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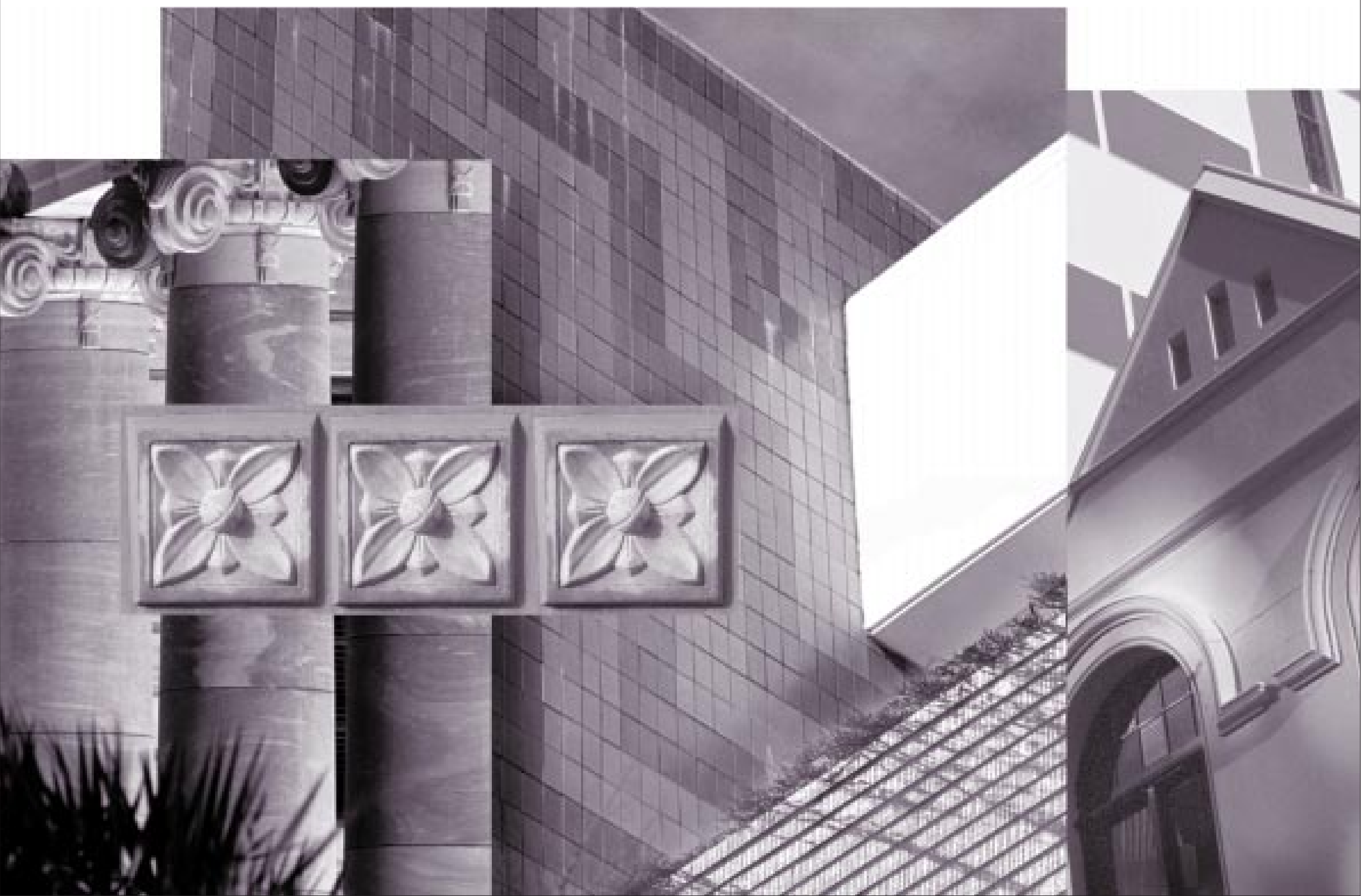
Shared Service Centres



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Shared Services Centres

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Summary

Chief executives in the Public Service departments have three options available to them for providing administrative services for their departments - in-house provision; contracting out (outsourcing); and shared service centres within or between departments. Currently most departments use a combination of in-house provision and outsourcing. The use of shared service centres is an option that is currently used infrequently by the New Zealand Public Service. This paper explores the potential use and applicability of the use of shared service centres in the Public Service.

