



Advisory • Investments • Research

Government Sector Outsourcing

March 2010

Transforming Public Service with Outsourced IT Services

The economic recession has made the calls for cost savings in public spending even more urgent than before. All means to cut people's tax expenses are being considered and outsourcing appears to be a very viable solution to this demand. In addition, more government agencies are looking at outsourcing as a means to gain specific value-added benefits to the services that public agencies are delivering to the people.

Introduction

In his State of the Union Address, US President Obama rallied state governments to limit tax benefits of companies which employ the outsourcing business model – this is just another manifestation that stakeholders are being called to be more prudent in applying the outsourcing model to certain sectors. Dissenters claim that the government needs to refrain from outsourcing because this is exacerbating unemployment in the country. Concerns about data security have also been a serious issue for those opposing public sector outsourcing. Despite these claims, industry analysts report that US state governments alone can spend up to about US\$6 billion in outsourcing activities – it has also been forecasted that this spending could go up to US\$11.4 billion by 2012.¹ In the UK, US\$13 to 18 billion is the estimated market size for outsourced ICT services (building and maintenance of IT systems, communication systems and databases) per year.² The public sector has accounted for 6.3% growth in 2008, from US\$159 billion to US\$169 billion of IT spending, fuelled by the spending for e-government projects and IT system updates for governments across the globe.³ Aside from the Banking, Financial Services and Insurance (BFSI) sectors, the public sector has sustained a strong position in the number of outsourcing deals created even during the economic downturn. It accounted for 19% of the US\$1.1 billion-worth of contracts signed in the 2Q 2009 for example. These figures show the huge potential in government sector outsourcing. Large deals are still coming in from UK and US federal and state governments, hinting of a continued trend for public sector outsourcing as more public agencies begin to embrace the outsourcing business model as a means to cope with the budget cuts while still maintaining quality of service.

This whitepaper will explore public sector outsourcing, the benefits that it offers and the major growth inhibitors that the sector presently encounters. The focus will be on IT services and contact support, the primary service lines that are outsourced by public agencies. Using cases of IT services outsourcing by federal and state agencies, this paper will explain the reasons of public managers for opting to outsource. Furthermore, this paper will look into what motivates companies to target the government sector despite the huge business risks that public contracts entail. What could possibly be in public sector outsourcing that has sustained its attractiveness as an industry vertical for service providers? Beyond simple cost savings and efficiency, what other significant gains do companies and governments derive out of this otherwise controversial government practice? Ultimately, could government sector outsourcing continue to flourish despite the political backlash that has casted a shadow of doubt over its capacity to provide benefits for the citizens that the government serves?

¹ INPUT 2007

² Business, Enterprise and Regulatory Reform *Public Service Industry Review* 2008

³ NASSCOM *Strategic Review* 2009

Overview: Outsourcing Government Services

Why Do Governments Outsource?

Government organizations are not too different from large corporate firms in that both have cost savings and operational efficiency as core objectives in carrying out their functions and mandates. It is with these objectives that government executives began to consider the outsourcing model for public sector functions. Among the bigger spenders in public sector outsourcing are the US, UK, Canada, India, Hong Kong, Japan and Singapore – who have been reported as the most experienced governments in outsourcing public sector processes. These engagements often entail the provision of IT solutions for public sector segments such as pensions and social security, taxation, assets registration, welfare programs such as food stamps distribution and financial assistance for the unemployed, and other e-governance initiatives. Further, as governments have strived to become more *technologically efficient*, more attention has been given to public sector outsourcing.

Outsourcing – or the contracting out to a private sector provider – certain processes within the government is not an entirely new concept for public managers. Governments have long been applying this practice to its various operational needs. This business model – contracting out government projects from infrastructure constructions to consulting services – has been practiced with the growing popularity of the New Public Management (NPM) concept. What this governance concept basically champions is the streamlining of government functions and services by adopting methods and best practices from private sector companies and organizations. NPM entails prioritization of efficiency and cost effectiveness in spending taxpayer money. It puts paramount importance to expertise in performing certain functions within the government, treating each citizen as a

