Managing Strategic Outsourcing in the Healthcare Industry

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EXECUTIVE SUMMARY
Hospitals and healthcare systems are facing increased financial difficulties because of the Balanced Budget Act of 1997 and managed care. As a result, healthcare executives face the challenge of reducing costs while maintaining quality patient care. One of the strategic tools healthcare executives use to meet this challenge is outsourcing.

Even though outsourcing has many benefits, outsourcing will fail if not managed successfully. Senior executives must choose outsourcing managers who have the necessary leadership capabilities. Managing outsourcing requires an understanding of outsourcing strategy, the benefits and risks of outsourcing, the evaluation process, and the methods to managing strategically. With appropriate management, strategic outsourcing should provide healthcare executives with a viable strategy for controlling costs and maintaining quality patient care.

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Healthcare executives face the immediate challenge of reducing costs while maintaining quality patient care in an environment of continuous change and turbulence. Recently, outsourcing has become one of the strategic tools some healthcare executives use to control costs without affecting patient care. Outsourcing is transferring services or operating functions that are traditionally performed internally to a third-party service provider and controlling the sourcing through contract and partnership management. It is an internal strategy organizations use to focus on their core or distinctive competencies and to create a network of outside experts for critical support skills (Allen 2000; Stacey 1998).

Often, because of rapid growth, new leadership, or increased competition, organizations turn to outsourcing during times of turbulent change. As a result, the most common complaints about outsourcing are poor performance and lack of coordination between organizations, with a number of organizations having to restructure, terminate, or renegotiate an outsourcing contract within the last two years (Scheier 1997). Despite these problems, when compared with other industries, the healthcare industry is currently outsourcing at a higher rate, as hospitals and health systems cope with reimbursement reductions from the 1997 Balanced Budget Act and managed care.

In the next two years, healthcare executives are expected to shift 5.5 percent of their budgets from internal to external sourcing, compared to 3.6 percent in general industry.

Full outsourcing will increase by 30 percent in healthcare, compared to 11 percent in general industry. The most outsourced functions in healthcare are information technology (29 percent), finance (20 percent), and support services (19 percent) (Shinkman 2000). Given the continued growth expected in healthcare outsourcing, healthcare executives need to avoid the failures and problems experienced in other industries by strategically managing outsourcing.

The literature suggests that while outsourcing may seem to be a viable strategy for controlling costs and achieving a competitive advantage for general industry, it may not be a viable strategy for service industries (Jennings 1997). Therefore, healthcare executives need to carefully examine whether outsourcing is a viable strategy for their organizations. Healthcare executives should answer three key questions to determine this viability. The answers to these three questions will provide a framework for managing strategic outsourcing:

1. What is outsourcing, and how does it help the organization achieve its strategic goals?
2. What are the benefits and risks?
3. What must managers do to ensure success?

**Strategic Outsourcing**

Outsourcing is a concept that has evolved from a manufacturing perspective to a strategic perspective, which views the concept as a way for organizations to focus and be more competitive. Managers view their organizational
operations as a value chain designed to provide value to customers. The organization determines what service in the value chain should be eliminated, outsourced, or joint ventured so that the organization can become the best in the industry. The activities that remain in the organization are the core competencies—activities that are critical to the delivery of services to customers. These core activities become the focus of strategic attention, and they are not considered for outsourcing (Quinn 2000; Jennings 1997). From a strategic perspective, outsourcing is the primary way that an organization can focus on its core or distinctive competencies. According to Quinn (2000), "the strategic management of outsourcing is conceivably the most effective management tool for the 21st century."

The basic premise of outsourcing is that a specialist organization can perform a particular service more efficiently than can internal operations because a specialist organization has an inherent advantage in producing and delivering a service. Superior technology, management skills, or economies of scale may contribute to this perception. The type of sourcing relationship depends on whether a long-term or short-term need exists. To save funds used for benefits for regular employees, temporary workers are hired. In this case, the organization (outsourcer) provides all necessary resources except the workers, who are provided by the vendor.