Contents

Introduction

Chief executives in the Public Service departments have three options available to them for providing administrative services for their departments:

- in-house provision;
- contracting out (outsourcing); and
- shared service centres within or between departments.

Currently most departments use a combination of in-house provision and outsourcing. The use of shared service centres is an option that is currently used infrequently by the New Zealand Public Service.[1] This paper explores the potential use and applicability of the use of shared service centres in the Public Service.

With regard to the use of shared service centres, the government has two options:

- maintaining the status quo whereby decisions are made by chief executives; or
- actively encouraging the use of shared services.

Encouraging the use of shared service centres would represent a deviation from the current public management framework. It is therefore necessary to explore the benefits and potential pitfalls of the use of shared services, in the context of this option being pursued. This paper captures the results of an initial literature review and of preliminary discussions relating to the emergent development of the use of shared service centres.

Definitions

‘Shared services’ means either:

- the consolidation of the ‘back-office’ (administrative) functions used by several business units of a firm into a single internal service entity; or
- the collaboration by separate firms to establish a single entity from which they purchase these functions.

The functions that could be performed by a 'shared service centre' or a 'centre of excellence' include finance, payroll and human resources (HR), legal, information systems and information technology (IT), purchasing, communications and public relations.

[1] Informal discussions with selected departments suggest that many have considered the option of shared services in the past and decided against it.

Two types of shared services providers are distinguished in the literature:

- *Shared service centres* – Undertake generic, high-volume, repetitive activities – generally relying on established databases and decision rules. Economies of scale can come from peak-flow management, specialised equipment, and concentration at a single site. Quality can be improved through faster processing times and longer opening hours.

- *Centres of excellence* – Concentrate specialists with skills and knowledge that are required only occasionally or on a project basis within a single unit. Economies of scale are achieved through reduced replication, and the quality of services is improved through access to a large pool of talent and knowledge.

The use of shared service centres in this paper encompasses both types of providers. The following table summarises the types of functions that are potentially suitable for shared service centres and centres of excellence

	Human Resources	**Accounting**	**Information Systems**	**Other**
Shared Service Centres	Payroll Records Management Leave Processing Training	Monthly Accounts Time-Cost Systems Accounts Payable Invoicing	Help Desks Records Management Library Services Media Training	Customer Call Centres Security Facilities Management
Centres of Excellence	Development Plans Restructuring Job Sizing Recruitment Performance Appraisal EEO / Diversity	Tax Audit Systems Design Finance	Systems Design Software Development Archiving	Legal Communications and PR Research Protocol Health and Safety

Examples of the Use of Shared Services

There are several examples of the use of shared service centres have been used in the Public Service. It should be noted that these represent a very small part of administrative services that are required by departments.

Inland Revenue Department

The best example of the use of shared services within a department is the Inland Revenue Department’s regional centres for processing tax returns.

Provision of Finance Services by the SSC

The SSC has provided a full accounting service for the Serious Fraud Office (SFO) since it was created in 1991. At this time, Ministers agreed that the SSC would do this work because of the small size of the SFO. The SSC also provides accountancy services for the Ministry of Cultural Affairs, also because of their size. Both the SFO and the Ministry of Cultural Affairs have indicated their satisfaction with the services they receive from the SSC and that they would be reluctant to lose the service.

Ministries of Youth Affairs and Women's Affairs

Several years ago the Ministries of Youth Affairs and Women’s Affairs were asked to investigate the sharing of administrative functions. This investigation was done, but all that eventually occurred was co-location into the same building and the sharing of a boardroom. Ideas about sharing other services were abandoned following a cost/benefit assessment by a chartered accountancy firm. The difficulties that were identified included incompatibility of information and IT systems which would have been very costly to integrate.

The Benefits and Pitfalls of Shared Services

International literature[2] on shared services indicates that there are many benefits but also some potential pitfalls associated with their use.

Potential benefits include:

- reduction in the cost of providing administrative services;
- improved performance, particularly through ‘centres of excellence’; and
- a better focus on core business.

