken place between state local government associations and councils in their respective jurisdictions. By contrast, as we have seen, a new and disturbing development has been the instigation of joint contractual arrangements between local councils and private firms which have been falsely styled as ‘shared service models’, but are in fact variations on market instruments, such as outsourcing, contracting out, public/private partnerships and even fully-fledged privatisation of services.

Given the tendency of private providers of local government services to label their activities as ‘shared service partnerships’ to allay public anxiety, it is important to draw a firm distinction between *bona fide* shared service arrangements in local government and for-profit partnerships between private firms and local government in service provision. While both types of partnerships hinge on the legitimate divide between service production and service provision in the public sector developed by Oakerson (1999) in his *Governing Local Public Economies*, it is essential to distinguish between them since they possess quite different characteristics from the perspective of local government. This observation represents a critical theme running throughout the Report.

Shared services in local government represent institutional arrangements of various kinds between groups of local councils themselves, local councils and their state local government associations, or local councils and state and federal governments for the provision of local government services. A common feature running through these three genre of shared shares resides in the fact they all involve full ownership and control by local government of the resources involved, the functions and services provided and the costs and benefits contingent on the activities in question. These characteristics substantially reduce the risks associated with these shared service partnerships and maintain local council autonomy. In essence, shared service models thus rule out partnerships with for-profit private organisations since such relationships inevitably involve at least some loss of ownership and control.

In addition to *bona fide* shared service models in local government, it is possible to identify several other types of service provision partnerships which involve for-profit enterprises. In effect, all these other partnership arrangements revolve around

outsourcing of one kind or another. Outsourcing in the present context may be defined as the procurement of functions or services from sources that are (a) external to the council and (b) are provided by for-profit organisations. Since the imperatives driving for-profit enterprises and not-for-profit organisations are radically different from those motivating service-orientated local councils, it is not surprising that these two categories of organisations have quite different characteristics altogether.

It is useful to briefly define the various market mechanisms that could be used in local government service provision and consider their main characteristics:

- **Competitive tendering** represents the process of calling for and receiving tenders from prospective service providers and selecting one or more of these providers on the basis of a formal evaluation. Competitive tendering does not necessarily involve outsourcing since service providers may be chosen from departments within councils. In addition, it need not embrace privatisation even if the service provider selected is not from within the council in question since other public sector agencies could secure the tender.
- **Outsourcing** refers to the contracting out of a local service to an organisation external to the council rather than providing the local service within the council. While outsourcing precludes service production within the council it does not necessarily mean private service production since other public sector entities might secure the contract.
- **Contracting out** refers to the practice of hiring an external organisation to provide a good or service rather than providing it 'in-house'. While contracting out necessarily implies outsourcing, it does not necessarily mean private sector service provision since public entities could secure the contract.
- **Corporatisation** refers to the process of establishing separate entities within a local council that are 'cost centres' and must run on a 'commercial basis. The idea is to bring 'market discipline' to bear on production units within councils. Corporatisation thus does not involve contracting out service provision.

It is important to stress that none of the options defined above represents privatisation *per se*. Although privatisation and contracting out are often used synonymously, they are conceptually quite distinct. In essence, privatisation refers to the transfer of ownership of physical assets from public ownership to private ownership.

4. SHARED SERVICES: RATIONALE, MODELS AND EVIDENCE

As we have seen, a central proposition advanced in the Final Report is that fundamental differences exist between shared service models in local government and alternative market-orientated approaches to local government service provision, such as outsourcing, contracting out, public/private partnerships and the privatisation of services. The Report distinguishes between three broad types of local government shared service models:

- **Horizontal shared service models** that are wholly operated and owned by participating local councils;
- **Vertical shared service models** that involve cooperation between all or some local councils in a given state jurisdiction and the respective state local government association; and
- **State-local government shared service models** where local councils *voluntarily* carry out various functions on behalf of state and/or federal governments.

