

# ***Why outsource and what makes it work?***

## ***Alternative arrangements for work in the health sector***

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### **ABSTRACT**

This paper addresses the question: In the health sector why have managers outsourced some functions in preference to others? The research specifically uncovers a reason for outsourcing which has not been highlighted in the literature; that being a desire to improve department management. The research has shown the importance of power, as illustrated in the use of outsourcing to improve department management and their associated resistance to change, and the importance of trust and loyalty between management and internal staff in retaining services in-house.

### ***Introduction***

The introduction of National Competition Policy (NCP) in 1995 occurred within the auspices of public sector privatisation and saw public sector managers required to implement a range of structural adjustments and programs to adhere to government pronouncements. In health organisations variations in the extent of outsourcing and the types of services outsourced occurred. This paper addresses the question: With the introduction then of NCP, noting its pervasiveness and effects, why have managers outsourced some functions in preference to others?

### ***Reasons for outsourcing***

Six reasons can be gleaned from the theoretical and empirical outsourcing literature to account for, or justify, its adoption. The first reason for outsourcing is that managers have wanted to reduce costs. From economic theory, the following are pertinent in this regard. Transaction Cost theory (Williamson, 1986) emphasises cost implications due to transaction frequency, asset specificity, uncertainty and the threat of opportunism. Agency theory (Eisenhardt, 1989) focuses on choosing the structure that maximises efficiency and contends that bounded rationality and self-serving behaviour by agents introduces inefficiencies which can be limited by using either behaviour-based contracts (internal production) or outcome-based contracts (external contracts). It proposes that factors important to the success of the outsourcing decision are information and information systems, outcome uncertainty, risk aversion, goal conflict, task programmability, outcome measurability and length of the relationship between the organisation and vendor.

Focusing on core competitive advantage is a second reason discussed in the outsourcing literature. In this instance, the specialised nature of an organisation's competitive advantage is raised by Porter's (1980) Corporate Strategic theory, as important when choosing which governance structures are put in place. Indeed, it contends that the ability to specialise is influenced by the frequency of the transaction, asset specificity and environmental uncertainty, all of which are similar to those found in Transaction Cost theory.

Introducing workforce flexibility is a third reason cited in the literature. Atkinson's (1984) flexible firm model contends that the division of labour into core and peripheral segments, whereby the former provide functional skills and the latter numerical skills, introduces workforce flexibility which produces cost savings and improved efficiencies.

The labour market and political literature (Burgess & Macdonald, 1990:32; Campbell, 1993) suggest a fourth reason for outsourcing is the management of industrial relations problems. The associated increase in the power of management over labour and weakening of the power of trade unions have been put forward as reasons for contracting-out. Pfeffer (1994) has supported the flexibility concepts and asserted the reason behind the growth in the externalisation of employment is that it is quicker to staff vacancies. It is also suggested that contingent employees provide a buffer in times of economic downturns, whilst the cost of unskilled labour employed periodically is less.

The satisfaction of decision-makers' personal objectives is a fifth reason and is primarily found in the political literature (Pfeffer, 1994). Public Choice theory (Hanke & Walters, 1990) asserts that public sector decision-makers are motivated by self-interest which Downs (1967) maintains is divided into self-interest, through a desire for power, money and prestige as well as more broader interests of maintaining loyalty to work groups, agencies, government or nation. In this vein, a sixth reason is the shaping of public sector agencies to align with the agenda of the government providing the funding. The reasoning here assumes that decision-makers are motivated by a desire for power and see this desire being fulfilled by acting in the interests of the government.

Table 1 summarises the reasons for outsourcing and lists the factors that the theoretical and empirical literature sees as important for the decision to be successful.

