

Outsourcing public services

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Abstract

The economic and social changes of the 20th and 21st centuries also require the "development" of the state. Significant part of the government budget is financing the state institutions, while at the same time the quality of public services is lower than prior decades, concerning education, health or even tax authorities. The rigidity of their operation and their inflexibility in organization also hinder economic developments. As the state recognized its significance and its tasks reconsidered its project mechanisms. Its main target is not to maintain a malfunctioning supply system at high costs. Clear relationship is needed with exactly set responsibilities and detailed cost calculation. A possible solution was to outsource the activities, which allowed to determine the public tasks based on market principles and procedures. The state may delegate task to the public sector in varying degrees and in different ways.

The theme of our work - as indicated in our previous thoughts already - is the outsourcing of public tasks to the private sector. Based on the available scientific literature, we briefly present the theoretical basis of public service outsourcing, risk associated to outsourcing and the applied methods. The main objective of this paper was to explore the benefits and obstacles of internal audit process achieved as an employee and as a contractor partner of an organization.

Keywords: outsourcing, public service, external auditing, internal auditing, performance

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1. Literature review

Until the 19th century, the most important tasks of the state were the defense, law enforcement, the judiciary and the operation of the taxation system. Public administration science in this area was born based on this. However, the industrialization and urbanization required a reorganization of public security, healthcare and education, which also required a rethink of tax

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revenues. All this brought a new approach to administration with itself, which required a new way of organization and service method. So far, there have been two approaches of addressing the changing needs of society and the budget spending surpluses and difficulties: one to raise taxes and the other to reduce public services. In the end, both led to dissatisfaction. One of the main reasons for the emergence of the New Public Management itself was the contradiction that public administrations were operating with bigger organization. Staff and budget support in all developed countries, the growing burden of which the private sector did not want and could not continue to finance due to maintaining competitiveness. (Balázs, 2016). The first major wave of New Public Management (NPM) took place between 1996 and 2002. The central idea of the NPM is that it is not the task of the state to provide public services, but to organize and regulate them. This approach has led to the outsourcing of public services. The scarcity of natural resources and the unsustainability of developed countries' welfare models are becoming more evident. However, the extension of social welfare is a prerequisite for lowering the costs of public services. To achieve this, the benefits of both domestic and international cooperation need to be enhanced. Well-functioning outsourcing can be the fruit of collaboration.

1.1. The public service

The main task of the state and municipalities is to provide public services. First, however, is it important to clarify what is called a public service? There is still no standard way of describing and documenting (European) public services. The European Services Directive implements a quite simple definition of (economic) services, namely "service means any self-employed economic activity, normally provided for remuneration" (EC, 2006). In the Study of the new generation of eGovernment Services another definition is adopted that is „public services are activities that are publicly funded and arise from public policy and that are for the collective benefit of the public, accountable to and governed by a political process. This includes both administrative and human services." Both these definitions suggest that public service activities are those activities that generate economic value and are related to the production of pure or mixed public goods and related services and do not include activities produced by the public authorities." (Hoffman, 2009) They are always organized by the state (municipality) and outsourcing is always subject to a legal norm.

1.2. Outsourcing of public services

The trend towards outsourcing has been based mainly on the search for alternative formulas for the provision of public services that allow them to maintain their extension and, at the same

time, reduce their cost. Although there is extensive empirical literature on the outsourcing of public services, it is often contradictory. As Dixit (2002) points out we can find opposing conclusions on the same field of application regarding outsourcing educational services. The economic analysis of the outsourcing of public services has been approached by different authors from different theoretical assumptions. Hart et al. present a model based on the balance between cost and quality objectives, from a lacking contracting perspective. The private contractor has ample scope to make a greater or lesser effort (which is not verifiable) without causing a breach of the contract. The contractor will therefore only make an effort to the extent that they contribute to savings in production costs, unless a renegotiation of the contract enables the contractor to accrue at least part of the benefits of an improvement in the quality of the service. This model has been reconsidered by Andersson et al. In their paper they assume that the contractual incompleteness excludes the possibility of incentive contracts, which constitutes a significant drawback of the model, given the importance of incentives in the actual practice of contracting. Many studies focus on the assessment of the quality of public services. Carvalho et al. present a holistic model that takes into account the relationships between citizens, public organizations and society as a whole. They state that the assessment of the quality of services, in general, is more complex than that of goods, due to their characteristics of intangibility, inseparability between production and consumption and heterogeneity. In this sense, it should not be forgotten that the measurement of the quality of public services must take into account these characteristics and their multidimensional nature.