While shared service arrangements can take a multitude of different forms, horizontal shared service models all have in common that the shared services, shared resources, shared equipment and shared facilities involved are fully-owned by the member councils. Thus not only are the activities and procedures of the shared service entity completely controlled by its members councils, but all costs, income, profit and risk fall ultimately on these councils. In other words, shared service arrangements falling under horizontal shared service models are wholly operated and owned by local councils. These characteristics substantially reduce the risks associated with shared service partnerships. In essence, shared service models thus rule out partnerships with for-profit private organisations since such relationships inevitably involve at least some loss of local ownership, local control and local autonomy.

As we have seen, the economic basis for shared services in local government rests on the observed fact that service provision can be separated from service production (the so-called purchaser-provider split) since scale economies and scope economies typically only arise during the production phase. Thus municipal councils too small to

achieve all economies of scale and scope on their own can nevertheless accrue these economies by entering into shared service arrangements with other local councils to form a production entity large enough to secure economies of scale and economies of scope.

The political basis for shared services in local government hinges on the need for cost savings without compromising local autonomy, local control and local democracy. This means that shared service vehicles must be fully operated and owned by participating local councils since alternative outsourcing methods using private firms *directly* jeopardises local autonomy, local control and local democracy by ceding at least some control over service provision to private providers.

Outsourcing can also have detrimental *indirect* impact through a fall in local wages, a loss of local employment and the associated multiplier effects on local economic growth, local population growth, as well as local and state service provision in the form of educational facilities, health services and the like. These concerns are especially acute in regional, rural and remote parts of the country.

A key question revolves around which municipal services are best suited to being offered through shared service models. Six characteristics are identified in the Report: ‘Low core capability’ of councils; ‘high supplier availability’; ‘low task complexity’; substantial scale economies; ‘specialized technology’; and ‘low asset specificity’. Several surveys of shared services in Australian local government have identified areas in which this approach is most commonly used:

- One such survey found these to include (i) waste management; (ii) environmental health/development assessment and town planning; (iii) shared use and purchase of physical assets; (iv) back-office operations; (v) access to IT services; and (vi) governance, compliance and audit services.
- A second survey of local councils in Western Australia found the most commonly shared services included: (i) waste disposal/collection and recycling; (ii) road works; (iii) shared equipment; (iv) IT services; (v) human resources; (vi) health and planning; (vii) shared library facilities and (viii) bush land management.

- A third similar survey in NSW by Byrnes (2005) identified eight services suitable for shared delivery: (i) fire protection; (ii) emergency services; (iii) health administration and planning; (iv) noxious plants; (v) museums; (vi) water and wastewater; (vii) tourism and regional promotion; and (viii) sale yards and markets.

The Final Report sets out three typologies of shared service models as a means of understanding their varied structural characteristics. The Local Government Association of Queensland (2006) developed the following taxonomy:

- ‘Merger/amalgamation’, where two or more councils are consolidated into a single larger local authority;
- ‘Significant boundary change’, where the spatial area of municipal jurisdictions is altered substantially;
- ‘Resource sharing through service agreements’, in which one local authority undertakes specific functions for other councils, like strategic planning and waste management; and
- ‘Resource sharing through joint enterprise’, in which municipalities combine their activities in a given service function in order to reap scale economies, such as official record keeping and storing.

This taxonomy is useful since it differentiates between ‘structural change’ involving the amalgamation of local councils as well as spatial alterations to the size of local government areas and ‘process change’ which leaves local councils intact but changes the configuration of service provision.

A more detailed typology has been provided by Dollery and Johnson (2005), which comprises seven alternative models of local governance:

- Existing small councils possess the most operational and political autonomy as well as highest degree of decentralization and are thus located at one end of the continuum;
- The next most autonomous and decentralized model resides in voluntary arrangements between geographically adjacent councils to share resources on an *ad hoc* basis whenever and wherever the perceived need arises;

- Regional Organizations of Councils constitute a formalization of the *ad hoc* resource sharing model which provides shared services to member councils;
- Area integration models retain autonomous existing councils with their current boundaries, but create a shared administration;
- Virtual local government consists of several small adjacent ‘virtual’ councils with a common administrative structure or ‘shared service centre’ that would provide the necessary administrative capacity to undertake the policies decided by councils, with service delivery itself contracted out either to private companies or to the shared service centre;
- The agency model in which all service functions are run by state government agencies, with elected councils acting as advisory bodies to determine the mix of services; and
- The most extreme form of centralization occurs when several small councils are amalgamated into a single large municipality.

