Thought Leadership

Government & Sourcing: Controversy or Opportunity?

Author: **Bobby Varanasi, COP**
Chairman & CEO

The Case for Governments To Adopt Sourcing Models

Let me start with the positive news: Way back in 2002, Thomas Healy, Managing Partner for Government Services with Accenture observed that outsourcing by governments is the fastest growing segment and is likely to overtake commercial outsourcing through double-digit growth estimates. The US federal sector alone saw its outsourcing portfolio grow by over 16% year on year since 2002, and continues to do so. The myth that governments cannot outsource is clearly dispelled. One of course would argue that it is possible with capitalist economies like the US and Western Europe to do so, but the fabrics of developing nations are of a different kind, and therefore outsourcing by such governments is a lot more difficult. Having said that, is it really so? The establishment of quasi-governmental organizations [known as GLCs in Malaysia-speak] have been, and continue to be the harbingers of growth for key economic sectors in most developing nations, where sufficient autonomy exists for such organizations to pursue business models [internal and externally oriented] where value-creation is given the utmost importance, while success is measured by both commercial goals [read profits and shareholder value] and social goals [read citizen value accrual and tax-payers dollars well spent]. Hence the argument remains - most GLCs seem to have deployed a variety of “partner” models to achieve successes and growth. However this seems to have been undertaken without indulging in aggressive adoption of sourcing models – outsourcing, shared services and other relevant models. So the questions that beg answers are (a) why then do governments need to even consider outsourcing? and (b) are outsourcing and partner models similar?

THE CORE ISSUE – CAN GOVERNMENTS LEVERAGE SOURCING

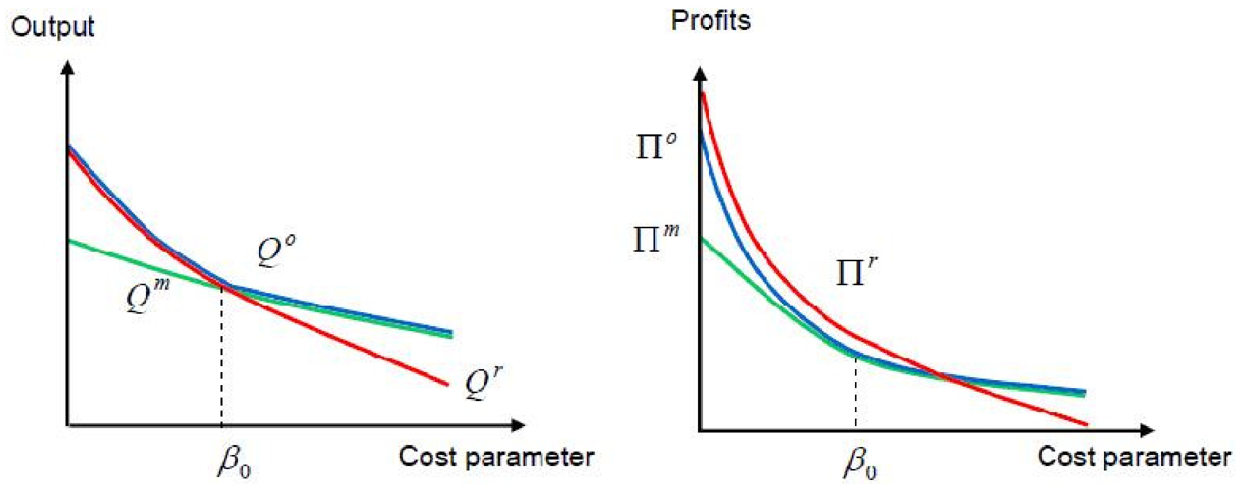
Governments globally in conscientious economies have become very conscious of the need to serve citizens better, put tax-payer dollars to the utmost beneficial use, and consequently improve services and general quality of life for citizens. A holistic goal - with a much-needed reality check – is to determine how best to reduce investments and operations of non-competitive public services [like waste management, mail services, public transport, road infrastructure etc] without compromising on the utility value citizens derive from such services. On the other hand a plethora of ICT solutions available have created a significant opportunity for governments to pursue some additional goals, that of rationalizing tax-payer spend through reducing "multiplicity" of cost-oriented back office work, while speeding up citizen access to existing and new services, with a view to enhancing quality of life, increasing citizen productivity and consequently spurring GDP growth and its consequent value accrual [measured as an increased GNI per capita]. Of course with the advent, and adoption of new technologies, the one single big question remains unanswered – will technology replace government human resources? More often than not, in the western world it seems to have. However developing nations have neither the penchant nor the cultural ability to indulge in human resource-slashing initiatives. This is the point where adoption of sourcing models by governments seems to have taken a back-stage.