Potential disadvantages include:

- high implementation and transition costs;
- reduced control of administrative services for participating departments;
- departments may need to compromise on specialised needs; and
- support services may be less accessible to or appropriate for departmental staff (e.g. HR).

It is worth noting that the benefits and pitfalls of shared services centres tend to be compared with in-house provision, with limited attention given to a comparison with outsourcing. The following discussion examines in further detail the benefits and pitfalls outlined above.

[2] See **References** (p.14).

Benefits

Cost Savings

Those who promote shared services assert that cost savings of between 25 and 50 percent can be achieved.[3] This is primarily because the replication of functions is avoided and resources are used more efficiently. However, others suggest that the actual average savings tend to be around 9 percent.[4]

The literature reviewed in developing this paper does not detail the methodologies used to estimate the likely cost savings. As such, it is difficult to assert how robust these estimates are. In particular, it is not clear whether transition costs have been included, or whether the organisations had exhausted all means of making in-house provision as efficient as possible. Furthermore, there is no discussion of the costs of sharing services compared to outsourcing.

Performance

It is argued that shared service centres allow organisations to become better at their 'core business' through being able to specialise. Also, the shared service unit itself can become a ‘centre of excellence’ through focusing on its specific role and so become more effective. Expertise can be pooled and benchmarking can be implemented.

The concentration of specialist staff in ‘centres of excellence’ can allow greater specialisation by staff, improve learning and training, create career paths, improve retention, and encourage innovation. The greater mass of staff and other resources allows the service centre to cope better with fluctuations in demand from individual clients. Furthermore, there is a lower risk that turnover of staff will affect the quality of the service provided to a participating client.

Potential Pitfalls

Costs

Departments may incur high transition costs when moving to a shared service centre, especially if they have incompatible IT systems (this applies to most administrative functions, such as HR and finance, as well as information systems). The move to a shared service centre may require that existing IT systems be scrapped and new systems installed. Moreover, there may be redundancy costs associated with setting up the centre (if all administrative staff from participating departments were to transfer, there would be limited scope for savings). If shared service centres were to be implemented in the Public Service, some of these costs may require further capital to be injected into some departments.

If a shared service centre were to fail, it could be difficult and expensive to decentralise the services back to the departments.

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3 A specialist in shared service centres, Akris.com, states that “savings of 25 to 40 percent [are] already demonstrated” whilst PricewaterhouseCoopers (USA) state that cost savings are “typically 30-50%”.

4 “Has Outsourcing Gone Too Far”, *Business Week*, 1 April 1996.

Reduced Performance

Departments that participate in a shared service centre may have to compromise on specialised needs, e.g. specialist legal services required by legislation unique to their operations.

Control

Shared service centres imply a loss of autonomy for departments (i.e. they may have less flexibility than they would with in-house staff). To balance this loss of autonomy, there is a danger that departments will develop 'shadow staffing' to meet managers' demands for immediate responses to their requirements.

Some departments have considered establishing shared service centres, but have generally decided against it. One argument they cite against the use of shared service centres is that it would be difficult to define the accountabilities of each participating department. They have also identified contracting difficulties in determining how the shared service centres would prioritise in times of heavy demand (e.g. all departments must produce their parliamentary reports at the same time).

Within the Public Service, departments are not able to set up a separate company to act as a shared service centre between departments. Consequently it is likely that a shared service centre would be based in one of the participating departments, raising concerns among the others about their access to services.

Policy Options

Two options are available with regard to shared service centres:

- Option 1: Maintaining the status quo – let the managers manage; or
- Option 2: Actively encourage shared service centres.

Option 1: Maintaining the Status Quo

A decision to maintain the status quo would be based on the assumption that chief executives currently seek to minimise administrative costs within their departments. The fact that many departments already outsource administrative functions, to achieve cost savings, appears to lend some legitimacy to this assumption.

This approach was recently endorsed by Cabinet in its decision on the Decision-Making Process on the Location of Government Agencies. Cabinet agreed that the 'tests' chief executives and their management teams apply in making decisions balance possible cost-savings in locating Government agencies with the potential risks.

Therefore, encouraging the use of shared service centres would represent a deviation from the current public management framework.