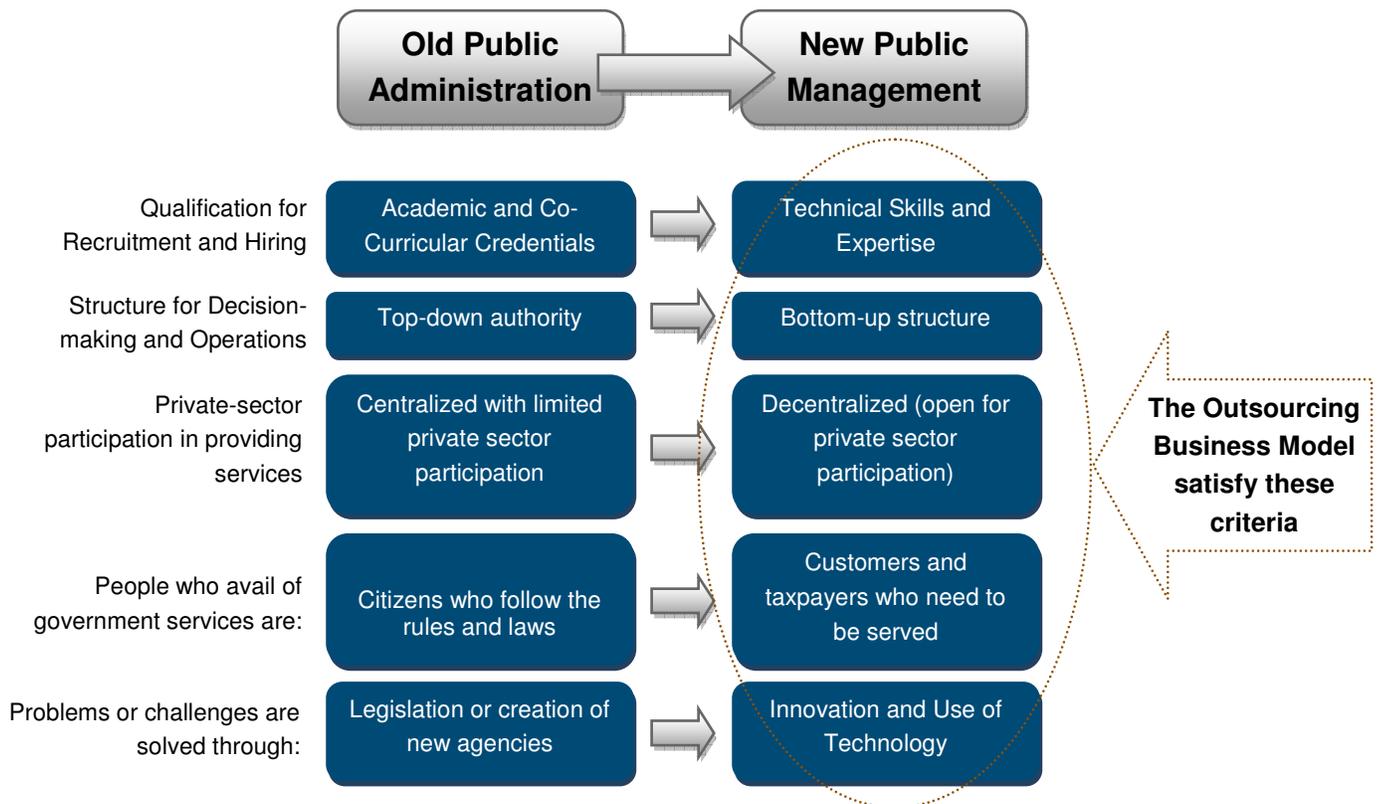
New Public Management vs. Old Public Administration

Old Public Administrations or OPA is said to be the traditional way of running the government. The government is seen as the lead organization for implementing the laws and administering order in the society. More concerned with structure and bureaucracies, OPA is often characterized by red tape and slow processes.

With the emergence of globalization and market liberalization, criticisms regarding OPA's inefficiency and ineffectiveness became more pronounced. The success of large multinational firms and organization has placed the spotlight on the shortcomings of the traditional system of OPA. This has urged reformists, scholars and public officials to look into the practices of the private sector with the objective of adopting them into how the public sector is operated. This gave rise to the New Public Management or NPM. The change of the word "administration" to "management" signifies the paradigm shift from seeing the government as an organization for implementing rules and laws to an organization that has resources to use in providing best quality of service to the public. Developed countries such as those in Europe and North America were the forerunners in implementing NPM since they were also the countries who were pioneers in building robust capitalist markets which can support such a change in public service delivery dynamics – there is a sufficiently strong private sector to serve as a model as well as potential supplier for government agencies. The economic system as well as the liberalist attitude has created an environment conducive for the NPM governance concept to begin and take root in these countries.

customer who needs to be served with utmost competence and efficiency. One remarkable factor that NPM also advocates is the use of technology in improving the often slow and overbearing bureaucratic protocols experienced in government transactions such as claiming of welfare benefits and applying for various licenses or permits. This is where outsourcing conveniently comes in. Outsourcing government contracts is one practice that is recommended by practitioners and advocates of NPM because this business model combines the use of technology with technical expertise, two elements that are often in short supply in government agencies.

Furthermore, NPM is gaining traction in many governments these days because the practice of this concept in governance is recognized by various international organizations, aid-giving bodies and development advocates around the globe. In fact, international funding agencies such as the World Bank and International Monetary Fund have included increasing government efficiency and effectiveness through technology in some of the agency recommendations for its member countries. However, more than following an international trend, governments around the globe are implementing the outsourcing business model to primarily save on cost and secondly, to benefit from the value-add that expert service delivery provides (as derived from external providers). Governments look to outsourcing for the progressive transformation of the overall operation of their agencies. The public agencies' bottom-line of providing quality service and optimizing taxpayers' money are the primary drivers for government sector outsourcing.



Government Contracts

The Public and the Private Sectors

Similar to private corporations, government agencies cannot afford to be tied down with voluminous routine-based processes. Despite the difference in bottom-lines – private sector is driven by profit while public sector driven by the aim to ensure that all citizens is reached by the services and benefits that the government provides – public and private sector both seek to limit their involvement in functions that do not directly contribute but are instrumental for achieving their bottom-lines. Both sectors need to free their resources from being bogged down by functions that do not enhance their core competencies. Data management and infrastructure management are examples of processes that are indispensable to the operations of large organizations. These processes are not only resource-intensive, but both sectors would likewise want to keep these fixed costs at a minimum in order to maximize the value of the services and/or products that they provide. Parallel to private sector's optimization of profit through minimizing fixed costs, governments are able to maximize their capacity to deliver the public services that citizens are entitled to, extending the reach as well as increasing the value of these benefits.

Furthermore, both sectors utilize the outsourcing model to add value to the services that they provide their end-users. Contracting out certain functions such as application development and contact support considerably improves the quality of their services. Corporations benefit from higher client satisfaction, especially since contact support improves their relationship with the end-users of their products and services. On the other hand, government agencies are able to make their services such as food stamps distribution, disaster relief, healthcare and pension benefits, etc. more accessible to a bigger number of taxpayers through software or web-based applications that are provided by an outsourcing provider.

Governments have needs and encounter problems similar to private corporations because the two types of organizations share a similar profile: large size of workforce requiring an equally extensive infrastructure to handle voluminous amount of data for various processes. These similarities with private corporations supply the rationale behind practicing the outsourcing business model in the public sector.