**TABLE 1**  
*Reasons for outsourcing and the factors likely to impact on the outcomes of the decision*

<b>Reason:</b>	Desire to reduce costs and increase efficiency
<b>Factors:</b>	<ul style="list-style-type: none"> <li>- transaction frequency</li> <li>- asset specificity</li> <li>- uncertainty</li> <li>- hierarchical costs</li> <li>- threat of opportunism</li> <li>- information &amp; information systems</li> <li>- outcome uncertainty</li> <li>- risk aversion</li> <li>- goal conflict</li> <li>- task programmability</li> <li>- outcome measurability</li> <li>- length of relationship</li> </ul>
<b>Reason:</b>	Desire to focus on core competitive advantage
<b>Factors:</b>	<ul style="list-style-type: none"> <li>- core competencies</li> <li>- frequency of transaction</li> <li>- asset specificity</li> <li>- environmental uncertainty</li> </ul>
<b>Reason:</b>	Desire to introduce workforce flexibility
<b>Factors:</b>	<ul style="list-style-type: none"> <li>- labour market characteristics, such as functional and numerical skills</li> <li>- environmental uncertainty</li> </ul>
<b>Reason:</b>	Desire to improve management of industrial relations' problems
<b>Factors:</b>	<ul style="list-style-type: none"> <li>- power of management and labour</li> <li>- labour market characteristics</li> <li>- culture</li> </ul>
<b>Reason:</b>	Desire to satisfy decision-makers' personal objectives
<b>Factors:</b>	<ul style="list-style-type: none"> <li>- relative power of management</li> <li>- opportunism or self-interest of decision-makers</li> </ul>
<b>Reason:</b>	Desire to adhere to the ideology of government
<b>Factors:</b>	<ul style="list-style-type: none"> <li>- environmental uncertainty</li> <li>- government ideology</li> <li>- political or fiscal environment</li> <li>- power of management and labour</li> </ul>

An examination of the effects of outsourcing displays both economic and political precursors, even though improved efficiencies and reduced costs have been proclaimed as benefits (Hodge, 1996). For example, some cost reductions have arisen solely from contractors' improved productivity (Cubbin, Domberger & Meadowcroft, 1987) or the payment of lower wages (Milne & McGee, 1992), but in other cases it has resulted from the movement towards more flexible forms of labour, such as part-time employment (Industry Commission, 1995:160) or from a combination of

reduced employment and fewer fringe benefits, as well as the use of modern equipment and better management practices (Hartley & Huby,1986:293). In still other arrangements, the movement to employment outside the award system has reduced costs (ACIRRT, 1999:142-3), lowered the level of industrial relations problems (Benson & Ieronimo, 1996:69) and allowed management to fulfill the objectives of government (Burgess & Macdonald, 1990). Empirical analysis (Industry Commission, 1995:127) has highlighted deficiencies in looking solely at economic criteria in the outsourcing process, with much of the analysis citing a lack of objective analysis and/or inability to cost outsourcing reliably. Economic criteria are also often claimed (Pfeffer, 1981:140) to be limited in their ability to explain completely the decision-making process.

Thus, the primary reason decision-makers give for moving to an outsourcing arrangement is economic, with pronouncements stating the cause in terms of the need to reduce costs, increase efficiency and focus on core competitive advantages. However, such rationales are not always supported by the subsequent behaviour of decision-makers.

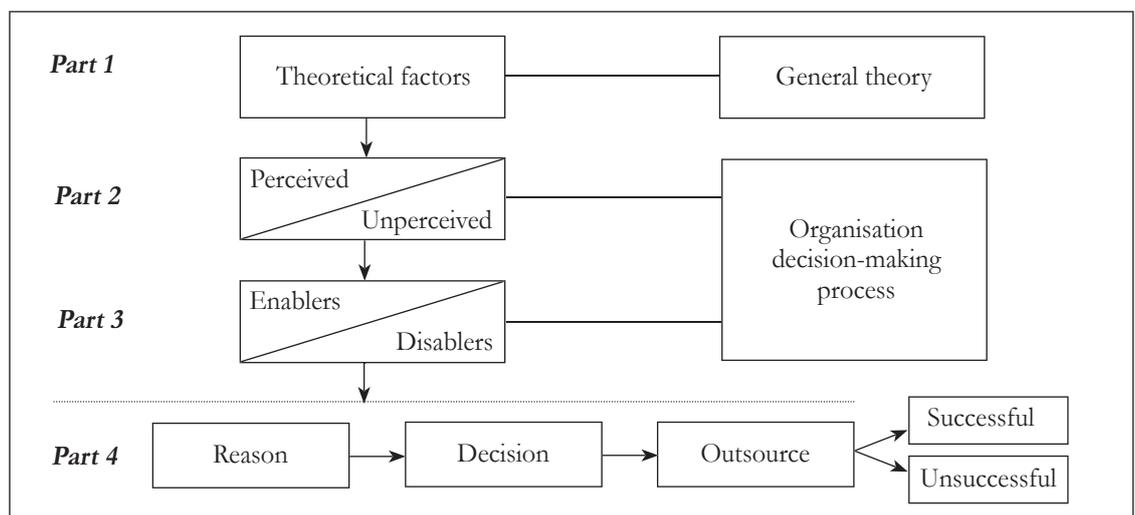
**Perceived and unperceived factors in the outsourcing decisions**

