

Theory to Practice

Commentator

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Article

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Public Administration Review

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Brown, Potoski, and Van Slyke

Managing Public Service Contracts: Aligning Values, Institutions, and Markets

In this article, Brown, Potoski, and Van Slyke offer a concise analysis of the developing literature on contracting public services, and go on to offer managers a framework for navigating key decision points in contract management. The purpose of this commentary is to discuss a few key implications of this literature for contract management, and to consider where important disjunctures exist in the public management of the "make-or-buy" problem. My analysis is meant to describe why it is so hard to offer a small set of prescriptions for managers, and why managers will continue to find contract management difficult in the public sector.

Institutions: Efficiency or Distribution?

Brown, Potoski, and Van Slyke

May | June 2006
Volume 66 | Number 3

offer three foundations for government contracting: public values, institutions, and service markets. I agree that public managers make decisions about contracting while trying to navigate and reconcile political values that are not always in accord with one another. As the authors indicate, these values make their way into the rules and regulations—the institutions—that define the public manager's environment. These institutions tell managers how and when to construct governmental markets for service provision—markets that depend on the services themselves and the external markets that exist for their provision.

It is institutions that provide important linking functions. Institutions link the public values that democratic systems are supposed to aggregate, assem-

ble, and express and the contracting decisions managers face on a daily basis. Institutions—formal or informal—act as the "rules of the game" (North 1990) for managers making important decisions with significant long-term public consequences.¹ Of course, Douglas North's work on institutions helps one better understand exactly how the rules of the game provide a long-term basis for the growth and survival of economies.

Likewise, the lessons of New Institutional Economics are not limited to the social consequences of rules, but also extend to the short- and long-term survival of organizations—something more like what managers may worry about when making public decisions about contracting. North's position has always been that over the long term, the rules of the game help economies become efficient, or the rules will not survive. In practical terms, institutions (in North's view) make society more efficient; if they do not, the rules are replaced, or society does not survive.

But rules are not always efficient in the short run. In fact, I suspect that most public managers can think of many situations where the rules sent down to them for guiding their decisions do everything *but* help them make contracting efficient. Arguing against North, Knight (1992) made this point more generally, claiming that the rules of the game often are meant to reward one at the expense of another, or to distribute the benefits of public power disproportionately. Again, in practical terms, institutions take from one person and give to another, without regard to the efficiency consequences for society.

How one views rules, as a means for efficiency or distribution, helps us better understand the environment within which public managers make contracting decisions. Strategically, one makes different decisions

based on a guess as to whether the rules of the game are meant to make government and society more efficient, or to move resources out of the public sector and to nonprofits and for-profit firms.

I want to be clear about how we make these assumptions and how these assumptions guide our decisions. For example, Brown, Potoski, and Van Slyke argue that, "If the goals are innovation and efficiency in service provision, then contracting with a private vendor may be more desirable because private employees typically operate with *higher-powered, compensation-based, profit-oriented incentives*" (emphasis added). Yet the best evidence from the private sector is that this is really an assumption.

In fact, private employees are less affected by high-powered incentives than one might suspect (e.g., Tosi et al. 2000), and the incentives in place (e.g., promotion tournaments) often are no different from those in place in many public settings. Moreover, experimental evidence is quite clear that high-powered incentives are neither necessary nor sufficient in many work settings to induce innovation and efficiency (e.g., Bottom et al. 2006; Fehr et al. 1997).

What these arguments really tell us is that whether you need contracting out or other devices to gain efficiency in government depends on the institutions in place. In some settings, good rules mean governments are probably just as efficient as markets. These arguments also tell us that political rules meant to cause governments to become more efficient will not always achieve this goal—that public managers may have very little latitude to achieve efficiency when the rules of the game are not meant to do so. Casual observers need only look to government contracts in the reconstruction of Iraq,

or to the expanded use of preferred provider organizations in Medicare, for evidence of the latter.

Service Markets: When Contracting Does Not Work

A second reason why so few clear prescriptions can be offered for managers, and why they will continue to find contract management difficult in the public sector, is that they often are asked to write contracts and job out services that should be "made, not bought." To be very clear, Brown, Potoski, and Van Slyke emphasize important dimensions of choice for managers. Managers can try to specify the contract or better manage service delivery under contract. But transaction cost economics (TCE) is fairly clear that there are many situations where contracts are inherently difficult to write.

The authors emphasize two dimensions of contract writing: asset specificity and ease of measurement. They also discuss whether competition in markets will reduce "principal-agent problems." But TCE also shows that contracting ease expands or contracts based on other dimensions, like inherent uncertainty or complexity in the contracting environment or the frequency of interaction between contractors and those they serve.

Economists think about contracting in terms of the "necessity of vertical integration" in the firm. They also think of the relationship between a vendor and a contracting government less in principal-agent terms and more in terms of bilateral monopoly (which is more of a bargaining/negotiation problem). The question is whether a government should use a contractor given a combination of asset specificity and uncertainty/complexity.

What matters are how the vendor and the contracting government experience asset

specificity (together, alone, or not at all) and whether the contracting environment is marked by uncertainty/complexity (low or high). In three out of six situations, vertical integration (no contracting out) is the best governance structure. In one situation, spot contracts are desirable; in another, long-term contracts are preferred. In the last, whether contracts are desired depends on the frequency of the interaction (e.g., Douma and Schreuder 2002; Williamson 1975).

How often can most public managers say that political directives to contract out actually considered these dimensions? Moreover, what is the incidence of those choices with these combinations of the environmental factors of asset specificity, uncertainty/complexity, and frequency? If the incidence is roughly 50 percent, that still leaves 50 percent of the time where vertical integration is probably preferred, or where long-term contracts are not preferred, or where spot contracts are unlikely to perform.

There are few accurate prescriptions in these cases. A prescription of getting the relational contract right does not necessarily outperform blind management, because relational contracting is only relevant one-sixth of the time—the case where long-term contracts are better than vertical integration or spot contracts, which occurs when both parties face high asset specificity and uncertainty/complexity is low.

If North is right, then politicians will recognize that the rules they pass down are asking public managers to find efficiency gains where efficiency gains are not possible in the long term. In that case, the best prescription is: to wait. If Knight is right, and rules are distributive, then the rules are not intended to deliver efficiency. In that case, managers are doing a thankless job, and a job where viable prescriptions should ac-

count for the true intent of the political directive.

Williamson, Oliver E. 1975. *Markets and Hierarchies: Analysis and Antitrust Implications*. New York: Free Press.

From Theory to Guidance

In the long run, the added value of Brown, Potoski, and Van Slyke's "Managing Public Service Contracts: Aligning Values, Institutions, and Markets" will be to shift our emphasis away from hand wringing about the benefits of contracts, the costs to public managers of having to write contracts, and the long-term implications of contracts for the public service (although, of course, all are excellent fields of endeavor). Foremost, instead, will be trying to understand how managers should strategically implement political directives to contract out. When the world is complex and the optimal choice is not clear, managers "do the best they can do." That is a strategic problem and well describes where this article directs our attention.

Notes

1. One such consequence is the changing population of nonprofit and for-profit contractors that now seek to receive one of those contracts. The nonprofit "population ecology" implications of contracting out are significant and persistent.

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