Table 1 – Similarities and Differences between the Public and Private Sectors

	Public Sector	Private Sector
Number of End-Users	Covers the whole population of a state, locality or the whole citizenry	For large multinational companies, millions of customers in multiple locations across the globe
Number of Employees and Departments	Departmental units for HR, finance, accounting, IT, research, etc. for each ministry/agency	Departmental silos for HR, finance, accounting, IT, research, etc. for each local/regional branch
Bottom-line	Maximum reach of delivery of high-quality public services such as welfare benefits, registration/licensing, health, education, etc.	Optimum profit for each shareholder/partner/proprietor
Common Operational Problems	Complicated bureaucracies, limited expertise Expensive costs in direct hiring of experts	Complex business organization – Each business unit in different locations has to adhere to local rules and regulations while still complying with the global business standards
How to achieve bottom-line	Cost containment, standardization, and innovation	Cost containment, standardization and innovation

Services that Governments Contract Out

Data Management

Public agencies handle huge amounts of data such as citizens' name, date of birth, place of residence, employment status, health records, social security numbers, just to name a few. Because of the sheer volume of data, it is already near to impossible to manage them manually or at least in a highly efficient manner. Handling them manually will inevitably cause delays in processing transactions that require these data not to mention the myriad of ways by which numerous incidences of human error could occur. The only way to minimize these inconveniences is through the use of advanced technology and automation. Through services in data management, public agencies are able to keep all records in one system which can be accessed by all the other branches of the government. Functions that fall under data management include data entry, maintenance of databases, data back-up/recovery and data protection. Data integration is also very important for governments, especially with the rising demand for a unified database for citizens' records.

Infrastructure Management

Government agencies outsource infrastructure management functions to third party IT services provider. With government agencies being urged to streamline their operations and IT systems,

service providers are contracted to maintain and manage multiple networks, security systems, standardized emails infrastructures, storage systems and data centers, etc. Industry analysts report that the available market for infrastructure management for the private and the public sector is at least US\$100 billion in 2008⁴ – a number that is not surprising when considering the expanse of each contract's service coverage and its corresponding contract value.

Infrastructure management may be done remotely – facilities such as data centers may be in US but the administration or management may be done in an offshore location such as India. One of the larger public sector outsourcing deals is the IT services and infrastructure contract between IBM and the State government of Georgia. This US\$873 million deal that will run for over eight years covers mainframes, servers, printers, service desk, end-user computing and disaster recovery. This project will be carried out with Dell and Xerox as subcontractors. Also part of this modernization initiative for Georgia, the government closed a deal with AT&T to provide services for a wide-area network, local area network as well as voice-based contact support services. This deal is worth US\$346 million and will last for five to seven years. Because of its extensive nature, infrastructure management failures can be disastrous for the service buyer. This service is intrinsically connected to the overall operation of the company and a serious problem in infrastructure management can stall the whole operation of an organization.

Application Development and Management (ADM)

E-governance portals, enrolment into pensions or forced savings program, automated filing for claims requests and online land and vehicle registration are just some of the applications that are designed and developed by third party service providers for various government agencies. These applications are custom-designed for the agencies that will be using them as well as for the customers that the application will be interfacing with. An example for such type of service is the one provided by HCL to the Department of Health and Human Services of the state of New Hampshire. HCL designed and implemented an online billing and enrolment application for childcare providers in the state. In certain cases, many applications being used by government agencies may be outdated and maintaining them can cost far more than simply developing a new, customized application. Furthermore, developing these types of solutions or online applications requires a high degree of technical expertise and because government agencies do not necessarily have these experts, the only *real* option may be for them to outsource. Insisting on developing in-house software solutions for example, would also be more expensive and would involve a significant amount of training and time. Outsourcing allows for a quicker response to the needs of the public sector because third party providers already have these experts and their previous industry experience to carry out such a project. Because government agencies, especially those that directly interface with people, have to avoid stalled operations and public service interruptions, expedient solutions from third party custom application developers become an important value proposition.

Customer Support

As previously mentioned, in applying the outsourcing business model to the public sector, government agencies are able to serve each citizen similar to how a company serves its

⁴ NASSCOM 2008

customers. Third party providers deliver customer support services, either from an onshore or an offshore delivery center. They receive and respond to inbound queries, either through calls or electronic forms filled up online, regarding a specific government program or agency. The state of Florida, for instance, has contracted JPMorgan Chase & Co. to manage the Electronic Benefit Transfer Program which uses government-issued debit cards. The customer support for the program is also handled by the company. Calls from the US are rerouted to the company's contact centers in India where operations are much cheaper than the US. However, the calls are now being answered in JPMorgan Chase & Co.'s centers in the US after the public criticized the state for allowing employment to be shipped abroad. In fact, a general theme for anti-outsourcing bills being filed in the US senate is the disclosure of how much work and jobs are being offshored through the government sector contracts. An example of this is the New York Senate Bill 1597. It requires 180 days' prior notice of offshoring (or any plan to engage in offshoring) to be given to the relevant state agency and to the employees in New York whose jobs are affected by offshoring (Refer to Section on Growth Inhibitors for Government Outsourcing).

Government contracts may be a combination of several types of services. Major players in the public sector outsourcing space offers multiple services – HP-EDS, Unisys, TCS, Wipro, etc. often have a suite of services that they offer to clients from the government sector. An example of this is the multi-million dollar contract that TCS closed with the UK government. The company is going to provide integrated services in financial management, case management and assessment, payment calculations and scheduling, and customer relationship management to the Child Maintenance and Enforcement Commission. For this particular project, TCS will be integrating “off-the-shelf,” non-custom designed software applications from Oracle, Genesys, IBM and Experian. This contract will also involve application management, contact support services as well as data management. Furthermore, some of the larger players in contracting out for government projects may provide both the hardware and services component of the project. Fujitsu, Dell, IBM, Xerox and HP-EDS have these types of deals with federal, state and local governments. Doing business with the government certainly offers a vast array of market opportunities.