One difficulty with operationalising the theory of outsourcing is to match the various factors with the actual considerations that influence the outsourcing decision in practice. Each reason points to factors that necessarily impact on the utility of outsourcing. In analysing the outsourcing decision, all factors should be considered because they represent variables which will have contingent effects on the outcomes of outsourcing. Failure to consider any variable on the part of decision-makers also creates a risk of unintended consequences, whether positive or negative. In practice, managerial comprehension of these issues is likely to be bounded. Those factors that influence the outsourcing decision are called ‘perceived’ factors, while those not considered are referred to as ‘unperceived’ factors. Failure to consider all factors creates a real risk of unintended consequences where the decision-maker has not planned for all of the effects of the decision. It also follows that outcomes may be sub-optimal, and may surprise managers because no allowance is made for unperceived factors.

Unperceived factors are not directly regarded or acknowledged by decision-makers. Nor do they appear in interview statements or formal internal documents. Although they may have been vaguely or informally understood, they are not articulated. If all the factors that may theoretically influence the outsourcing decision are ranked according to their applicability to organisations, some will be positive in their effects (to be termed ‘enablers’) and others will be negative (to be termed ‘disablers’).

It follows that the model of the outsourcing decision will have four parts. This model is shown in Figure 1 below. First are the factors identified in theory as a justification for outsourcing. These are as general as the theory. Second are the factors perceived or unperceived by decision-makers in a particular context. Third are the factors that are relevant to a particular organisational context, which are called enablers or disablers. Fourth is the linear process leading from reasons for outsourcing to outsourcing decisions and outcomes.

**FIGURE 1**  
Model of Outsourcing Decision-Making: Choices and Outcomes



## Method

Case study research operates within an interpretivism paradigm and is used in the present research to uncover why outsourcing decisions are made. Initially, interviews were conducted with the Chief Executive Officers of each of the health organisations, using semi and unstructured questions to ascertain the extent of, and processes used in outsourcing specific functional areas, and in areas that have not been outsourced. Further interviews with decision-makers and staff in both outsourced and non-outsourced areas were then conducted. Interviews lasted approximately one-and-a-half hours and were held over a two-year period, covering all levels of hospital management, both line and support, as well as proprietors and staff of the outsourced areas, and union officials. Job positions of those interviewed are shown in Table 3. Data was obtained from the hospital and network's annual reports, and internal financial and consultant's reports, which are not cited fully in the reference list to maintain anonymity and confidentiality.

**TABLE 1**  
*Reasons for outsourcing and the factors likely to impact on the outcomes of the decision*

<i>Job positions</i>	<i>Case Study 1</i>	<i>Case Study 2</i>	<i>Union</i>	<i>Industry Association</i>
Executive Officers	1	1		
Senior Manager	2	2		
Middle Manager	5	3		
Union Officer			5	
Outsourcing Vendor	2	1		
Consultant	1			1

Tape transcriptions were then forwarded to the interviewees for checking, before being filed in a locked cabinet in the office of the writer for privacy purposes. The verification fulfilled the need for credibility checks and ensured that the information was reflective of the participants' meanings and the interviewer did not introduce bias. As the information produced by qualitative methods is voluminous, content analysis, as proposed by researchers such as Patton (1990:381), was used to identify, code and categorise its primary patterns. Categorisation was performed on the basis of reasons, decision and outcomes as per the model. Further coding occurred to segment data between economic and political associations. The information was organised by health organisation, then delineated by services. The analysis of this information was performed in terms of the factors that surrounded the outsourcing decision.

