

# Relational Contracting and Managing Networks: New Public Management and the Search for Gains from Repeated Interaction

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**Abstract:** Drawing upon recent advances in the theory of relational contracts, we advance a more nuanced theoretical conception of the impulse for contracting under the New Public Management. Our analysis yields prescriptions for managing in networks. Primary among these is that managers must terminate some relationships while maintaining the credibility to begin and cultivate others to make relational contracting most efficient. We tie this concept and its corollaries to notions emerging from the literature on network management, and conclude with a discussion of role of institutions versus that of personal leadership .

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Government effectiveness research is plagued with numerous complications and complexities that obfuscate useful and generalizable results. Nonetheless, a “positive” public management research program has advanced in recent years; Importing theories from the disciplines and testing predictions with more sophisticated modeling and statistical techniques, this movement has given the field newfound energy and direction.

We focus presently on an important component of global public management reforms, namely the contracting-out of government services (see generally Pollitt and Bouckaert 2000). Advocates of the New Public Management (NPM) have led this charge to contract as an antidote to the perceived rigidity and task specificity that characterize public bureaucracies. Beyond the normative wrangling over the appropriateness of its message, however, lies a set of generally accepted NPM principles: (a) delivering more public services through contracts with non-governmental entities; (b) greater reliance on quasi-governmental arrangements; and (c) more discretion in the hands of managers, and, correspondingly less legislative meddling in their affairs. These principles provide the context in which any theoretical understanding of modern public management reforms must be developed.

Despite its reliance on efficiency and metaphors of market-based incentives, NPM scholarship has not been terribly theoretical. It can reasonably be argued that public administration research has focused an inordinate amount of attention on the normative question of whether it is appropriate to contract with non-public organizations in public service delivery, but virtually no attention on the theoretical question of how and why public sector outsourcing works. This may be, as Lynn (1998) has put it, because public administration scholars have had difficulty accepting the migration of other disciplines into their perceived “domain.” Whatever the reason, the bulk of the contracting literature is comprised of empirical “effectiveness” studies, yielding evidence that contracting is appropriate in some situations and not in others.

It is, of course, fundamental to social scientific inquiry that a notion of the implications of a false claim be understood in advance of any empirical examination of that claim. We posit that the trouble with inquiries into the effectiveness of public sector contracting does not stem from a lack of empirical scientism, but rather from a weak body of theory guiding the inquiries. In a significant exception to this trend, Brown and Potoski (2003) have developed a research agenda aimed at unpacking the management component of contracting. In doing so, they have borrow extensively from the new institutional economics literature. They argue that developing an understanding of how public management impacts the effectiveness of a given contract should be at the forefront of contracting research. We agree that transactions cost economics (TCE) is indeed the right place to develop a more detailed theory of NPM, though we claim that NPM is not just about governing contractually but rather about governing in through relational contracts, which scholars have recently and theoretically integrated into the TCE paradigm.

The costs of repeated policy design at the micro-level render efficiency gains less than satisfactory. Without enhancing and developing the relational nature of contracting, NPM risks devolving into a complex form of patronage with the costs of that scheme (or the benefits, depending on one's vantage as citizen or contractee) absorbed throughout a network of providers. Moreover, an expansion of the analytical lens from the contract to the network does not entirely mitigate this problem. Network analysis—when it moves beyond metaphor (see the argument in Dowding 1995)—systematically examines policymaking activity in networks, but provides less guidance in understanding incentives that glue the network together or account for its rise in the first instance. We argue that the theory of relational contracts can be used in tandem with current empirical strategies for examining management networks makes it possible to reconcile such studies with NPM.

We begin with a review of the literature on the study of governmental effectiveness. Notions of effective governance, i.e., the choice of contracting versus government provision, drawn from NPM are then discussed. In the following section, we then draw from the economics of contract and recent advances in the theory of relational contracting to better describe the nature of the contracting impulse under the NPM. Some propositions emerge from this analysis that yield prescriptions for managing in networks. Primary among these is that managers must terminate some relationships while maintaining the credibility to begin and cultivate others to make relational contracting most efficient. We tie this concept and its corollaries to notions emerging from the literature on network management, and conclude the paper with some brief remarks about the role of institutions versus that of personal leadership.