Under the Dollery and Johnson (2005) taxonomy *ad hoc* resource sharing models, Regional Organisations of Council, area integration models, virtual local councils and agency models all represent institutional vehicles for accommodating shared services to a greater or lesser degree.

Tomkinson (2007) proposed a taxonomic system in his *Shared Services in Local Government* which contains four alternative shared service models:

- The **Intra-Service Model** includes limited shared services options, such ‘regional procurement models’, which provide procurement and purchasing services to member councils;
- The **Service Model** embodies a degree of formality which enables the participating group of councils to cede control to the council which takes on the role of the ‘lead council’ in terms of budgetary control, service specification, statutory service responsibilities, etc;
- The **Corporatist Model** involves two or more councils forming a joint arrangement to deliver a specific service or services at a mutually agreed standard in which both the costs and benefits are borne by all partner councils on a negotiated basis. In general, this means the creation of a joint governing

body to sit between the sharing councils and the delivery body which is wholly owned by these councils; and

- The **Supra-Corporate Model** enables two or more participating councils to set up a separate ‘special purpose vehicle’ to deliver a specified service or services on behalf of member councils. This vehicle could take a variety of organisational forms, such as a joint venture company, a company limited by shares or by guarantee, a not-for-profit organisation or limited liability partnerships.

Extravagant claims regarding the economic advantages that flow from shared services permeate the Australian local government literature. However, in its extensive survey of Australian and international evidence, Chapter 5 of the Final Report drew five major policy implications from the rather scant Australian and international empirical evidence:

- There is little ‘hard-core’ rigorous evidence in support of the local shared service arrangements and no such evidence against this approach;
- From existing ‘soft-core’ evidence it seems that shared service arrangements can be beneficial for councils both in terms of cost savings and enhanced service quality;
- The success of particular arrangements seems to vary depending on the specific local circumstances. It thus appears that all possible impediments and shortcomings of shared service delivery should be carefully considered prior to the conclusion of any agreement;
- The fourth general policy implication centres on the types of local services most suitable for shared service models. Six broad areas are cited in empirical evidence: (i) procurement; (ii) human resources; (iii) governance, compliance and audit services; (iv) IT; and (v) waste management; and
- A final conclusion concerns the overall role of shared services as one amongst many means of ameliorating the financial constraints on local councils. There is little theoretical argument and no empirical evidence that shared service arrangements can solve all the service provision problems of local governments. All the work cited on shared services indicates that it is a useful cost-reduction and quality-enhancing tool rather than a general panacea.

5. OUTSOURCING: RATIONALE, MODELS AND EVIDENCE

Part C of the Final Report considered alternative market-orientated approaches to local government service provision, such as outsourcing, contracting out, public/private partnerships and the privatisation of services.

Numerous typologies exist that seek to categorise the various forms of ‘privatisation’, used in a broad sense to describe the introduction of market forces to a government organisation. However, in the context of local government, important distinctions reside in the character and role played by the purchaser and the provider, and the method by which payment is made to stimulate exchange between the two. Thus, in order to clarify the variety of organisational arrangements that are pertinent in a local government setting, a simple three-fold framework based on the notions of ‘purchaser’, ‘provider’ and ‘payment’ is offered in the Final Report.

Each of these dimensions is considered against their ‘public’ versus ‘private’ attributes or character. The framework provides a useful starting point for considering the consequences of separating the purchaser and provider functions within local government and emphasises the important role played by incentives in any organisational realignment.

This framework provides an instructive introduction to the analysis of the divide between local government service provision and purchase on two main grounds:

- Firstly, the framework demonstrates that a range of organisational and institutional arrangements can be engineered to produce this dichotomy – it is not a simple choice between the ‘market’ and ‘government’. Put differently, the framework demonstrates that ‘private’ or individualistic behaviours might be stimulated on several fronts and need not relate to ownership of resources.
- Secondly, the framework highlights that separating purchaser and provider does not guarantee that the end user of municipal services will emerge as the purchaser *per se*.