### **Case study one: Rural public hospital**

The town in which this hospital is located is the largest in the region, and in 1996, at the time outsourcing was being considered, had a population of 26,776. The healthcare campus serves a region with a population of 59,606 (ABS, 1996). The hospital is one of the region's major employers of labour with 543 effective full-time staff. In 1999, it treated approximately 13,000 acute inpatients and 73,000 outpatients. Turnover amounted to \$45 million with total assets of \$55 million.

Within this hospital the services considered for outsourcing included radiology, pathology, garden and ground maintenance, engineering and equipment maintenance, and food services, although in the latter two instances, outsourcing did not eventuate. The fiscal environment produced pressure on the hospital through the lack of government funding for capital replacement. The Hospital's Annual Report of 1993/94 (p.12) stated that 'all attempts to secure capital funding from the Department of Health and Community Services to re-equip have proved fruitless, resulting in the pursuit of privatisation'. The industrial relations environment also had an impact with the Director of Human Resources (interview, 14 December 1999) arguing in relation to pathology, that 'the push by the union for unsustainable income levels resulted in a statewide push for privatisation of pathology. Industrially they also had the ability to completely stop blood supplies and had strong bargaining power through their unity'. As such, political factors were important in setting the context in which each decision was made. The inter-relationship between the economic and political environment was particularly evident with regard to the

outsourcing of radiology. Interviewees (26 September 2000; 24 November 1999) referred to declining staff morale due to the political and unethical actions of the incumbent radiologists and the decline in patient numbers of 28.5 per cent between 1988/89 and 1992/93. This soon reduced the hospital's private revenue, adding to the problems of insufficient funds to replace outdated equipment. Therefore, staff were exposed to job insecurity, reduced workload, poor equipment and conflicts of interest between the medical radiologists and the hospital (interview, 26 September 2000).

And the characteristics of the rural labour market placed added pressure on the hospital through the inability to obtain professional staff. The Hospital's Human Resource Manager explained, 'inland hospitals struggle to find staff. Staff attraction and retention is better for larger multi-national companies that can contract across the State' (interview, 14 December 1999).

Previous downsizing had produced fear and reduced morale on the part of staff. Hence the very threat of outsourcing under the guise of the benchmarking process changed work practices, introduced workforce flexibility and reduced costs.

This resulted in the unions starting to play ball with work flexibility. The climate allowed productivity gains that the public sector couldn't achieve prior to this process occurring. And privatising decreased the union strength and power shifted (interview, 23 May 2000).

Political factors and tactics, the rural nature of the hospital and the relationship with internal staff were also evident in the decision to maintain internal production in the areas of engineering and maintenance, and food services. The Chief Executive Office believed the food department staff were very loyal, not highly paid and lacked transportable skills. Furthermore, in the past they had co-operated with hospital management to reduce costs and achieve savings by working with new technology, and changing rosters and work practices. He explained:

A country hospital's decisions impact upon a lot of people and we have to bear in mind ramifications and consequences .... The hospital owes a debt of gratitude to them for making these changes, and so does not wish to privatise ... (interview, 24 November 1999).

In the same vein, the department manager stated, 'This is a local hospital employing local people and producing meals for local people' (interview, 7 March 2000). He added, 'It was not a good idea to outsource as jobs would be lost, including my own'. He explained that most hospitals did not want to contract-out because they would lose management control. As such, their decision was not based so much on public interest as self-interest. Support came from a union official when he argued, 'If the service is outsourced the manager gets the sack, so it is really about protecting their own jobs' (interview, 7 August 2000).

Therefore, overall, political factors, which were important in the decision making included the power of management over labour and trust between the two groups. In addition, political tactics were displayed in keeping services in-house, through the manipulation of data and lobbying of the board. Economic factors perceived to be important related mainly to human and physical asset specialisation and core competencies. Although other economic factors, such as frequency of exchange, hierarchical costs, outcome measurability and task programmability may have increased costs of using either internal or external arrangements, they were not generally mentioned by the interviewees as important or relevant in their decision-making. Specifically, each decision had different economic and political considerations that decision makers perceived as important.

### ***Case study two: City public health network***

In 1995, at the time outsourcing of market testing and outsourcing, the network had a configuration of ten hospitals and health services. It served a population of nearly one million people living in two metropolitan areas, as well as offering a range of specialist services for the whole state. Its major hospital operates 1200 beds and is a leading tertiary teaching hospital in the state with activities extending to training and research. The network services approximately 67,000 acute inpatients and 232,000 acute outpatients.