### **Examining Government Effectiveness**

Government reform is inextricably linked with effectiveness; reformers are trying to “improve” government, however they define that term. During the 1980’s and 1990’s, New Public Management (NPM) was the driving force behind widespread reforms in Britain, New Zealand, Australia, and continental Europe. The reinventing government movement (REGO) during the 1990’s can be viewed as the American extension of the NPM movement (Moon and deLeon, 2001). The National Performance Review (NPR) was headed up by then vice president Gore and inspired by Osborne and Gaebler’s influential book *Reinventing Government* (1992). The initiative sought to improve government effectiveness by promoting a more customer-oriented approach to governance and to free public employees from the burdensome red tape widely perceived to be rife in the federal bureaucracy. Ban (2002) suggests the administrative reform aspects of the NPR can be characterized by the three “d’s”: delegate, decentralize, and deregulate. By loosening controls,

putting customers first, and empowering public employees, proponents of the NPR hoped to dramatically improve the effectiveness of the federal government.

One of the most important principles stemming from *Reinventing Government* is that government should be more about “steering” and less about “rowing”, implying that when faced with the “make or buy” dilemma, government is often better off buying. To advocates of REGO, government bureaucracy is by its nature a less attractive option for service delivery. Therefore, increased contracting-out and the adoption of businesslike principles by public sector organizations are viewed as paramount (e.g., Osborne and Gaebler, 1992; Kettl, 2000).

So far the evidence suggests that the results of NPR initiatives are mixed. Some studies suggest some early gains in efficiency (Sanders and Thompson, 1996), while other more recent research suggests that the NPR did reduce administrative costs, reform the procurement system, and empower line managers. However, Thompson (2000) found that NPR did not significantly decentralize the civil service system and more importantly enhance service delivery to the public. As the Clinton-era NPR gives way to the President’s Management Agenda in the Bush Administration, the empirical focus on efficiency continues.

Measuring effectiveness in public organizations and programs is complicated by ambiguous, complex, and often conflicting goals (Dahl and Lindblom, 1953; Diulio, 1995; Chun and Rainey, 2005). Moreover, gains in efficiency can not be advanced without taking into account other important public sector values such as equity and accountability. An emphasis on accountability, for example, often leads to strict adherence to rules and procedures in place of efficiency (Lynn, 1981; Dahl and Lindblom, 1953). In one study comparing managers in public organizations to managers in private organizations, Buchanan (1975) found that the vagueness and value conflict in public organizations resulted in lower commitment to the organization and lower job satisfaction in public managers. Rainey and Steinbauer (1999), however, contend that large public agencies can be just as

effective as private organizations as suggested by their illustrative “galloping elephants” metaphor. The idea of government effectiveness ultimately reduces to a normative concept. Since efficiency must be tempered by accountability, it is difficult to determine which value is more important in any given context.

Given the complexities of assessing government effectiveness, it is not surprising that no single framework has been accepted in the literature for evaluating effectiveness. In one notable study of high-performance public agencies, Hale (1996) found that effective agencies were characterized by a learning environment, a focused mission, a nurturing community, and enabling leadership -- where leaders are integral in providing the proper direction and a conducive environment to employee growth and development. Similarly, Porter, Sargent and Stupak (1986) suggest that high performing agencies emphasize human relations, employee training, and entrepreneurialism. In a study of ten successful organizations (five public and five private), Gold (1982) suggests that effective organizations emphasize clear missions and objectives, well defined job tasks, reward employees for good performance, and provide access to feedback channels. In addition, Gold suggests that successful organizations do not shy away from innovation, but rather frequently engage in it.

In light of the increasing complexity and the multi-organizational nature of public service delivery (Hall and O’Toole, 2000), different conceptualizations of government effectiveness have emerged in the literature. Network analysis attempts to unpack the interactions and complexities of inter-organizational service delivery with a theory stretching beyond the single agency perspective or dyadic principal agent models (O’Toole 1997). The unit of analysis shifts from the organization outward to its network. In one attempt to measure effectiveness at the network level, Provan and Milward (1995) found that centralization from the top (i.e. a strong central agency within the network), adequate resources from an external entity (state agency), and stability had a positive effect

on performance in mental health networks. In a subsequent article they propose a framework for evaluating network effectiveness at multiple levels: the individual, the network, and the community (Provan and Milward, 2001).

Instead of focusing on the network as a whole, Meier and O'Toole (2003) concentrate on managers. They are interested “the nitty-gritty ways that managing in networks might be different from managing solely in and through a hierarchy focused on program operations” (Meier and O'Toole 2003, 690). Estimating a variant of their management model (see O'Toole and Meier, 1999) to a data set of Texas school districts, they find that superintendents who actively network can influence the resources and constraints facing their school districts – ultimately leading to improved performance.