While deliberations over service provision have often been characterised by acrimonious ‘private versus public’ discourse, many nuances can emerge from the

bifurcation between purchaser and provider. In this context, competitive tendering, outsourcing, contracting out, contracting in, internal markets, managed competition, commercialisation and corporatisation have often been treated falsely as analogous to privatisation.

The Final Report holds that, in principle, there are potential gains in productive efficiency from instituting these arrangements. However, to assume that all separations of purchaser and provider give rise to similar outcomes grossly underestimates the range of incentives that might impact on the behaviour of productive agents. Enthusiasm for separating municipal service production from provision can be traced, in general terms, to the ideological view that individual self-interest can be better harnessed under a regime of this type. Moreover, it is presumed that arranging production and provision along these lines brings efficiencies that can be garnered to produce advantages to local governance. Whilst some aspects of economic theory support this view, insights drawn from New Institutional Economics point to the need for a much more holistic approach. More specifically, transaction costs may potentially erode many of the reductions in transformation costs, which are purported to accompany the amendments to production relations.

The question of the desirability or otherwise of outsourcing local government service provision or production thus cannot be resolved on *a priori* theoretical grounds. We must therefore consider the empirical evidence.

After carefully considering the problems associated with the measurement of the benefits and costs attendant upon outsourcing, the Final Report demonstrates that the weight of empirical evidence suggests that cost savings may result in the short run, but that it would appear that these savings tend to disappear in the longer term and that deleterious quality changes often accompany outsourcing. This is hardly surprising in the case of complex local government services that are difficult to evaluate with any degree of precision. After all, the profit imperative driving private service providers will always provide a motive for quality shading where accurate monitoring is impossible. Since this is the case with most local council service provision, outsourcing of complex local services is not advisable.

Having examined the theoretical rationale, institutional vehicles and empirical evidence on the outsourcing of local government services, Chapter 10 of Part C of the Final Report considers the ‘special case’ of outsourcing currently being marketed in Australia as ‘transformational outsourcing’, ‘shared services partnerships’ and ‘Strategic Services Delivery Partnerships’. The Final Report notes that these efforts are being given great assistance in Queensland with the establishment of the Queensland Partnership Group by the Local Government Association of Queensland and its endorsement of ‘shared service partnerships’ by private sector corporations.

Strategic Services Delivery Partnerships in local government service provision have their roots in current British local government policy. The basic idea is that a method of overcoming the various problems associated with outsourcing in local government service provision is to develop contracts with commercial enterprises which redistribute at least some of the risk away from the contracting local council to the contracted private firm. If this is possible, then this approach may be able to meet many of the conceptual and empirical objections to the outsourcing of municipal services, which were examined in detail in Part C of the Final Report.

In the United Kingdom, Public Private Partnerships represent the generic term name for joint projects which involve the private sector in the operation of public services, including municipal services. Within the range of Public Private Partnership options, the Private Finance Initiative is the most frequently used method in public sector service provision. In contrast to other methods of outsourcing, under a Private Finance Initiative assets used in producing a service are owned by the private firm rather than the public sector. For instance, if a given service requires an actual building and equipment to generate a service, then a local council would pay the private company which provides the building and associated services a fee. For a service of this kind, a typical Private Finance Initiative project would normally be owned by a company set up specially to run the project often comprising a consortium of private firms, including a real estate firm, a finance house and a facilities management company.

In Britain, HM Treasury has defined various types of Public Private Partnership models frequently used in public service provision, one of which is particularly relevant in the current Australian local government context: private firms delivering

local public services using assets which they own. In the context of the Final Report, the most salient example of this kind is the so-called Strategic Service Delivery Partnerships between commercial corporations and local authorities, which typically run municipal 'back-office' functions.