For long-term need, the vendor has full responsibility for delivering the service; the outsourcer provides only a liaison. In some cases, the vendor and the outsourcer provide multiple components of the service. For example, if engineering services are outsourced, the outsourcer may provide the building, equipment, and supplies; the vendor, on the other hand, supplies the workers, management, and technology. Mixed outsourcing and contracting are more challenging because of the integration of personnel. In addition, the level of complexity increases with the monitoring and controlling of individual resources (Allen 2000; Jennings 1996).

The business and healthcare literature discusses outsourcing as if reducing or controlling costs and enhancing efficiency always drive it, but this is only one of several reasons for outsourcing. Other reasons for outsourcing include putting the organization in a position to adapt quickly to a rapidly changing environment without committing internal resources and reconfiguring entire processes to generate value across the organization (Quinn 2000; Useem 2000; Allen 2000). Healthcare organizations outsource for some of the same reasons as firms in general industry: (1) to conserve organizational resources for use where they are most effective and (2) to reduce resources where they are least effective. Accordingly, they get the expertise from vendors who are most efficient in those areas where the organization is not as efficient. The rapid growth in expenditures on external relationships indicates an increased awareness by healthcare executives of the value of external sourcing. However, in a service industry such as healthcare,
outourcing may undermine the core competencies for its future capability and future development. Outsourcing offers both great benefits and great risks.

**BENEFITS**
The benefit of all outsourcing relationships is that outsourcing allows an organization to concentrate on its core business and its customers. Partnering with leaders in non-core functions also helps organizations achieve greater efficiencies. Moreover, outsourcing can substantially lower costs and risks, while greatly expanding organizational flexibility, innovative capabilities, and opportunities for creating value-added stakeholder returns.

Healthcare executives increasingly understand that outsourcing for short-term cost reduction does not yield nearly as much as outsourcing for long-term benefits such as greater knowledge and access to innovative ideas, increased quality, and creative solutions. As a result, organizations can expand their own knowledge and physical investment capabilities by using the facilities and program funds of the vendor. The organization also benefits from access to the latest technology without the substantial, often prohibitive, investment otherwise required (Quinn 1999).

For example, Tenet Healthcare Corporation outsourced 96 of its 113 regional hospitals food service programs to Sodexho Marriott Services and Morrisons Management Specialists. Previously, two-thirds of Tenet’s hospitals managed their own food service, while Marriott and Morrisons managed the other one-third of Tenet hospitals’ food services. According to Tenet’s chief operating officer, the five-year contract is designed to take advantage of the vendors’ expertise and economies of scale (King 2000).

Moreover, consolidating food service operations is an ideal way to enhance services to patients and guests while cutting costs significantly. The contract represents several months’ analysis, where benefits, quality improvement, and efficiency for various nonclinical support services were examined. The analysis indicated that there were benefits for some hospitals. In other hospitals where there were no benefits, food service programs remain internally operated. Tenet expects the vendors to provide unique food service programs for caregivers and excellent programs and services for patients (King 2000).

External vendors can also add enormous value by providing integrated services for clients. Activities that can be profitably integrated are typically smaller units that seriously lack the depth of knowledge, highly qualified specialists, or information systems that the best external sources have. One of the most effective ways to achieve desired effectiveness is to outsource the entire activity to a vendor that has the specialists but can flexibly adapt outcomes to meet internal needs. If managed properly, integrated outsourcing can decrease costs and lower risks (Quinn 1999). The benefits of outsourcing are clear: increased productivity, quality, and profitability. However, it is important that healthcare
executives also recognize the potential risks associated with outsourcing.

**Risks**
The greatest perceived risk by healthcare executives is loss of control and flexibility. Organizations are afraid of losing some control over the delivery of outsourced services and finding themselves overly dependent on the vendor or liable for the vendor’s actions. Outsourcing sensitive information, particularly confidential information, has inherent liability if information security is breached by the vendor.

Other important risks include the contractor not performing as expected; compliance violations; loss of internal technical skills and expertise, such as in information technology and human resources, that could benefit the organization in the long term; and loss of positive reputation. The organization’s reputation may be harmed because outsourcing is viewed by a significant number of Americans as the exploitation of low-cost workers. Negative publicity regarding this issue can be very damaging to the organization’s reputation. Another risk is exposing the organization to compliance violations.

