

Summary of “How to Compare Costs Between In-House and Contracted Services” by Lawrence Martin (March 1993)

Attempting to compare the costs of in-house and contract service delivery is difficult. Savas (1993) suggests that the cost of in-house service delivery is frequently underestimated by as much as 30 percent. Case-study evidence also suggests that the cost of contract service delivery is often underestimated as well, due to a failure to properly account for such costs as contract administration and monitoring. Although Martin’s paper was written from an American context, his guide provides a structured approach for making cost comparisons between in-house and contract service delivery that will be applicable within Canada. Martin’s approach is summarized below and is based on:

- 1) mainstream public financial management thinking;
- 2) the best identified practices of US federal, state, and local governments; and
- 3) a desire to keep the process as simple as possible while ensuring a high degree of validity.

In-House Fully Allocated Costs = Direct Costs + Share of Indirect Costs

The total cost of providing a target service in-house is known as the fully allocated cost.

Direct Costs: These costs only benefit the target service. Examples include salaries, wages, and benefits of employees who work exclusively on the target service as well as supplies, travel, printing, rent, utilities, and communications. Some direct-cost items that are frequently overlooked include interest costs on purchases of capital items, pension costs, and facility and capital equipment costs, including depreciation.

Indirect/ Overhead Costs: These costs benefit the target service and at least one other service. Examples include administrative and support services, and their wages, benefits, supplies, travel, printing, rent, utilities etc. Overhead costs can be apportioned among services according to personnel costs, total direct costs, and the step down method. The step down method is least commonly used, but it divides all departments into either support or production departments, and allocates all the costs of support departments to the other entities they serve.

Total Contracting Cost = Contractor Cost + Administration Cost + Conversion Costs (amortized) – New Revenue

Contractor costs: The total costs a contractor proposes to charge for performing the target service. They can be taken from a bid or proposal.

Contract Administration Costs: All activities that take place from the time a decision is made to contract until the contract is fully executed and final payment is made. Examples include procurement, negotiations, processing of change orders, resolution of disputes, processing of invoices, monitoring and evaluation. Informed judgement or the US Office of Management and Budget Tables are used to assess the cost of contract administration. A reasonable estimate is between 10%-20% of contractor costs.

One Time Conversion Costs: This cost includes personnel related costs, property or equipment related costs, and other costs such as penalty fees in lease or rental agreements.

Off-Setting Revenues: This revenue is any new or enhanced revenue stream that will accrue.

Comparing the Costs of In-House and Contract Service Delivery

When to Use Fully Allocated Costs: This cost is useful in determining if the in-house cost of providing a target service is comparable with private-sector market prices. It can also be used for comparing efficiency, but it does not reflect the cost savings that will be realized through contracting out. Contracting out a target service may reduce the workloads of service departments like personnel, finance, or facilities management, but those reductions may be insufficient to have any effect on the staffing levels or cost of maintaining those departments.

However, when in house departments are bidding against private contractors, the public provider should be required to bid based on fully allocated costs, not marginal costs. This is because the public provider often maintains excess capacity.

Avoidable Costs- Total Contractor Costs = Cost Savings

Avoidable Costs: Avoidable costs are the in-house costs that will not be incurred if a target service is contracted out. Avoidable costs should be used when assessing the likely cost savings. Virtually all direct costs will be avoidable. Determining what portion of overhead costs may be avoidable is a matter of judgement, depending on the political will to reallocate resources efficiently; the extent of the privatization effort (1 small department or several); and the time period (more costs are avoidable over the long term).

Total In-House Cost / Total Contractor Costs = Cost Comparison Ratio

The Cost Comparison Ratio: The purpose of the cost-comparison ratio is to establish a threshold that justifies a decision to change the mode of service delivery. Many government agencies adopt the policy that cost savings should be sufficient to warrant the organisational upheaval associated with changeovers. The US government, the state of Texas, and the City of Cincinnati, Ohio, have all established a threshold level of 110% for the cost comparison ratio when considering a change from in-house to contract service delivery.

References:

Savas, E.S. (1987). *Privatization? The key to better government*,(p.259).Catham, NJ: Catham House Publishers.

Martin, L. (1993). *How to compare costs between in-house and contracted services*. Retrieved Feb 2, 2011 from <http://reason.org/files/ba9b149031669883385db8c2ff63b9ef.pdf>