Table 2 – Sample of Government Contracts

Contracting Parties	Deal Size and Duration	Services	Departments/Agencies Involved
State of Virginia – Northrop Grumman	US\$2.0 billion for 10 years (2005)	Infrastructure Management and Contact Support	IT system and infrastructure of Virginia's state agencies
State of Indiana – IBM and ACS	US\$1.16 billion for 10 years (2006)	ADM, Data Management, Contact Support	Medicaid, Temporary Assistance for Needy Families
State of Georgia – IBM	US\$873 million for 8 years (2009)	Infrastructure Management	IT system and infrastructure of Georgia's state agencies

State of North Carolina – CSC	US\$265 million for 7 years (2009)	ADM, Data Management	Department of Health and Human Services and Medicaid Management Information System
US Federal Government – Unisys	US\$428 million for 3 to 10 years (2009)	ADM, Data Management, and Infrastructure Management	Department of National Defense (RFID system)
City Government of Santa Clara (California) – Unisys	US\$20 million for 5 years (2009)	ADM, Data Management, Contact Support and Infrastructure Management	City Departments and Administrative Offices
UK Government – CSC	US\$2.4 billion for 10 years (2003)	ADM and Data Management	UK Royal Mail Group (a government-owned limited company)
UK Government – TCS	US\$899 million for 10 years (2010)	ADM and Data Management	Personal Accounts Delivery Authority and the National Employees Savings Trust
UK Government – CSC	US\$570 million for 10 years (2009)	ADM, Data Management, Contact Support and Infrastructure Management	UK Identity and Passport Service
UK Government – IBM	US\$397 million for 10 years	Data Management	Replace UK Border Agency's Immigration and Asylum Fingerprint System
Indian Government – TCS	US\$329 million - maximum price (2008)	ADM, Data Management, and Infrastructure Management	Ministry of External Affairs Passport Seva Project
Australian Government – EDS	US\$604 million contract extension until 2012 (original contract from 2000-2010)	Infrastructure Management	Australian Taxation Office
Australian Government – Unisys	US\$39.7 million contract extension until 2013 (original contract from 2007)	ADM, Data Management, Contact Support and Infrastructure Management	Australian Department of Immigration and Citizenship

Table 2 lists some of the bigger government outsourcing deals. They demonstrate how winning one of the larger contracts from the government can secure a company the stable yearly revenue of about US\$30 million to US\$200 million for five to ten years. The table also shows that a sizable

market opportunity can be found in state and central governments. Specifically for state governments in the US, service providers may offer data management, ADM and contact support to the health care and welfare distribution agencies. Infrastructure management for multiple state agencies can still be optimized – only three US states have outsourced the majority of their IT infrastructures. This means that there are still at most 47 states which are potential clients for multiple forms of infrastructure management contracts. For federal and central governments, infrastructure management and data management for various agencies such as immigration and passport services present a huge opportunity for long-term deals. On the other hand, the National Outsourcing Association has forecasted that in the UK, the colossal budget cuts which resulted from the government bailout of several banking institutions will pressure public managers into exploring their options in the shared services industry. The UK National Health Service alone is expected to spend about US\$9 billion for its National Programme for IT. This amount only covers the centralized health department initiatives and the local IT spending would still add a significant amount to this spending for 2010.

The market for public sector outsourcing is certainly far from saturation. As some of the major contracts that were listed above expire, the deals will be either renewed or put up for a new round of bidding. Services that have been previously outsourced are unlikely to be moved back to an in-house operation, especially with the government's deficit on expertise and infrastructure. These dynamics build a promising market opportunity for current and future service providers.

Outsourcing Offshore vs. Onshore

In public sector outsourcing, an important question that governments have to answer is whether to outsource onshore or offshore. There are two main considerations that will have to be factored in when deciding where to outsource. One factor is the type of work that is being outsourced – is it handling sensitive data which need more stringent security? Those functions which require stricter security measures, if outsourced at all, are typically kept onshore. Some services under data management fall under this category while application development, infrastructure management and contact support, in some cases, can be done offshore.

Table 3 – Outsourceability and Offshorability of Select Services for Public Sector Outsourcing

	Data Sensitivity	Outsourceability	Offshoreability	Reasons
Data Management	+	+	+	Higher risk if offshored due to differing data security and protection standards in different countries
Infrastructure Management	+	+	+	Can be remotely done; what is crucial is service consistency and sound backup/recovery system
Contact Support	+	+	+	A lower value service with limited data sensitivity involvement; can be done remotely
Application Development and Management	+	+	+	Highly outsourceable because public sector has neither the expertise nor the resources to perform in-house

Another factor that can help answer the question of where to outsource is cost savings. Application development and contact support are delivered offshore because doing so typically generates significant cost savings. Software developers in the US or UK demand much higher salaries than those in India. Furthermore, the minimum salaries for employees who deliver low value services such as contact support within the client nations is also incomparably higher than those in offshore Asian locations. Workforce costs combined with infrastructure and overall operating expenses compound the cost difference between operating onshore and offshore. This means that even if data security may not be as strict in these cheaper offshore locations, clients from US or UK may allow service providers to source their ADM or contact support functions outside of the country when cost considerations are factored in. These savings are very significant – in 2002, a contractor of New Jersey for the State's call center for welfare and food stamp services set up a center in India. This resulted in public outcry and dissenters alleged that the call center in India was a detriment to producing employment in the State. After a year, the contractor finally moved the center to the United States. Moving this 12-employee operation onshore has made the State shell out an additional US\$886,000 on top of the original contract cost. This means that keeping about 1,400 jobs of this type would cost the state an extra US\$100 million per year.⁵ This example demonstrates how much savings a government agency can realize from outsourcing, specifically offshoring, non-core functions to cheaper locations.