When organizations decide to outsource their billing and reimbursement claims, particularly for Medicaid and Medicare, they need to consider their exposure to compliance violations. Because organizations cannot control the compliance processes of the vendor, they must assess each prospective outsource partner to determine its history of compliance violation and to identify specific measures that it has in place to ensure compliance (Gustafson 2000).

Vendor nonperformance because of underfunded technology or understaffing affects service levels and pricing complexities as well as causes technological inadequacies and administration chaos. Vendor management can become a full-time endeavor in these cases. In some cases, vendor underfunding occurs because of low-cost contract bids. Lower bids may not mean additional savings for the outsourcer because sometimes the apparent cost of delivering a service may not represent actual costs (Williamson 1981). For example, savings from low-cost wages may not compensate for the costs incurred from turnover and quality problems that come from an inexperienced, poorly trained, and unstable workforce (Mobley 2000; Allen 2000).

Finally, unless a thorough evaluation of the outsourcing strategy takes place prior to outsourcing, the organization risks outsourcing capabilities that are critical to the success of the organization, even though those capabilities are not an actual source of competitive advantage. These capabilities include primary and support activities used to counteract environmental threats or to complete necessary ongoing organizational tasks. An organization’s potential to continuously evaluate its strategies, learn, and create new capabilities and core competencies may be harmed by outsourcing much of the expertise that gives the organization its value (Mullin 1996; Quinn 1999). Fortunately, by evaluating activities thoroughly before the contract
is signed, many of these risks can be minimized.

OUTSOURCING ASSESSMENT AND EVALUATION
As healthcare executives consider outsourcing as a strategic tool to achieve greater performance for their organizations, the primary challenge is how to get the best alignment between the strategic goals of the organization and the vendor relationship. To achieve its strategic goals, healthcare organizations need to assess and evaluate the outsourcing process to determine whether outsourcing is a viable strategy. Organizations also need to determine whether achieving the same performance gains would be possible if inefficient functions could be transformed into efficient service providers. In the short term, outsourcing may seem more cost effective, but in the long term, given fixed costs and the break-even point, outsourcing may not be more cost effective. To achieve its strategic goals, organizations must thoroughly evaluate their outsourcing strategy. The evaluation is a six-step generic process, which can be applied to any organization (see Table 1 for a summary of these steps):

1. The objectives of the outsourcing strategy must be clearly stated. Determine what the organization expects to achieve from outsourced services and how the achievement of those expectations will be measured. The strategy should define the relationship: explain what the company is seeking in the relationship, the process to be followed in that relationship, and the personnel that will be involved in formalizing the relationship. Will it be an arms-length relationship where the outsourcer uses a vendor as its primary supplier of services and the vendor is not involved in the outsourcer's strategic plan, or will it be a strategic relationship where the outsourcer has a more formalized long-term relationship with a carefully chosen vendor(s)?

In a long-term relationship, the contractor assumes the role of strategic partner and is allowed a better understanding of the outsourcer's strategies. It should be made clear to the vendor that (1) the strategic relationship has been formed because of the contractor's history of excellent performance and (2) the continuation of the relationship will depend on maintaining that level of performance. The outsourcer must be clear about how confidentiality will be maintained and then monitor the vendor to ensure compliance. Successful outsourcing begins with clearly defined and articulated expectations that fit the outsourcer's mission and strategic goals.