Another stream of research with important implications for understanding government effectiveness takes the pithy, yet not entirely evocative name governance research. The structural definition of governance is certainly not monolithic. Indeed, Rhodes (1997, 47) notes six different definitions of the concept. On one view, governance has been related to “the use of markets and quasi-markets to deliver ‘public’ services” (Rhodes 1997, 47). But, governance can also be considered in a legalistic sense, as a structure of rules that constrain organizational activity (Rhodes 1997, 48). The incentives and managerialism of New Public Management as well as notions of “good” or “efficient” government, are also part of how scholars conceive of governance (Rhodes 1997, 48-50). Note Peters and Pierre (2000, 22, emphasis original), “the assumption is that if you want to get governance ‘right’ you need to manipulate the structures within which it is presumed to be generated.”

Lynn, Heinrich, and Hill (2001) propose a framework for approaching governance research. Their definition falls in the structural and legalistic category; governance refers to “regimes of laws, rules, judicial decisions, and administrative practices that constrain, prescribe, and enable the

provision of publicly supported goods and services” (Lynn, Heinrich, and Hill 2000, 7). In their “logic of governance,” such regimes are in place at three distinct levels: the institutional, the managerial, and the technical (or primary work level). An important aspect of their framework is that outcome or output measures should be used as dependent variables. To the authors, then, governance research is by definition effectiveness research. Taking this approach, Heinrich and Lynn (2000) found, consistent with Provan and Milward’s (1995) evidence regarding network effectiveness, that performance of training programs under the Job Training Partnership Act improved when coordination and centralization of authority was high.

Trends in effectiveness research are not sensibly decoupled from trends in public management practice and its reform, the most influential of which has been NPM. We link its reform agenda to the rationales for public sector contracting in the next section.

### **The New Public Management and the Contracting State**

In the public administration literature, NPM has been concomitantly vilified as an attempt to apply a business like principles and market efficiency to the public sector while potentially sacrificing important values like accountability (e.g., Terry 1998; Box et al, 2001); trumpeted as a global phenomenon propelling significant public management reforms (e.g., Pollitt and Bouckaert 2000; Hood 1991); or dismissed as yet another passing fad in public administration and management (but see Lynn, 1998). We use NPM as a conduit to understanding effectiveness, network management, and governance.

As we pointed out in the previous section, the ambiguity and subjective nature of goals in the public sector make defining effectiveness extremely difficult. NPM is predicated on establishing performance goals ex ante through agreed upon contracts, whether those arrangements be internal performance agreements—as in the U.K. Next Steps agencies—quasigovernmental (e.g., Bertelli

forthcoming; Skelcher 1998), or external contracts for explicit services (Brown and Potoski 2003). Effectiveness, then, is defined by the nature of the contract, and contracts come in varying forms. In fact, the literature upon which we base our argument—that of relational contracting—posits that contracts are simply a (more formal) part of the *relationship* that governs transactions (e.g., Goldberg 1977). NPM advocates contend that managers can actively facilitate performance improvement by developing adequate performance measures in the contract negotiation and renegotiation processes, but they certainly understand that relationships are involved. While we agree, it must be observed that the nature of that theory has been given too little attention. Our specific claim is that relationships are the key to efficiency under NPM reforms as their time horizons broaden.

#### *Theories of the Contracting State*

In the public administration literature, theoretical rationales for contracting-out typically fall into three distinct camps. The first suggests that public agencies cannot efficiently provide public services because they face no competition and operate under no profit incentives. Thus, at the level of the individual service, market incentives must be brought to bear on service providers to encourage the kind of innovation, cost-reduction, and product differentiation that make markets efficient. Since all of the contracts include the same buyer—the state—a complex procurement mechanism must be developed to diligently protect the state from rent-seeking activity in specialized sectors where the number of sellers is very small and opportunism is a possibility (compare the “monopolistic screening” models in Maskin and Riley 1984; Baron and Myerson 1982). We should not then be surprised by the finding of O’Toole and Meier (2004) that increased contracting increases the number of bureaucrats over time, as they suspect, from a rise in central administrative staff.

The second typically stated rationale is political liberalism. Privatization can act to mitigate and limit the government’s ability to encroach further into people’s lives, preserving personal

freedoms (Savas, 2000). This too is overly simplified. With the government as the contracting party in myriad agreements tailored to very specific programs, it is likely that the same intrusiveness is possible with correspondingly *lower* transparency. The only time a contract is likely to become publicly noticed is when one party feels that it has been breached—a service provider announcing that the government cannot keep its promises or the government characterizing the provider as a mere hack. Interest groups have the incentive to monitor uncontroversial contracts, but the costs of doing so rise with the number and specificity of contracts. Thus, general “good government” groups become ill-equipped to monitor the breadth of the government’s contractual obligations, leaving this task to subject-specific “special” interest groups (compare McCubbins and Schwartz 1984). The result is a costly form of pluralism, but not the kind of liberalism envisioned by normative champions of the government contract. Opponents of public sector outsourcing argue that important aspects of democratic governance such as accountability are jeopardized by contracting (Dicke and Ott, 1999). Moe (1987) urges that those functions which are of a purely governmental or public in character should remain with public agencies.