Industry reports have forecasted that increased public sector outsourcing for these services will be a continuing trend for 2010 onwards. With economies still in the recovery phase, outsourcing companies will continue on cashing in from governments that are increasingly embracing outsourcing as a means to cope with budget cuts. Outsourcing providers will continue of targeting government clients as many companies have lost regular private sector clients from early contract terminations or non-renewals due to the economic difficulties from the last few years.

Benefits of Outsourcing Government Functions

Benefits to Governments

Efficiency in Performance of Public Service

Many governments, even those of wealthy developed countries, find it very costly to upgrade department IT systems. Aside from typically being all-encompassing of several agencies, these types of projects are often long-term undertakings that may take years to complete. Take the e-government portal in India's Andhra Pradesh for example, which covers services for birth and marriage certificates, vehicle and land registration, pension, tax information, and bill payments. These services were made accessible by TCS for the state's 75 million citizens. This will be built and operated by TCS for five years. Wipro implemented an identity and access management facility at the market operator for the Australian National Electricity Market. This covers more than 10,000 users of more than 20 applications across five states. These projects show the extensive nature of government contracts.

⁵ National Foundation for American Policy, *Anti-Outsourcing Efforts Down But Not Out*, 2007

Furthermore, some projects only require a fixed service delivery schedule. For instance, after development and installation of particular IT system or platform, there may no longer be a need for the deployment or integration team to remain contracted by the government agency. Often their work contract is terminated and only a small portion of the team is rehired as permanent employees who will be maintaining the facility or service. Such arrangements are often detrimental to cost savings for governments as governments have to abide by stringent employment rules (i.e. employee benefits, higher salaries due to contractual status of hires, etc.) - direct contracting and hiring of experts means having to spend more on human resources. There will also be a need for additional number of people that supervisors would need to directly oversee in implementing projects. This can become problematic because most managers in the government sector do not have the technical expertise necessary to supervise complex IT projects. The disconnect in expertise and the functional experience necessary to carry out a project often causes delays because public managers still need training in the technical matters on the project. As such, public managers without the appropriate IT or client relation management specialization can be ineffective at best or a liability altogether when an IT project or a customer support portal is being carried out.

This is where outsourcing to private service providers conveniently comes in. The outsourcing companies who have the expertise and required industry experience to carry out projects of this magnitude successfully. TCS has effectively deployed a web-based disaster unemployment assistance application to enable people to file their claims online. With the company's expertise, they were able to process 60,000 requests in one month alone. The system was made available by TCS to end-users in just five days. Another example is Affiliated Computer Services (ACS) and the American Red Cross in 2005. Post Hurricane Katrina, the American Red cross contracted ACS to set up its Family Assistance Hotline for disaster stricken Louisiana. After 10 days, the ACS call center in California started receiving calls from this hotline. Without outsourcing, setting up a contact support center like this would have taken the client three to six months before beginning full operations. ACS utilized its existing facilities, customer service representatives and managers and built the operations for a 900-agent center in ten days. Such feats cannot be as effectively carried out by direct hires of the government, especially if they do not have any previous experience and facility for setting up a similar system.

Furthermore, outsource service providers have delivery teams and operational structures that allow them to better minimize costs. Contracting out unloads the government of the managerial burden that could have arisen had they chosen to keep these projects in-house. Direct management of the teams who will be working on the projects is taken over by the supervisors of the outsourcing companies. This removes the additional managerial work from government supervisors who are experts in public management and not necessarily in IT systems or client relations.

Strengthening Government Institutions Politically

There are analysts that specialize in the government sector who believe that contracting out helps a government improve politically. Outsourcing helps government agencies build an image of a modernized organization which puts paramount importance on technological advances for effective governance. The vast improvement that a successful government contract delivers elicits public approval from the people. Outsourcing lends government institutions a higher level

of credibility through the experts that this NPM practice introduces to the overall operation of the government. While appointing technocrats may also have a similar effect, outsourcing still provides this credibility better because it affects the government operations directly. Appointed technocrats often occupy positions that are more concerned with project planning. The improvements they bring into government administration may not strongly impact the citizens who experience the presence of these government institutions by availing of the public services they provide. Because outsourcing can improve services which people directly interface with, the people are better able to appreciate the improvements that government agencies implement. In this sense, outsourcing provides a wider avenue for governments to gain public approval and citizens' satisfaction – factors that are fundamental in strengthening government institutions.

In addition, engaging the private sector in the practice of governance and service delivery supports the idea of people's participation in the government. Outsourcing directly involves non-government sector in government operations and for many countries which subscribe to democratic ideals, this manifests a sincere commitment to strengthening public-private partnerships. Favorable business relationships established by successful outsourcing contracts cultivate the precedence for other types of partnerships between corporations and governments. Thus, aside from the tangible improvements that outsourcing IT services deliver to public agencies, governments are also able to enrich their overall relationship with the public they serve.

Benefits to Outsourcing Companies

A Catalyst for Expanding Domain Expertise

As previously mentioned, government contracts are characterized by the voluminous amount of work each project entails. Because of the magnitude of these types of projects, especially those that require an overhaul of the IT system and the complete migration of records, their contracts stipulate a long-term engagement and extensive planning from the service provider. An example of a massive outsourcing deal is the Indiana State government contract with IBM and ACS. The project is worth US\$1.16 billion and will run for 10 years to manage Indiana's system for food stamp distribution, Temporary Assistance to Needy Families program and Medicaid payments. UK Government's National Employees' Savings Trust have awarded TCS a service contract worth more than US\$900 million for 10 years for services such as employer participation, member enrollment, collection and reconciliation, cash management, accessing pension savings and administration of accounts. This service contract will commence on October 2010.