Finally, outsourcing is not a phenomenon limited only to the private sector but has also been increasingly extended to the public sector. Just like in business, it is based on mutual trust and respect, honesty, and the recognition of common interests. Its peculiarity is that the state performs the regulatory, financing and control functions. Among the most frequent reasons for deciding to outsource, both in the private and in the public sector are the followings: focus on core business, lower costs, lack of competence or experience within the organization itself, quality improvement and flexibility gains.

.1.3. Risks of outsourcing

Outsourcing is a reasonable consequence of efforts by public services to minimize waste and promote efficiency and effectiveness (Nolan 2001), shift toward greater managerial autonomy, promote competition through the development of contracts that decrease costs and increase quality, and move toward private-sector management approaches. Different kinds of outsourcing have different degrees of risk so municipalities need to use several different

governance models that are adjusted to the degree of risk of the service being outsourced. There are many frameworks and models used in relation of outsourcing but most of them are based on “Four Governance Model Framework” by Considine. The four models (procedural, corporate, market, and network) can be evaluated in terms of its source of rationality, form of control, primary virtue, and service delivery focus. The assumption emerging from this work is that, as a municipality expands its outsourcing activities, it must seek to evolve from the least sophisticated model (procedural) to the most sophisticated one (network). There is no good or bad governance model but municipalities have to consider carefully which model is the most appropriate for a particular service being outsourced. Because of the differences of risk, a municipality must always evaluate the risk related to poor vendor performance anytime it meets an outsourcing decision. The risk has been largely of a financial nature, and has been assessed in light of the difficulty of providing services within a budgetary constraint (Ball et al. 2003). In other studies, it has been viewed in terms of a vendor's capacity to deliver the necessary services, or the uncertainty of the task to be performed (Venkateswar 2005). According to Steane and Walker, it has focused on the logistics of managing the vendor (Steane and Walker 2000). In all of these works, a central issue has been the information asymmetry between the vendor and a municipality, which can lead the municipality to assume more risk than it realizes (Demetz 1968). The keys to good outsourcing are setting up a good working relationship from the beginning; establish well-defined rights and obligations in terms of price, task, responsibility and deadlines. There is also a high demand for a clear and precise definition of accounting, control and expected performance.

1.4. Outsourcing difficulties in Hungary

Outsourcing has been very popular in the public sector in recent decades. In parallel, a number of problems have arisen, and countless errors have been made by outsourcers of practicing this new technique. Problems resulting from outsourcing include: the public sector and the public have been sceptical about the public sector's involvement with the private sector; the question is that who is responsible for the public service following the outsourcing? The risk inherent in outsourcing is that the provision of data of public interest and transparency is not completely solved as it is limited by the regulation of private business secrets and interests. The cure of reoccurring problems has not always been successful, which has clearly contributed to the outsourcing process being replaced by the re-deployment of public tasks by the state. In the public finances' audit, the Government Accountability Office, which has the most mandate, has examined and criticized a number of audits on the implementation of certain PPP programs

(SAO Report No. 1287 on Controlling the Contract and Utility of Priority Cultural and Higher Education Projects in the PPP Context); In April 2007, the Government Accountability Office presented its international and domestic experiences in the field of private and public sector cooperation. (Source: www.asz.hu)

1.5. The EU and the public service outsourcing

Ensuring the free movement of goods, services, workers and capital is the EU's four fundamental right. However, when organizing public services, there may be restrictions on the free movement of services, as domestic service providers are favoured within each Member State. With this in mind, the EU has placed the outsourcing of public services within legal framework. The European Union supports the liberalization of a specific part of public services, helping to create a competitive environment in the Union's internal market. The aim of EU reforms is to improve service standards and ensure unified access conditions. The "commercialization" of public services has already taken place in several sectors, such as natural gas, electricity and postal services. However, the process does not end here, and further uniform regulation of public service provision is expected.

