A Closer Look at the Financially Effective Contract Management:

Focus on the Internal and External Control Mechanism

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Last few decades have witnessed a growing number of publicly funded service delivery and management by for-profit and non-profit organizations through contracting out, regardless of level of government. Much attention about the significance and impact of contracting out became inevitable among researchers in public administration field. As a result, various metaphors have been created, such as “hollow state” (Milward & Provan, 2000), “contracting regime” (Smith & Lipsky, 1993), “government by proxy” (Kettl, 1993), and “third-party governance” (Salamon, 1981). Besides, this situation has provided many scholars with unique social experiment opportunities to investigate how contracting out can be operated effectively (e.g., DeHoog, 1990; Fernandez, 2007) or how much cost can be reduced through contracting out (e.g., Hodge, 1998; Prager, 1994; Savas, 2000). But surprisingly, little research has been empirically undertaken on the important question that has not answered yet in the prior literature—under which conditions public funds can be spent properly against financial corruption such as fraud, waste, and abuse at large.

Meanwhile, many serious managerial and ethical challenges (e.g., loss of control and accountability in public service delivery) also have taken place in practice. Scholars have long recognized contractors’ opportunistic behaviors (shirking) that lead to a propensity of financial mismanagement and corruption in contracting out (e.g., Brown, Potoski, & Van Slyke, 2006; Donahue, 1989; Kettl, 1993; Van Slyke, 2009). For example, Van Slyke (2009) argued, “[i]nstances of fraud, waste, abuse, corruption, and monopoly all can and do occur under contracting because of a lack of governmental oversight …, a lack of market competition, and asymmetric information issue” (pp. 141-142). In addition, recent reports by New York Times (Halbfinger, 2012; 2013) revealed that billing fraud accompanied by overcharges and improper accounting has been common in the contracted education services such as preschool special education. Public officials in state and local governments tend to heavily rely on the contractors' own accountants whose independent audits to report fiscal problems.

With such a dearth of scholarly research and practical challenges in mind, we need to focus on the significance of control systems when public service provisions are contracted out. Makeyenko, Gabrielian, and Holzer (1998) noted, "[f]inancial control is a very important part of any control system … financial controls are intended to prevent misallocation of financial resources, such as misuse or abuse of financial funds" (p. 526). In this regard, this study attempts to highlight that governments need to employ more rigid financial performance control systems. More important, public managers must recognize that only internal controls (monitoring and oversight by governments), despite long-term collaborative relationships, are not sufficient to ensure financially effective contract management. Marvel and Marvel (2007) argued that contracting does not necessarily raise monitoring works of governments and sometimes they rather actually decline (p.529). As such, public services are barely monitored effectively than expected because of unfulfilled expectations for cost savings (e.g., risk of manipulation by providers) and physical and financial burdens (e.g., caseload size and monitoring costs) (Amagoh, 2009; Frederickson & Frederickson, 2006; Hefetz & Warner, 2004).

In light of such recognition, there is a clear need to pay greater attention to external controls as one of the primary prevention strategies for the larger contracting fiscal corruption. While internal controls include so-called, arms-length contract monitoring tools, such as monthly or quarterly reports by contractors, review of financial documentation, and field observation, external controls contain communicating with service clients by using citizen complaints and satisfaction surveys, and ombudsman systems (Brown, Potoski, & Van Slyke, 2006; Dicke, 2002). In particular, although citizens are traditionally considered direct recipients as well as individual consumers of contracted goods and services, perhaps they have direct knowledge and information about contract performance along with stronger incentives to report their under-performance (Osborne & Plastrick, 2000; Van Slyke & Roch, 2004). Thus, as real principals (owners) in the contracting process, citizens whose opinions can be mirrored effectively through external control mechanisms in that they may help mitigate the contract risks associated with mismanagement and supplement government's oversight accountability.

Overall, this research posits that both internal and external controls over contractors' opportunistic behaviors are required in contracting out. Without proper internal and external control mechanisms, governments would fall victim to financial fraud, waste, and abuse, and further discover that their contractors have effectively become conventional monopolists. Accordingly, all contracts should be rewarded or sanctioned based on sound financial management, adherence to proper performance measures, and strong monitoring methods. For future research, more exploratory approaches, based on data from survey and semi-structured interviews with contract administrators, are necessary to improve our understanding of the contracting out in general. Such in-depth studies might help guide how control mechanisms should be designed to minimize misappropriation of public funds, thereby ensuring efficiency and accountability throughout the entire contracting out process in particular.

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