Outsourcing companies thus find government contracts a lucrative source of profit and a stable source of long-term revenue. While the huge projects may also entail large investment, especially in human resources and infrastructure, some of these capital resources may stay within the company long after the contracts have been fulfilled. Thus, service provider companies will have the opportunity to *re-utilize* these resources, and gain expertise from the experience that their resources have acquired through such projects. A government contract can thus be treated as a catalyst for expanding service provider capabilities and intellectual capital for future use in other business opportunities, either government-related or not.

Such is the case for the acquisition of ACS by Xerox which will be completed in the early part of 2010. ACS already has a significant government BPO sector presence through its ACS

Government Solutions unit while Xerox has an established marketing group dedicated for federal clients as well as previous experiences in doing print-on-demand and managed printing services for government sector clients. This acquisition is a positive step towards enhancing both companies' core competencies. Xerox's limited hardware-oriented footprint in the public sector market will be expanded by the introduction of the BPO and ITO services that ACS brings into the merger. On the other hand, ACS sees this acquisition as an opportunity to improve its healthcare solutions with Xerox technologies which will streamline the management of healthcare documents, data and images for clients. This will improve ACS' service offering, specifically in Medicaid processing, for its federal, state and local clients which makes about 40% of company revenue. One must note that this expertise in IT solutions for healthcare verticals is not only applicable to public sector clients. There is also a huge market for healthcare solutions in the private sector, and thus, ACS' competency improvement specifically for government-provided healthcare also broadens its overall capabilities in BPO and ITO services. Furthermore, in the managerial perspective, Xerox's general manager dedicated to client accounts of larger federal agencies will certainly help improve further Xerox-ACS' value proposition. The ACS Government Solutions unit expects to forge a close partnership with Xerox's managers for government clients to develop a deeper understanding of the complex needs of larger federal clients. It appears that improving domain expertise through the targeting of public sector clients have become a deciding factor in this acquisition move and such is also the case for other recent major M&A deals – Dell acquired Perot Systems and HP bought EDS with one of their main objectives being the expansion of their capabilities through scaling up their business with both companies' public sector clients.

Servicing government contracts therefore is an effective way for a company to gain domain expertise, thus improving their competitive advantage over other companies. In fact, Indian companies TCS, Wipro and Infosys are actively competing for smaller outsourcing deals in the US. Despite being used to servicing government contracts worth hundreds of millions, they are able to bid for smaller orders from the private and public sector. At a time when their large clients are tightening their budget belts and renegotiating current contracts for discounts or early termination, being able to bid even for these somewhat *smaller* deals because of their domain expertise is vital in keeping a positive growth rate even in times of crisis.

Investing on the Corporate Image

Companies may also benefit from the publicity mileage that doing business with governments benefits them with. The recent economic slowdown has intensified the need for companies to maintain a positive public image. They would want to remain in the potential clients' radar, even more so when economic activity finally normalizes and begins to pick up. Servicing government contracts, especially when done effectively, could be an excellent form of indirect advertisement for the outsourcing provider. This has been another reason why the improvements and acquisitions that have been happening in the industry have had a public sector flavor. Because the government continually operates regardless of the economic conditions, being an active player in this space would mean having a constant presence in the outsourcing industry.

The very character of government contracts – the expertise they require and the strong management capabilities that they demand – function as a very convincing marketing spiel. Government contracts can require the outsourcing company to accomplish several projects for

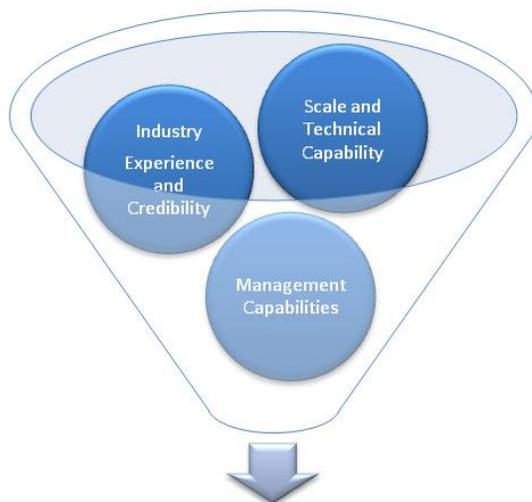
multiple public agencies. Firms interested in bidding for these kinds of contracts need to convince the government of their capacity to carry out the services; of their excellent management team that can anticipate possible difficulties and have sound contingency plans in place; and their ability to meet bureaucratic requirements and processes that are necessary through the duration of service delivery. Moreover, government contracts also entail complicated (and demanding) timelines as well as stringent penalties for non-compliance. A company that can successfully deliver under such conditions establishes industry credibility that is very difficult to refute.

Growth Inhibitors of Government Outsourcing

Limited number of companies that can participate in the sector

Despite the growing demand for government outsourcing and the large deals that they entail, government outsourcing has failed to overtake the market for business activities by traditional

verticals that have held the lead in industry, i.e. BFSI, healthcare, etc.