In Queensland, The Ipswich City Council has entered into an arrangement of this kind with the Queensland Partnership Group to form Services Queensland, with ownership evenly shared between the Ipswich City Council and the Queensland Partnership Group. As we have seen, the Queensland Partnership Group is a joint venture between the United Customer Management Solutions Pty. Ltd. and the Local Government Association of Queensland struck in 2007. Services Queensland began the formal operational stage of a ten-year partnership with Ipswich City Council on 18 September 2008 focused on the Council's customer service and property rates functions, which seeks to 'share' administration services between the Council and the private provider. This agreement is the first of its kind in Australian local government.

A characteristic feature of this kind of 'shared service partnership' is that they typically combine existing council staff with additional employees who work for the new entity. Based on the proposition that this will enable 'private sector expertise' and 'business process engineering' techniques to permeate through the new entity, existing council staff (on existing employment conditions) learn improved methods in conjunction with new staff, thereby improving service quality. If they wish, council staff can join the new entity on a permanent basis.

However, experience in the United Kingdom has demonstrated that 'shared service partnerships' of this type have numerous negative attributes. The Final Report has considered the British experience with local government 'shared service partnerships'.

Various public policy disadvantages attach to these 'shared service partnership' arrangements:

- The claim that risk has been transferred from local councils to the private sector appears illusory;

- The frequent refinancing of ‘shared service partnerships’ has taken place which has raised the borrowing costs borne by councils;
- ‘Shared service partnership’ arrangements often use Special Purpose Vehicles (i.e. new limited liability entities like Services Queensland) which have no assets. If these Special Purpose Vehicles fail there is no legal recourse to the parent companies;
- ‘Commercial in-confidence’ clauses often result in secrecy surrounding contracting terms and thus there is limited public transparency;
- A high degree of commercial complexity represents a typical feature of Special Purpose Vehicles, which further diminishes transparency; and
- ‘Contract failure’ can expose local councils to significant risk if Special Purpose Vehicles fail; while profits accrue to the Special Purpose Vehicle, when a venture fails, the local councils concerned must assume responsibility.

From the perspective of local employment, the Final Report has identified several negative characteristics of ‘shared service partnerships’. These include the following:

- Very little monitoring of ‘shared service partnerships’ by public agencies has taken place in Britain, despite the radical shift from ‘in-house’ local government service production to private contractors;
- Unison (2008) has found evidence of a deterioration in employment conditions, especially in pay and conditions; and
- A ‘two-tier workforce’ has evolved between ‘old staff’ on existing pay and conditions and ‘new staff’ hired on inferior pay and conditions. This has had deleterious effects on staff morale and given the Special Purpose Vehicle incentives to hire new staff rather than take on transferred staff from the local council.

6. CONCLUSIONS

In the light of its deliberations, the Final Report reached the following main conclusions:

1. *Bona fide* shared service arrangements are commonplace in Australian local government. While these are most often ‘horizontal shared service models’ that are wholly operated and owned by participating local councils, ‘vertical

shared service models’ and ‘state-local government shared service models’ also occur.

2. Empirical evidence indicates that modest economic gains flow from these arrangements, despite extravagant claims to the contrary.
3. By contrast, the provision of local government services through market mechanisms, such as outsourcing, contracting out, public/private partnerships and the privatisation of services, as well as the new form of outsourcing known as ‘transformational outsourcing’ or ‘shared services partnerships’, has economic characteristics quite different from *bona fide* shared service models.
4. These characteristics involve a loss of local council autonomy and local council control over local service provision.
5. The weight of empirical evidence on outsourcing techniques suggests that cost savings may result in the short run, but in the longer term these savings tend to disappear and that deleterious quality changes occur. This results from the fact complex local government services that are difficult to monitor and the profit imperative driving private service providers provides a motive for quality shading where accurate monitoring is impossible.
6. Outsourcing also has deleterious indirect effects on regional, rural and remote local government areas in the form of a loss of local employment, local economic activity and local public service provision.
7. Given the need to increase the operational efficiency of Australian local government, the Final Report thus concludes that, from a public policy perspective, *bona fide* shared service models represent a superior means of achieving this objective compared with alternative outsourcing techniques in local government service delivery. Local government policy makers should therefore encourage *bona fide* shared service models and discourage the use of alternative outsourcing methods.