1.6. Outsourcing the control in regard of the Hungarian law

The central budgetary organizations which have economic organization, as a general rule, the internal auditor could be employed in *employment relationship* (employment, civil servants, etc.) according to Bkr.15 (5). In the case of organizations other than the above, it is possible to carry out internal control tasks *outside the employment relationship*, also in the framework of a "civil law contract" (Article 15 (7) of the Bkr.). The "other" legal relationship for employment may be the *assignment* (Articles 6: 272 - 6: 280 of the Civil Code) and the *enterprise* (6: 238 - 6: 250 of the Civil Code). The difference between the two is that the order is so called obligation to conduct, while the enterprise is so-called obligation to achieve a result. It is a matter of viewpoint where internal control is classified. If we say that the essence of internal control is the pursuit of controlling the activities, it is rather an obligation to conduct.

1.7. Internal and external auditing

The role of internal audit is to provide independent assurance that an organisation's risk management, governance and internal control processes are operating effectively. Internal audit is an important function for the control environment of a public organization and contributes to more effective risk management. The internal audit function provides assurance service, a

service where the internal auditor engages in systematically obtaining information and objective evaluation. Relationship between internal audit and external audit will help and improve the work of both auditors, avoid duplication, and ensure the maximum coverage of the risks faced by the entity. It will also help the governing body obtain a comprehensive view of the controls and the risks of the entity (ECIIA, 2013). The most important provision for external auditors that establish whether the external auditors can use the work of the internal auditors is provided by the ISA (International Standard on Auditing) 610. ISA 610 sets out how the knowledge and experience of the internal audit function can inform the external auditor understands of the entity and its environment. The external auditors will examine the objectivity of the internal audit function, the technical competence of the internal auditors and whether the work of the internal auditors is likely to be carried out with due professional care (IFAC, 2013). There are different studies that identify objectivity, competence, and work performance, like most significant factors on the judgment of external auditors whether or not to rely on the work done by the internal auditors (Haron et al, 2004). There are many the international standards for internal auditing that define how internal audit may rely on other assurance providers, external auditors (IIA, Standard 2050). The main purpose of coordination and cooperation between internal and external auditors is to improve the effectiveness of audit and minimize the audit cost (Ho & Hutchinson, 2010). Engle (1999) defined three main benefits of the cooperation which are the followings:

- meaningful audits has a significant impact on achieving organizational objectives,
- the external auditor who depends on internal auditors' work has a significant ability to decrease his fee, and
- reduce the disagreements between the external auditor and senior management that may occur regarding the application of accounting principles.

2. Research methodology

The purpose of this paper is to identify the opinions and attitudes of internal auditors regarding the nature of the outsourcing here in Hungary resulting from a survey that was conducted in May 2019. The research methodology use deductive methods regarding theoretical concepts and inductive methods like observation and induction based on the practical experience and as the result of a structured questionnaire that authors have applied to the internal auditors. The study is an analytical survey, which aims to explain the opinions and relationship of internal auditors to external audit tasks rather than to describe a population opinion. The representativeness of the sample to the population was not the target of the study. The authors

tried to ensure validity of the data, and to present opinions of auditors with the experience in auditing clients that have an internal audit function. An important objective of the study is also to find out whether management can rely on the work of an internal auditor with assignment or service agreement. As database, registered members of the belsoellenorzes.hu were used (the site belongs to one of the authors). The paper presents the opinions of internal auditors through an online survey distributed to 326 auditors. In order to measure the opinions of auditors as employees regarding to the outsourcing activities a five-point Likert-type scale was used. The survey also had two open ended questions that required the respondents to elaborate on their points.