THE POSITIVE CASE FOR OUTSOURCING BY GOVERNMENTS: REGULATION VS. OUTSOURCING

A recent study compared two regimes. In the regulation regime, a utilitarian government decides to set up a regulated firm run by a public manager. The government controls the investment and production decisions of the regulated firm [read GLCs] and is therefore accountable for its profits and losses. Such a combination of control rights and accountability duties is typical of public ownership. The government designs incentive contracts to entice the firm's manager, who has private information about the firm's cost, to set the efficient level of production at some informational cost.

In the outsourcing regime, a private investor is invited to serve the market, possibly in exchange for a franchise fee. The private investor gains control and cash-flow rights on the outsourced activity, while controlling the investment and production decisions and therefore is fully accountable for profits and losses. As it is, the private firm is allowed to set the laissez-faire monopoly prices. Yet, because laissez faire is not necessarily optimal, the government can improve welfare by offering ex post contracts to the private firm; that is, once investment costs have been sunk and uncertainties have been solved. Ex post contracts are used by governments to entice the private firm to reduce its prices and increase sales. They are designed to fight the deadweight loss generated by monopoly pricing. However, to accept such ex post contracts, the private investor must at least obtain laissez-faire profit, which raises its participation constraint to the scheme. The right panel of Figure 1 illustrates this point; the private firm's profit under outsourcing (in blue) is everywhere larger than the private monopoly profit (in green).

Figure1: Output and profit under regulation (red), laissez-faire (green) and outsourcing (blue)



This goes to show that optimal outsourcing contracts are more selective than the contracts under public management; that is, low-cost private firms are offered ex post contracts that lead them to produce the regulated outcome, whereas high-cost private firms are not. As a result the level of production under outsourcing is the maximum of the level of production under laissez-faire and regulation. The left panel of Figure 1 illustrates this point by showing the output levels under regulation (in red), laissez-faire (in green) and outsourcing (in blue).

This result is intuitive. At the contracting stage, the public manager of the regulated firm knows the cost parameter, whereas the government does not. It takes advantage of this information to obtain rents. To prevent managers of low-cost firms from inflating their cost reports, the government must reduce the output levels it asks to high-cost firms. Incentive issues can be so harsh that the output levels of high-cost firms become smaller than the output levels that they would achieve under laissez-faire. The left panel of Figure 1 illustrates this point by showing the firm with cost parameter β_0 such that output is the same under regulation and laissez-faire. There is no point to offer an ex post contract to a private firm with this cost because its output level equals the government's preferred output level. Ex post contracting and laissez-faire would yield the same consumer and producer surpluses. Consider next a firm with a cost larger than β_0. If the government proposes an ex post contract to this firm, it is unable to get a surplus larger than under laissez-faire because incentive compatibility obliges it to distort its output downwards. Moreover, any transfer to this firm also increases the rents of all firms with lower costs. Because the government is harmed by both effects, it offers no ex post contract to firms with such large costs. The government thus has no obligation to subsidize the high-cost firms under outsourcing, and expected transfers to private firms are lower. In the right panel of Figure 1, the private firm's profit under outsourcing (in blue) is smaller than the public manager's rent under regulation (in red) for most cost parameters.

Outsourcing hence generates a positive fiscal effect because the government is able to terminate subsidies to those money-losing projects and possibly to collect a franchise fee from the private investor. Outsourcing also generates an economic surplus effect, as production can be higher under outsourcing than under a publicly managed firm. Well, so much for the case of positive benefits with outsourcing. Has this been achieved elsewhere? Yes it has been, closer to home in Singapore.

