Barriers to Outsourcing in the Public Service

Key Point

The present system of government accounting puts significant barriers in the way of achieving the optimum use of external service delivery .

Introduction

One of the elements of the Public Service Reform Plan announced by Minister Brendan Howlin on 17 November, 2011 relates to the external service delivery or outsourcing of non-critical functions.

The way the present system of government accounting operates puts significant barriers in the way of achieving the optimum use of external service delivery .

A budget holder will only pursue the objective of buying services externally if the net impact on their budget is favourable. Even if the external provider is more efficient there are at least two elements which fall to be included in the cost of bought in services, which do not impact on services provided internally. These act as a wedge inhibiting outsourcing.

These are VAT and pension costs.

Most bought in services will attract VAT at a rate of 23 %. If it costs 100 to provide services internally, as far as the budget holder is concerned, the cost of the equivalent bought in service cannot exceed 81 (plus VAT of €18.63) before the external provider will be competitive with the in house service. However, in the buying in case, the Exchequer will be better off by the amount of VAT paid. The solution is to give the budget holder a credit for the VAT due in the accounts used to determine their performance (management accounts).

The second distortionary element is that the pension costs of the public sector are unfunded and so do not impact on the current cost of the internally provided service. The cost charged by the private operator will include the cost of any pension benefit provided. To address this, management accounts in the public service need to include a charge for pension costs.

Implications

Unless these distortions area addressed, the level of external service delivery will be sub-optimal and it is very unlikely that the potential benefits which can arise from external service delivery will be realised.

Steps are being taken to address these issues. A Business Case Model is being distributed to departments to allow them to consistently evaluate alternative delivery models. The rules prohibit departments from including VAT in the external delivery price for comparison purposes. Departments are also required to include a loading for public sector pension, taken from a 2009 Comptroller and Auditor General report on Public Service Pensions so that the internal options better reflect their true cost.

Regardless of business case comparisons, departments will still be required to pay VAT at the prevailing rates on outsourced contracts and this could continue to cause perverse incentives at a local level. To address this, Departments need to be given a credit for VAT paid on outsourced services in their Vote accounts.

References

The link to the Public Service Reform Plan is here

http://per.gov.ie/wp-content/uploads/Public-Service-Reform-pdf.pdf

Notes

Management Accounts are aimed at internal users of accounting information. They are used to send signals to management by including charges for items such as the cost of accommodation, which do not give rise to actual payments and do not appear in the financial accounts.