Option 2: Actively Encouraging Shared Service Centres

Before actively encouraging the use of shared service centres the following three types of question need to be satisfactorily addressed:

- *Empirical* – Does the practical experience of shared services in other jurisdictions (e.g. Ontario, Canada; Victoria, Australia) suggest there are significant net benefits to be realised which are unique to the shared services approach?

- *Conceptual* – Would agencies adopt shared services if this was a more effective and efficient means of supplying services? and

- *Systems* – What are the possible systematic indirect effects of the centre actively encouraging shared service centres?

If the decision-making processes of departments had not adequately assessed the benefits and pitfalls of shared service centres, then further research could be undertaken to determine:

- the size of the problem;

- the potential savings; and

- how to manage the risks from moving to a shared services centre approach.

An investigation of the cost savings to be gained from sharing services would need to begin by collecting data on the size of the 'back-office' areas within departments. Determining the sizes would not be easy because of differences in the way administrative functions are treated within different departments. Some larger departments with several business units have centralised support functions (akin to shared services), whilst others have decentralised support functions (presumably deciding against shared services type arrangements).

There is no agreement in the international literature about the levels and types of savings offered by shared service centres. Because any centrally imposed move from the status quo would require the co-operation of chief executives, would suggest that work specific to the New Zealand Public Service would need to be done to investigate this. This may involve benchmarking the size and cost of administrative functions in both public and private sector organisations.

Systemic Effects

There are many costs and risks involved in moving to a shared services centre approach. If New Zealand were to undertake this approach, it would have to identify strategies for managing the costs and risks involved. The key risk identified to date is blurring the accountability of chief executives for the performance of their agencies by attenuating their decision rights.

Conceptual Problems

Three potential problems need to be addressed in making any decision about the adoption of shared services:

- information gaps about the efficiency of shared services;
- incentive alignment problems that can lead agencies to choose inefficient arrangements; and
- constraints that preclude departments from adopting more efficient arrangements.

These problems/issues are discussed in detail in Appendix 1.

It is concluded in this appendix that information gaps are best addressed by the provision of information to the key players. The issue of incentive alignment is more complex, with a number of potentially significant agency costs:

- lack of appropriability of benefits, corporate services manager remuneration tied to job size;
- difficulties of capturing spillovers; and
- the inflexibility of the budget process.

However, command and control approaches such as mandating shared service centres are a poor solution to incentive alignment problems.

Empirical Evidence

The available empirical evidence is patchy and mixed. The authors are not aware of a good empirical evaluation of shared service centres in a central government context or of good empirical evidence on where shared service centres are inefficient.

Conclusion

There are a range of support functions currently undertaken "in-house" by Public Service departments for which a shared services approach may be more efficient.

Both shared services centres for high-volume, generic activities and centres of excellence for highly specialised project-based activities may offer economies of scale and improved quality over time. Major areas of potential include:

- human resources;
- accounting;
- customer call centres; and
- facilities management.

However, the basic assumption should remain that individual departments have adequate incentives and sufficient freedom to determine the most efficient arrangements for support functions. Departments are likely to have better information about the relative costs of alternative arrangements, especially about transaction costs and the costs of changing existing arrangements.

If it is clear that departments do not face strong enough incentives to cut costs, or if the benefits to government as a whole from coordination are not being adequately considered, the "first best" solution is to realign departmental incentives while leaving them free to choose how to arrange their support services. Direct intervention specifying when and how departments engage in shared services is a "second-best" solution that is unlikely to be based on full information about true costs and available alternatives.

Appendix 1: Why Aren't Departments Adopting Shared Services?[5]

There are several possible explanations why departments do not adopt a shared services approach when this appears to be more efficient than their current arrangements:

- departments have better information about the efficiency of shared services relative to current arrangements;
- there are incentive alignment problems that lead departments to choose inefficient arrangements; or
- departments face constraints that prevent them from adopting more efficient arrangements.

Departments Have Better Information

To the extent that we have faith in the public service management model, we should assume that when departments choose not to adopt a shared services approach, they have good reasons for doing so. Chief Executives should therefore be left to make their own decisions. The reason for devolving control over inputs was that departmental managers are expected to have better information about the true costs and benefits of alternative arrangements, and to face appropriate incentives to make efficient choices.