Take the instance of "consolidation" strategy adopted by 8 statutory boards [similar to Malaysia's parastatal agencies like MIDA, MDeC etc]. These boards were seen to have multiplicity with common services like procurement, human resource management, finance & accounting etc. In order to initiate inter-ministry billing while reducing the overall cost overheads, instill a commonality with new technologies deployed, and remove redundancies across board the government decided it would be best to deploy a shared service entity under the aegis of iDA Singapore [a parastatal agency acting like the Govt. CIO] where all services described above were consolidated. A host of benefits were achieved - Workflow optimization, technology standardization, reduced total cost of ownership with IT systems, smooth and faster billing patterns, integrated end-to-end citizen centric processes, outcome-driven policies, increased emphasis on talent management and risk management etc. The consequent savings achieved were phenomenal, approx. SG$50 Million p.a. The resultant model didn't reflect any job losses. On the contrary, existing jobs were transformed as they moved into the shared service entity. This goes to further reinforce the fact that sourcing models, correctly deployed, can add significant value while remaining citizen-centric. The most interesting aspect of this model has been the enhanced ability of the Singaporean government to proactively engage its citizens and respond to their needs nimbly and empathetically.

Can This Be Replicated in Other Nations?

First, I would say an absolute yes. The questions surrounding wherewithal, and willingness to adopt sourcing models is passé. For e.g., within the Federal Govt. of Malaysia, the recently completed National Key Economic Area [NKEA] Labs under the Prime Minister's Office have clearly adopted outsourcing/ sourcing for governments as the most appropriate strategy to create citizen value, while continually enabling the larger pool of citizens. This necessarily compliments various initiatives being currently undertaken by specialist agencies like MAMPU [Malaysia Administrative Modernization & Planning Unit] and MIMOS [a Malaysian Federal govt. owned strategic R&D agency]. Recently, I engaged in a long and positive conversation with Dr. Ravi, CTO of MIMOS who explained how his agency, through engaging competent Malaysian Ph.D graduates and researchers, transformed its citizen services. MIMOS has a portal which focuses on providing a range of services – agriculture, health services, global connect etc – to all citizens at the click of a button. The development of the portal has been a MIMOS initiative; the services and information offered for concerted decision-making comes from a host of private-sector sources [both local and global]; the technology supporting these services is vendor-neutral [meaning all technologies are being deployed]; while the channel used is cloud computing and free laptops distributed to citizens across the nation. Is MIMOS the generator, aggregator, outsourcer, vendor, provider? I would imagine it has become a combination of all these roles. This is a positive case for bundled outsourcing with technology and delivery models.

Viewing outsourcing in its restricted state of providing cost-savings at the cost of jobs is very limiting. It is vital that the private-sector engage with government entities where conversations like the above are undertaken. Mutual value is a consequence of citizen services, increased productivity, higher GNI per capita and competitive solutions that can then be globalized. There is sufficient proof that outsourcing/ sourcing can be rigorously and successfully deployed in many developing nations as they endeavor to enhance their public services while transforming their economies. A host of private-sector companies can contribute to the effort. Such models can then be taken to other developing nations and replicated [with local flavors of course] so as to further enhance competitiveness and happiness of citizens by rigorously creating value, show quick-wins and enable transformation in a manner that government services become competitive, citizen-centric and forward-looking.

About The Author

Bobby Varanasi, COP

Chairman & CEO, Matryzel Consulting Inc
IAOP Ambassador
Chairman – IAOP Malaysia Chapter

+60.17.379.0215; +1.302.465.6471
bobby@matryzel.com

Bobby is the [founding] **Chairman & CEO** of **Matryzel Consulting Inc,** a strategy consulting, sourcing advisory and management firm headquartered in New York. Matryzel advises corporations and governments worldwide adopt concerted strategies aimed at enhancing competitiveness while focusing on their core competencies. He advises federal governments across four continents on ICT sector development with particular emphasis on policy development, industry-government partnerships aimed at creating GDP growth and enabling positive economic impacts. Bobby has advised Fortune 500 customer organizations on Strategic Planning, Mergers & Acquisitions, JVs, Private Capital Investment Evaluations, Process Reengineering, Pricing Strategies, Sourcing Relationships, Business & Financial Modeling et al, contributing immensely to global sourcing for clients. He is a sought-after speaker in conferences and round-tables worldwide where he moderates panels and presents content on thought leadership. He has been quoted and published in Forbes, fDi, Economist, The Outsourcing, ZDNet, CIO Africa, Brazil Exportati, Times of India, Business Week, New Straits Times, Malaysian Business, Technology Inquirer, Logicall Worldpress etc.