Since the early 1990s, the network, under the umbrella of NCP, had embarked on a review of services in the Infrastructure Division, and pathology and pharmacy departments.

The result of the review process was that car parking and garden and ground maintenance were outsourced to external contractors. Internal teams won the contracts for food services and engineering, whilst pathology continued to operate within the internal hierarchical structure.

The Infrastructure Division, of which the non-clinical services were part of, was the first area subjected to the review process due to its peripheral nature with regard to patient care, and the financial savings which management believed could be made through changing work processes and downsizing. An executive director in supporting internal bids, explained to the internal staff:

'You can win it, but you're going to have to change your work practices.' So it gave the network an insight into whether these people really could make it or, whether, in fact, it was the same old public service syndrome, come to work Monday to Friday and have [the odd] Friday off. As management had the opportunity to set the specifications, it was a way to change work practices without necessarily having to go down the track with the unions (interview, 24 January 2002).

Her priorities were to 'cull the departments, change work practices, bring the workforce into the 21st century and train them. Make them understand that this is what you have to do to survive and it is hard and we're all going through the same thing' (interview, 24 January 2002).

With regard to outsourcing food services to the internal team price carried the greatest weight (interview, 24 January 2002). In addition, the line manager claimed that the committee looked favourably on the changes the in-house team had already made in reducing staff numbers and transforming work practices (interview, 25 January 2002). A manager of a receiver hospital (interview, 5 February 2002) added that network managers believed that the service was sustainable, in terms of it being long-term with low risk, compared to the service offered by some external contractors. On awarding the contract to the internal team, 'wholesale workplace reform' resulted as all processes were investigated for change, from floor washing to pot scrubbing (interview, 24 January 2002). With regard to engineering, the line manager claimed that they won on the basis of first, cost and secondly, corporate knowledge. He explained, 'We had all of the knowledge of critical areas and the person walking off the street was not familiar with the operation of the hospital at the depth that the in-house team had' (interview, 25 January 2002).

Supply was outsourced externally as changes to the management style were required. The Director of Infrastructure explained that the Supply Manager employed internally had a very high opinion of himself, an opinion not supported by the executive team. She contended that she could not remove him from his position easily and his capacity for making change was limited (interview, 24 January 2002). Another manager, in support, added that workplace change and increases in efficiency had been sought for two years prior but could not be produced with the management team employed at the time (interview, 5 February 2002). The current supply manager concurred and added:

One of the motivations in market testing was that the network believed an external change agent would be more successful than an internal staff member because they wouldn't have to protect the status quo. The individual hospital managers were reluctant to co-operate because at the end of the day there would only be one supply manager. (interview, 5 February 2002).

In addition, improvements were needed in staff training. The objective was to increase the skill levels of the staff and at the end of the contract revert to internal management. The Director of Infrastructure (interview, 24 January 2002) explained, 'At the end of the contract the internal staff would be trained, and the people that went to work for the contractor could be bought back whilst retaining the knowledge'.

The outsourcing of gardens and grounds failed as the contractor who worked across a variety of host organisations, such as local government and parks and gardens failed to meet the specifications. An executive director explained, 'We couldn't find the contractor and we spent so much time going around to check if he'd done what he should have done in accordance with the contract, it cost money' (interview, 24 January 2002). The director added, 'fortunately it wasn't worth a lot of money, but it proved that, like it or not, it [the success of the arrangement] is still based around personalities, whether in-house or contracted out' (interview, 24 January 2002).

At this network, even where transaction characteristics favoured internal production, generally, as long as political factors, such as staff/management problems favoured outsourcing, the decision was taken to outsource. Asset specificity, or the availability of specialists, alongside the lack of department management skills, seems also to have been deciding factors. In all cases, the decision that was made coincided with the location of asset specificity being either in the market place or within the organisation. The nature of the clinical services, with regard to their teaching and research components, also heightened the risks inherent in outsourcing, and instead the choice was made to retain internal production whilst reducing costs and introducing change.