Limited number of major service providers



One of the major issues that have been impeding government outsourcing is rooted in the essential characteristics of the project contracts. Because of volume of work that is involved in carrying out a government contract, many companies are eliminated as prospective bidders. Only a few large players, many of them multinational in nature, can guarantee stable facilities to deliver the service. Furthermore, government protocols (and internal mandates) may require that only companies with specific net worth can participate in the bidding process as a form of safety net and guarantee of the *real capacity* to deliver the projects. For these filters alone, a vast majority of providers would have already been disqualified. Outsourcing for the government sector is very different from other leading sectors such as BFSI – in these sectors,

small to medium sized companies which primarily move in niche markets can participate in, and in some cases, even challenge large service providers effectively for contracts. Should governments choose on getting these small to medium sized providers whose reputation for providing government services is not widely recognized, public managers will find themselves explaining to the public their reasons for doing so. Because government agencies are under constant public scrutiny, they would rather avoid contracts with companies which are relatively

less renowned than the major players in the industry to avoid controversies that may spark negative public opinion.

The discussion above does not intend to argue that small to medium players have questionable credibility and less capabilities when compared to major players. What is being elucidated is the behavior of governments in outsourcing and the possible rationale behind the decision to award contracts to service providers which have a more pronounced local and international presence. This merely explains why participants in the government outsourcing sectors is more limited than in the other industry verticals that subscribe to the outsourcing model.

One way to appreciate how only a few service providers can successfully supply the unique needs of a government contract is by looking at the various ways by which a service provider can fall short in delivering its end of the deal. The State of Virginia's contract with Northrop Grumman Corp. to carry out the overhauling of the several state agencies' IT system – the contract spans a total of 59 projects to be carried out for over 72 agencies at more than 2,000 sites. This IT system upgrade covers PC replacement, servers, mainframes, email and network security. However, this US\$2 billion-deal that was supposed to run for ten years beginning in 2005 has been reported by the Joint Legislative Audit and Review Commission in 2009 to have failed in almost every aspect. The projects are behind schedule, despite several extension deadlines that have been granted to the company. In addition, there is also the low client satisfaction for some of Northrop Grumman's services – 41% ranked the network services as poor, 44% of the agencies found the disaster recovery system inadequate and 48% felt that the helpdesk services were poor. There were complaints regarding calls being routed to technicians with the wrong expertise or assigning low priority to urgent calls for assistance and thus leaving important problematic situations unresolved. The company and the consultants hired to review the contract agreed that these shortcomings are largely due to poor planning and management. The bureaucratic arrangement has also made it difficult to carry out certain solutions – managers have to secure the consent of several bureaucratic officials for an alteration in the project plans. The service provider also failed to anticipate the problems that may arise in carrying out the projects. They may have possibly under-estimated the real volume of work that the projects require causing their response to problematic situations to be delayed and often inadequate. At 4:00am, a state correctional facility lost incoming phone service. Northrop Grumman assigned it a priority level that allowed the company 18 hours to finish repairs. The priority level was assigned with the number of employees at the facility as the determining factor and not by the fact that the facility has 1,000 inmates. Such management decision demonstrates the service providers' inept appreciation of the needs of the government agencies.

The disappointing outcome of the outsourcing deal between the state of Virginia and Northrop Grumman Corporation exhibits the need to ensure that a company that is aiming for this sector is realistically capable of taking on a huge government contract. It sheds some light on why large service providers are more commonly winning these types of contracts. While there are indeed many outsourcing firms which may have the expertise to carry out functions required by the government, there are only a few companies who have the industry experience to implement the service. Delivering on a public sector contract requires a specialized type of management strategy and project planning. They also demand a deep understanding of government needs that may not be accessible yet to companies which are used to servicing smaller contracts from private sector clients. This is one of the reasons why despite the forecasted US\$100 billion

opportunity in public sector outsourcing, only large established companies such as IBM, HP-EDS, TCS, Wipro and Infosys have explicitly expressed their intention to develop a business segment dedicated solely to competing for government contracts. The nature of the work essentially limits the number of potential competitors for public sector contracts thus inhibiting a more rapid growth of this industry segment.

Outsourcing is “shipping work abroad”

Another issue that is rooted in the public opinion factor is the perception that outsourcing ships out employment from already struggling economies. Groups opposing government outsourcing argue that contracting out has led to the laying off of many government employees and that the citizens are losing their jobs to the cheap labor in developing countries. Highlighted even more during times of economic uncertainties, many dissenters of government outsourcing argue that contracting out to the private sector, especially to multinational firms, often leads to offshoring, which takes the jobs out of the client country and delivers services from cheaper, foreign locations. Because of this political backlash, specific legislation has attempted to limit government outsourcing and these efforts have come in various forms: limitations to the processes that are eligible for outsourcing, stipulations against offshoring, terms or conditions that favor keeping the operations onshore, and requiring full disclosure of the locations of the firms’ service delivery centers.

In 2004, the US Consolidated Appropriations Act 2004 was the first legislation that explicitly banned outsourcing of government contracts. It prohibits government functions which have been contracted out to be performed in locations outside of the country unless such functions have already been previously delivered from an offshore location. In a Tennessee bill, an explicit preference was given to vendors which would set up their call centers or data entry operations for state contracts within the United States. The states of Georgia, Massachusetts, Minnesota, Nevada, North Carolina, Oklahoma, Oregon and West Virginia also had similar proposed or approved legislation that keep contact centers within the US.

Many industry analysts, from the outsourcing and government sector alike, are of the opinion that contracting out does not have grave effects to local employment. In fact, according to a report released by the US Bureau of Labor Statistics in 2005, of the 50 or more of the most recent layoffs at the time of report, only 2% had outsourcing as a contributing factor. In another report in 2006, the Duke Center for International Business Education and research stated that 90% of all R&D offshore implementations have not created any job loss in the country.⁶ These studies show how media reports may have overstated the negative effects of offshoring on local employment, indicating that even the claim regarding that offshoring government contracts cause unemployment may also have been over-estimated. Despite these expert opinions however, government agencies practice utmost prudence in putting up government process for outsourcing. Public managers find themselves trying to strike a balance between public opinions and accomplishing processes in the most efficient way possible.