3. Results

The online survey had a response rate of 42%, 137 responses were collected. The majority of the respondents are working in public administrations (79 %) while the rest of internal auditors are belonging to business organizations. 19% of the respondents performs audit task on contractual basis. Regarding ‘*Benefits of providing an internal control process as an employee*’ respondents were asked to rank different benefits from 1 to 5 (1: not important, 5: very important). The auditors responses were similar, respectively 89 % of the respondents agreed that the security (secure livelihood) and better understanding of organization culture are the most important aspects working as an employee. They considered the closer relationship with the management less important feature. This can be explained by the fact that the management exerts too much influence on internal control and is not independent, which may lead to a number of conflicts due to errors detected. Although stronger management contact would make the audit activity much more accepted inside the organization and would lead to less conflicts with the colleagues.

Concerning ‘*Obstacles of providing an internal control process as an employee*’ respondents were asked to rate a list from 1 (no obstacle) to 6 (very strong obstacle). Table 1 shows the ranking from the mildest to the strongest obstacles.

Table 1. Top 6 obstacles related to internal control process achieved by an employee

Rank	Obstacles
1	Need for managers to carry out operational work alongside their professional responsibilities.
2	Conflicts with the colleagues
3	Exhaustion / overdrive
4	Professional loneliness
5	Lack of motivation
6	Monotony

In regarding to the ‘*Benefits of providing an internal control process as a contracted partner*’ majority of the respondents said that the most important aspects are the objectivity and independency, meaning to say that management or subordinate relationships do not influence their professional judgment. Respondents considered it’s important that the external agent has greater authority in the eyes of both managers and employees, and is thus more receptive. The advantages of being an entrepreneur, being on your own time, being personal have been also mentioned many times. As opposed to the employee relationship, they have only professional duties, no other operational duties, and the job is varied. In responding to the ‘*Obstacles of providing an internal control process as a contracted partner*’ the respondents ranked first place the lack of information. As a contracted partner only those information can be obtained that is in connection with specific audits. Contexts, background information, and information about the organization as a whole are less available. or it takes longer time to assess local conditions and information.

Table 2. Top 6 obstacles related to internal control process achieved as a contracted partner

Rank	Obstacles
1	Conflicts with the organizational members
2	Timing
3	Lack of competence of internal auditor
4	No reliance
5	Lack of knowledge about organizational culture
6	Less information is available

In responding to the ‘*Reliance of the management on the internal auditor’s activity*’, 58% of the respondents responded with ‘good’ respectively 34% of respondents said that the reliance is ‘bad’ and 8% said that the reliance does ‘not exist’.

Also, the survey have had two open-ended questions, the results are summarized as follow:

Q1: Why the external auditors avoid using the work of the internal auditors?

The most answers conduct to the follow:

- lack of competence of internal auditors;
- lack of independence of internal auditors;
- lack of knowledge of internal auditing standards.

Q2: Why is internal audit process achieved by a contracted partner is more effective?

The most answers conduct to the follow:

- greater financial esteem thereby higher motivational level
- lack of conflicts with the organizational members

- more focus oriented work - there is no need to carry out any other operational work not related to the internal audit process

4. Conclusions

This paper has examined the outsourcing of public services with a focus on achieving an internal audit process as an employee and as a contracted partner. The results suggested that the internal audit process performed by an employee leads to several benefits. It increases both the efficiency and effectiveness of audit and decreases audit fees. However the loss of motivation and professional loneliness inside the organization might lead to poor level of audit quality. It can be stated that the "outsourcing" and "re-nationalization" of the public tasks is a current topic of public administration. At the same time, it is certain that reforms will continue for many years, and that public tasks will continue to expand as major socio-economic changes are taking place today, fundamentally changing the current system. At the same time, we can say that the fact of some form of outsourcing is not a cure for the problems that arise. The internal auditor needs to have a broad range of professional experience, which can only be gained by working in a variety of fields. The internal auditor should be independent and at the same time reliable. Therefore, it may be worthwhile for an organization to choose a market solution for internal control. The reliability of the internal auditor, who is organically linked to the senior management in his own organization, can naturally be assured, but his organizational independence is the greatest in the case of outsourcing. Effective cooperation between internal and external auditors leads to several benefits for them and also for the clients whom they serve. It increases both the efficiency and effectiveness of audit work.

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