2. Detailed service deliverables information must be obtained. Functions or services to be outsourced and the expected levels of improvement in quality, efficiency, and effective performance must be assessed. The vendor's performance should be measured by timeliness, adherence to budget, and success at meeting the project's agreed-
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<th>Steps</th>
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<td>1. Evaluate whether outsourcing is a viable strategy for the organization given its current strategic goals and objectives.</td>
<td>1. Develop a clear understanding of the strategy for the function being outsourced. Consider the impact on achievement of organizational mission and strategy, including cost, quality, flexibility, and timeliness. Consider changes in the environment that require a change in strategy.</td>
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<td>2. Analyze and assess information on services outsourced and service deliverables.</td>
<td>2. Identify services to be outsourced and the expected level of performance. Ensure a clear definition of services to be outsourced and their value. Protect and retain core services and capabilities. Be clear about the scale of costs and potential savings by including all costs.</td>
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<td>3. Select the appropriate vendor.</td>
<td>3. Identify the number of viable vendors, and document vendor’s technical and managerial capabilities, culture, and fit. Explicitly state and agree on expected service levels.</td>
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<td>4. Secure a contract that protects the organization yet flexible enough to accommodate unplanned events.</td>
<td>4. Negotiate an agreement that is fair and equitable. Specify expected performance from each partner and how it will be measured and compensated and how disputes will be settled. Specify contingency clause and how subcontractors will be managed.</td>
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<td>5. Develop a transition plan for transferring outsourced activities to vendor.</td>
<td>5. Establish a temporary transition team to organize and supervise the transition. Involve employees that may be affected, and make sure that key executives and managers from the outsourced function or department are involved.</td>
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on objectives. Performance ratings may contain quantitative and/or qualitative scales, with ratings ranging from poor to excellent. The results should be shared with the vendor, especially if a long-term relationship exists (Stacey 1998).

3. The appropriate vendor should be selected based on the potential vendor’s technical and managerial capabilities to provide the required level of service and the vendor’s understanding of and commitment to meeting stated performance expectations. The vendor’s prior experience and documented evidence of expertise from references can provide that information. Choosing the right vendor can mitigate the risks of outsourcing, including increased insurance and liability exposure (Woodard 2000).

4. The contract must be negotiated. Because predicting future events is impossible, the contract must be written so that it is specific enough to protect the organization yet flexible enough to accommodate unplanned events. In addition to outlining expectations, defining costs and deliverables, and explaining evaluation criteria, the contract should contain a contingency clause that allows either party to adjust for unexpected events. The contract terms should also bind subcontractors because some vendors will subcontract without the outsourcer being aware. Moreover, since the outsourcing contract is subject to disagreement at some point, some dispute-resolving method such as arbitration is needed. Key results from the analysis should be incorporated into a formal, detailed contractual service agreement with appropriate performance guarantees. A detailed contract should be the road map for the outsourcing relationship between the outsourcer and its vendor.

5. A transition plan to transfer the selected function or service to the chosen vendor should be established. This plan is designed so that the outsourcer can manage its side of the interface between the two organizations by retraining and managing its own employees. A temporary project team can organize and supervise the transition, but employees who may be affected by the decision should be included in the process to minimize resistance and maximize success. Once the function has been outsourced, the contract must be managed and the vendor’s performance monitored.

6. The vendor’s service provisions must be reviewed and actual outcomes must be measured against expected outcomes to decide whether the chosen vendor should continue at the end of the contract period. The contract has to detail the vendor’s performance. After this final step in the assessment and evaluation process is completed, the results should be given to all employees involved in the outsourcing process, so that they have a framework for understanding the
reasons for outsourcing (Woodard 2000; Allen 2000).

MANAGING STRATEGIC OUTSOURCING
Outsourcing is a top-management issue as well as a middle-management issue. As outsourcing moves from contracting cafeteria functions to higher strategic levels, the responsibility for the activity must be borne by higher-level managers as well. To achieve the kinds of benefits and successes expected, experts consistently state that an executive, at least one level higher than those affected, must become the champion. Ideally, a three-level contact system is necessary for information exchange and personal contacts among top managers who can ensure responsiveness by lower-level managers (Quinn 1999; Useem 2000; Allen 2000). Operating-level employees, in turn, can interact and build personal relationships to solve problems before they occur or solve them faster than ordinarily possible. This system creates champions on both sides of the relationship whose careers depend on the success of the relationship. With relationships at these three levels, the knowledge of how things are really done, advance warnings of problems, and rapid conflict resolutions are guaranteed. Without this system, people with occasional arms-length confrontations may dominate the relationship, causing costs and apparent difficulties to increase substantially (Useem 2000; Mullin 1996).

Feedback systems are needed to share knowledge in both directions of the relationship. One of the greatest values of outsourcing is the innovative ideas that come from the interactions at the customer-producer level. Creating and developing interactive capabilities at the vendor and partner levels can leverage an organization’s own knowledge resources. A prerequisite for feedback systems and the three-level contact system is organizational leadership by top management (Useem 2000; Quinn 2000).