⁶ National Foundation for American Policy, *Anti-Outsourcing Efforts Down But Not Out*, 2007

Concerns over data security

Similar to the concerns of private firms which resort to outsourcing, government agencies are also apprehensive about data security. Data points handled by the government range from the very trivial i.e. name, gender, age, to mention a few; to the extremely sensitive, i.e. home address, social security number, even health or biometrics records. Government projects may require centralization and universal access to these types of personal data for most if not all of the government agencies. While such types of upgrades can largely improve efficiency, they also increase vulnerabilities to data security breach. Many are not comfortable with the idea that a body other than the government has this open access to a vast amount of personal data of the big portion of the population. Likewise, such groups are not keen on systems that allow private (for profit) companies unfettered access to sensitive data, and this apprehension is compounded by the fact that the governments, in contracting out specific services, often relinquish a certain degree of its control over data to the contracted private entity.

The apprehension over security is further aggravated by the possibility of offshoring as there have been continued doubts over data security and privacy standards of many developing countries. Governments cannot send this information to locations where data security is in question. For instance, despite the higher spending of India compared to UK in their data security initiatives, many still oppose offshoring because many outsourcing countries have poor reputations for effectively pursuing, litigating and persecuting incidents of security breaches and intellectual property violations. Responding to offshoring and data security concerns in the State of Indiana, H.B. 1127 was filed as response to data security concerns in offshoring. The bill stipulates that written consent of the individual must be secured annually in order to allow the transfer of individually identifiable health records to a location outside of the United States.

Similar to how the private sector encounters difficulties in offshoring the processing of sensitive data, governments also have to contend with pronounced opposition regarding privacy and data security issues. This concern will consistently serve as a major factor in government being prudent in selecting their outsourcing partner as well as the contract model – whether offshore or onshore – for current and future government deals.

Conclusion

The economic recession has made the calls for cost savings in public spending even more urgent than before. All means to cut people's tax expenses are being considered and outsourcing appears to be a very viable solution to this demand. In addition, more government agencies are looking at outsourcing as a means to gain specific value-added benefits to the services that public agencies are delivering to the people.

Despite the allure of using outsourcing as a means to finally achieve a positive transformation of the overall operations of various government agencies, the debate about the economic and political implications of leaving certain processes in the hands of private sector providers still rages on. This is because outsourcing reshapes a fundamental characteristic common to all governmental institutions – authority and the control that such authority guarantees. What outsourcing essentially does is relinquish some degree of control that would otherwise be absolutely held by the government authority. Furthermore, the outsourcing model challenges the traditional conception that government ought to be the biggest employer within the country. Outsourcing results to limiting the direct employment opportunities in the government and transferring these opportunities to the discretion of private corporations. Certain groups may find this rather alarming because it may be a manifestation of the diminishing government capacity to secure employment opportunities for its people. Viewed in this manner, it does not seem too surprising that anti-outsourcing legislation has become a popular response of several lawmakers. They deem it necessary to secure the integrity of the government by coming up with laws that will limit outsourcing.

However, judging by the evolving needs of the growing population, it seems that supporting more public sector outsourcing would be a better option for preserving government integrity. Contracting out has proven its capability to significantly improve service delivery and increase savings on public spending. Contrary to the belief of dissenters, outsourcing in the public sector strengthens the institutions of governments by improving public services. Their presence is felt by more people because the reach of their service has been broadened with the use of advanced technology. In this way, governments are able to optimize the benefits that outsourcing offers.

Public sector outsourcing's first driver was the need for expertise to manage the evolving needs of the citizens it serves. It has been made more relevant by the realized cost savings, and even more so during the economic recession that has triggered budget cuts for public spending. However, what will possibly sustain the continuing popularity of outsourcing is the transformational effect it has on government institutions. What public sector outsourcing essentially offers is an opportunity to streamline government functions and ultimately enhance its capabilities in achieving the governments bottom-line – efficiently and effectively serving the country's people.

Author:
Jhoana Mutiangpili

Editor:
Manuel Ravago
Research Director

Copyright Notice

This Tholons document was published as part of the Tholons Advisory, Investments and Research Services portfolio, covering all consulting projects and publications.

For further information related to this document, reprint rights or general inquiries regarding other Tholons services, contact info@tholons.com or call any of our global offices.

Reproduction of this document and all content within is prohibited unless authorized by Tholons. All rights reserved.

For more details about Tholons' Services Globalization and Investment Advisory capabilities, please visit our website at:
www.tholons.com

You may also contact:
Saugata Sengupta
saugata@tholons.com

Tholons is a Services Globalization and Investment Advisory firm that combines "Best of Breed" consulting experience with deep execution expertise and investment insights to deliver truly effective services to its clients. Tholons offers a detailed understanding of business processes and combines it with practical hands-on expertise in executing the strategy. Tholons draws upon the considerable experience of a hand-picked team, which has successfully formulated and executed globalization strategies to unlock value for Global Fortune 1000 companies. Service providers leverage Tholons expertise to optimize their global delivery model. Tholons advisors engage with government bodies to build compelling strategies for making countries attractive destination for outsourcing.

THOLONS Global Offices

North America Office

5 Penn Plaza, 23rd Floor
New York, NY 10001
Phone: +1-646-290-9320
Fax: +1-646-349-3546

Europe Office

Asmec Centre
Eagle House, Bracknell
Berkshire RG12 1HB, UK
Phone: +44-1628-566140

Asia Office

2/10, 2nd Floor, 80 Ft Road
RMV Extension Stage II
Bangalore 560 094, India
Phone: +91-80-23519760

Philippines Office

Unit 803, Richmonde Plaza
21 San Miguel Avenue, Ortigas Center
Pasig City 1600, Philippines
Phone: +63-2-635-9236