### **Discussion**

The six reasons for outsourcing initially proposed focused, in economic terms, on the desire to reduce costs, focus on core competitive advantage and improve workforce flexibility and, in political terms, on the desire to adhere to government ideology, satisfy decision-makers' personal objectives and improve industrial relations problems. The literature tended to group 'management problems' together as a reason for outsourcing; the focus being on the use of outsourcing to reduce union power (Burgess & Macdonald, 1990:32), to induce staff to adopt change (Reilly & Tamkin, 1996:24) and to solve problems of recruitment and selection of staff (Pfeffer, 1992). However, in discussing management problems, this research has uncovered a seventh reason for outsourcing which was not as apparent in the literature; that being a desire to improve department management, specifically related to their skill levels and their familiarity with new operating procedures. This research found that outsourcing was often used to replace middle managers, with the rationale that new managers would inject professionalism and skills such as in radiology in the rural hospital and food services and supply at the city network. The health organisations operated under the assumption that contract organisations had the expertise to introduce changes to work processes and to train the operating staff in new procedures. However, in some cases (i.e., city network gardens and grounds service), contract managers did not exhibit the desired skills and those with a lack of health sector experience had problems in meeting quality expectations and adhering to the contract specifications at the contract price. And when contracts were terminated it was typically due to the contractor's inability to perform the work to the required outcomes due to having under-priced the contract or having not understood the specific requirements of the health organisation.

When choosing between outsourcing and internal staffing, differences in reasoning were evident between the rural and city health organisation with regard to the importance placed on relationships between the hospital and its staff, a factor not highlighted in the literature. The rural health organisation's management tended to talk about the operating staff in terms of their loyalty, as well as the reciprocal loyalty of the hospital to the staff. This reflected the prominence of the rural hospital in its community, the lack of employment opportunities for employees, and the public perception of the hospital's role as an employer and provider of services to the community. However, the lack of skills in the local labour market, alongside the distance from Melbourne, caused problems in staffing both clinical and non-clinical positions where expertise was required.

It was also evident that outsourcing occurred more often in non-clinical services than clinical services. The proficiency required by health organisations in operating their clinical services such as pathology and radiology was apparent, and even though tenderers were believed to be able to introduce economies of scale, cost savings could not be demonstrated. Due to the clinical services' core nature and the link to patient care, outsourcing was not proceeded with at the city network. The outsourcing of non-clinical services, such as engineering and maintenance services, was thought to be less risky to patient care. In addition, the white-collar areas such as medical and nursing services were exempt from the whole process, thus displaying their core nature and their ability to exert influence and power over bureaucrats and decision-makers.

Consistent with what might be expected in terms of the model, the reasons for outsourcing varied both within and between health organisations, illustrating the autonomy of individual boards of management and managers. There was a general view that, in adhering to government ideology, costs could be reduced, through changing management practices, introducing more flexible work practices, and downsizing.

However, specific decisions about which services were to be outsourced were made on other bases, which included the characteristics of the labour market, including employee skill levels and the nature of industrial relations, the perception of what was core in relation to patient care, the level of internal management skills, the ability of internal teams to implement change and the relationships between management and staff. Moreover, managers were of the opinion that, in some instances, due to minimal sunk capital costs, the outsourced service could be brought back in-house if the contract was unsuccessful, if circumstances changed or once objectives, such as downsizing or increases in expertise, were obtained.

Decision-makers often ignored factors highlighted in the theoretical economic literature (Williamson, 1986) as optimising the decision between outsourcing and internal production. These included frequency of exchange, length of relationships between organisation, contractor and staff, and information availability. Whereas other economic factors such as asset specificity, outcome measurability, technology, hierarchical costs, labour market characteristics and goal conflict, and political factors, such as the relative power of management over labour were more likely to be perceived as important in the decision. Furthermore, consistent with the model, the negative effects of outsourcing related to factors not perceived at the time of the decision, which were the length of relationships between the parties and information availability. The former was important in relation to trust and loyalty and the latter raised problems with adherence to contract specifications, quality and ability to monitor outcomes.

Outsourcing has been performed for various reasons, but rarely do decision makers consider the full range of factors that may potentially affect the optimal nature of the decision, or the organisational characteristics of their workplaces. The research has shown the importance of power, as illustrated in the use of outsourcing to improve department management and their associated resistance to change, and the importance of trust and loyalty between management and internal staff in retaining services in-house.

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