For individual leaders to be effective, executive support and clear performance standards are essential. Without executive support, individual efforts can be hampered, and outsourcing will probably fail. Most important, healthcare executives must be clear about how results will be evaluated. To make accountability clear, detailed performance measures and a method for revising those measures over time are necessary. In addition, successful outsourcing requires four key management practices: (1) bridging the cultural differences between the outsourcer and vendor, (2) training organizational members responsible for the relationship, (3) intensive exchange of information and expertise between the organizations, and (4) performance-based pricing and incentives using objective criteria (Quinn 2000; Mullin 1996). If these management practices are to be realized, specific leadership capabilities are necessary.

Research by Useem (2000) indicates several leadership capabilities that are essential for successful outsourcing, as managers must lead by negotiating results and sending work out rather than pushing work down within the organization. The four necessary capa-
bilities are strategic thinking, partnership governing, negotiating contracts, and managing change. These four skills emerged as essential skills for those responsible for outsourcing decisions, contracting, and oversight. Strategic thinking occurs when managers decide which activities to maintain internally and which can be best achieved by others external to the organization. The ability to determine how the outsourcing will serve the organization's strategy and gain a competitive advantage is demonstrated using this strategic thinking skill. This skill is essential for top executives and managers responsible for deciding which activities to be contracted out.

Partnership governing involves fostering a relationship so that service quality is enhanced and both partners derive financial benefits. Discerning what to keep and what to outsource and then managing those outsourcing arrangements is a key component of the process. Making the transition from internal to external is a major part of partnership governing. If executed appropriately, governing should survive conflict and stress. It requires patience, a futuristic perspective, and exceptional relationship skills (Allen 2000; Useem 2000).

Negotiating contracts requires an ability to create common ground between prospective but wary partners. Managers must secure the right services from external providers and ensure their effective use by internal managers. This requires anticipating the future, protecting the organization, and overcoming problems as changes occur. Depending on the outsourcing, the negotiations can be as complex as a merger or acquisition. Therefore, a top executive should sponsor the negotiations. Key executives and managers—such as the department head of the function to be outsourced, the heads of the departments served by the function to be outsourced, and the director of human resources—should participate because employee issues are involved. Unless the outsourcing agreement involves some nonessential function such as operating the cafeteria, it cannot be delegated to middle management.

Managing change is minimizing resistance to change. Many department heads, and virtually all hourly employees vigorously oppose outsourcing because it involves potential job loss and job vulnerability. Leading change through outsourcing requires proactively identifying changes that are necessary regardless of the resistance expected. Reassuring employees affected by outsourcing that the change is not a reflection of their individual performance and changing their perceptions of outsourcing is essential (Allen 2000; Useem 2000).

While these keys to successful outsourcing may be readily apparent to some organizational leaders, it does not mean that all executives observe them. In many instances, outsourcing fails to realize its intended objectives because outsourcing is undermanaged and poorly monitored. Because the outsourcer is ultimately held accountable for results, management must strategically monitor all vendors. Monitoring vendors means ensuring goal value and value congruence. This
means that managers must ensure that the vendors, outsourcee’s incentive structures, and value systems are comparable. Written goal statements of the relationship, specific agreed-on outputs measurements, incentives to ensure that goals stay aligned, and ways to periodically review that alignment will fulfill this requirement.

CONCLUSION
Managing strategic outsourcing in the healthcare industry can be a successful and beneficial experience. However, healthcare executives must develop management controls and choose managers with the leadership capabilities necessary for successfully managing the outsourcing strategy. Managing outsourcing requires an understanding of outsourcing strategy, the benefits, and risks of outsourcing, an understanding of the assessment and evaluation process, and the factors that influence long-term success. Even though healthcare executives have yet to use strategic outsourcing extensively, industry surveys indicate that, the rate of healthcare outsourcing will continue to increase in the future. Strategic outsourcing, with appropriate management, should provide healthcare executives with a viable strategy for controlling costs and maintaining quality patient care.

References