If we see departments failing to adopt a shared services approach when we expect it to be more efficient than current arrangements, we should first question the basis for our expectations. There may be many hidden costs of adopting a shared services approach, and many hidden benefits of the current arrangements. Because the government is generally more risk averse than a private sector shareholder, departments may keep in-house services to ensure greater control where a private firm would choose to cut costs through shared services or contracting out.

For example, observers may under-estimate the costs and risks of transition to a shared services arrangement, and the transactions costs involved in managing a shared services relationship. They may fail to consider aspects of quality and responsiveness in support functions that are easier to specify and monitor in-house than if purchased from a shared services centre or an external contractor.

However, if there are clear reasons to doubt that departments have made efficient choices about the way they obtain support functions, there may be scope to improve efficiency through the intervention of Cabinet and/or central agencies. Providing more information to departments about shared services technology and opportunities for training in its use may be an important step to encourage departments to adopt this approach.

[5] Extracted from a draft discussion paper produced by John MacCormick for the State Services Commission entitled *Shared Services*, August 1999.

Incentive Alignment

Departments may not adopt the most cost-effective arrangements for obtaining support functions if the incentives for managers to do so are weak. This may be due to several factors:

- Managers in government departments (and in most firms) are not 100% shareholders, and so do not have "residual claims" to 100% of any increased surpluses they achieve by cost cutting. Other incentives such as performance bonuses, reporting requirements, reputation effects and accountability systems are imperfect substitutes. Managers may gain personal benefits from maintaining functions in-house when shared services or contracting out to external suppliers would be more efficient. Internal functions may make managers jobs easier, offer greater prestige and increase personal power.

- Shared services may generate "externalities" - benefits that accrue to the public sector as a whole that are not taken into account when departmental managers make decisions about arrangements for support functions. For example, in the IT area, a co-ordinated approach between departments will reduce the cost of exchanging information and designing new systems. Individual departments making separate IT investment decisions may select the cheapest option that meets their needs, without considering the implications for other agencies.

- The economic incentives that make cartels unstable may also apply to some extent to shared services - where departments join forces to increase their purchasing power and lower costs. One department may be able to benefit from the efforts of others to co-ordinate, but choose to "defect" from the cartel itself.

- The budget process itself may undermine incentives to develop shared services. The budget process emphasises the "operational silos" approach to organisational structure. If managers perceive a risk that engaging in shared services will reduce their control over departmental budgets or functions, or lead to a reduction in baselines, they are likely to maintain a separation between their support functions and those of other departments. If long-term funding is uncertain, departments may choose not to adopt shared services arrangements that require long-term commitments. Tight cost control may constrain departments from investing in the set-up costs of shared services.

If these types of incentive alignment problems are the cause of departments' failure to adopt shared services, the best solutions will be to improve managers' incentives. Options include:

- greater rewards for desired behaviour - recognition of innovators, financial incentives;

- stronger sanctions for undesired behaviour - inclusion of this in Departmental Performance Assessments (DPAs) etc;

- better information on the collective interest benefits of co-operation; and

- developing a stronger culture of collective interest amongst departments.

"Command and control" solutions such as directing departments to establish shared services centres are "second best" solutions. By dictating the manner in which departments will arrange to obtain their support functions, the government must act on poorer information than is held by individual departments, and will preclude potential alternatives such as contracting out. Departments may be able to find more suitable alliances with other departments or Crown entities if left to do this themselves, rather than having the nature of these alliances dictated by the Government or by central agencies.

Removing Constraints

Even with appropriate incentives, departments may fail to adopt the most efficient support function arrangements if external constraints preclude more efficient options.

Ministerial requirements	Local requirements
If the Government or individual Ministers are highly risk-averse, or re-specify the nature of outputs unpredictably, departments are likely to be constrained from adopting alternative arrangements which offer less control than in-house provision of support functions.	There may be legal constraints that prevent departments from sharing services: • privacy issues may prevent departments sharing services if this would allow service centre personnel access to multiple sources of information about members of the public; and • different departments may be subject to different legal rules about process that prevent them from sharing a single system (debt collection, official information).

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