The third common explanation is a particularly myopic characterization of the theory of “public choice.” It focuses on the Niskanen (1971) assumption that the directors of public agencies seek to maximize agency budgets rather than operate their bureaus efficiently. The Niskanen model requires the bureau to be able to engage in perfect price discrimination with the legislature regarding the services that it provides (see Conybeare 1984). Contracting-out and privatization can break this monopoly, but only if the legislature shares with the agency the authority to contract with service providers or, at least, the information regarding the conditions of those contracts. It is quite logical to speculate that increases in the number of specific contracts generates a dizzying array of agreements made between the agency and various organizations which can be presented to the legislature with not a little obfuscation. This problem of asymmetric information becomes that of a

legislative principal and bureaucratic agent well-known in the literature on political control of the bureaucracy (e.g., Weingast and Moran 1983), where a solution is some mechanism created ex ante by the principal and agreed to by the agent that keeps a transparent record of contractual activity for ex post monitoring by interest groups who sound “fire alarms” to the legislature when the agency is contracting opportunistically (McCubbins and Schwartz 1984). The deck is stacked in constructing the ex ante mechanism such that it is the interests of the winning coalition in the legislature that are most likely to sound the fire alarms, rather than the opponents of that coalition (McCubbins, Noll, and Weingast 1987). Thus an increase in central administrative staff responsible for contract oversight is likely for a second reason.

Evidence of the effectiveness of contracting-out is mixed. In many instances, competition for contracts is limited weakening market competition rationale for outsourcing (Boyne, 1998). Greene (2002) suggests that the greater efficiency found in many studies is likely more attributable to competition than to private service delivery. That competition may also have deleterious impacts on the organizations themselves (Fernandez, Lowman, and Rainey, 2001; Berman, 2003). Using transactions cost economics as motivation, Brown and Potoski (2003) posit that there are three components of contract-management capacity: feasibility assessment capacity, implementation capacity, and evaluation capacity. They assert that if any one of these three components is low, contract performance will suffer. They find empirical support for the hypothesis that governments can invest in management capacity to improve contract performance in U.S. local government data. They also find, however, that local governments lacking resources will not invest the necessary funds to improve management capacity even when facing the appropriate incentives to do so. Thus, contracting capacity is an investment decision, and some governments as well as some firms may be better positioned to make those investments.

Though the approach in Brown and Potoski (2003) seems the most fruitful take on the problem at the level of the *contract*, each of the theoretical explanations fails at the network level. Why is networked policy management so prevalent? Why is it a central aspect of the new governance, rather than offensive to NPM ideals? If the market for each service is competitive, why would individual providers incur the transactions costs of operating in a network at all? Is the network a fixed cost of doing business with the government? That would decrease efficiency. The network does not make it easier to monitor government operations – liberalism/pluralism – or remedy the legislature’s information asymmetry in the political control game. By diffusing information across the nodes, networks probably make those problems worse. Network analysis provides significant analytical traction for understanding the operation of those networks, but much less for understanding their emergence and overall significance in modern governance.

We feel that attention must be paid to the incentives surrounding contracting as an element of NPM. By viewing the optimal contract as a relational one, one can develop a better understanding of the normative impulse for outsourcing as well as a set of background conditions for managing in this environment.

### **The Economics of Contract**

Social institutions are the rules, norms and laws which provide the context for all economic activity. New Institutional economics began with the seminal observation of Coase (1937) that hierarchies (the typical structure of the firm) emerge because they are efficient. Economic organizations are best understood, according to Coase, by comparing the efficiency provided by hierarchy to market efficiency. Given that the assumption of perfect competition rarely reflects real world conditions, Coase suggested that transaction costs, not entirely captured by market exchanges, will drive organizational arrangements. If the transaction costs of operating in the market exceed

those of organizing into a hierarchical firm, a rational executive will choose hierarchy (and vice versa). Moreover, the relationships within the organization are transactional in nature.

The ability to evaluate contractual relationships is not limited by the “black box firm” of classical economics, which curiously, as noted in the preceding section, is part of the unrealistic parochialism of public administration’s theoretical accounts of the contracting state. As Sclar (2000) points out, “this synthesis gives us a theoretical framework that allows us to work with the reality of public contracting as it is rather than as we wish it to be.”

Williamson (1985) notes three determinants of the magnitude of transaction costs: asset specificity, frequency, and uncertainty. When assets are highly specific, there are frequent transactions between the parties, and there is considerable uncertainty surrounding the contract. Asset specific exchanges generally involve unique knowledge or equipment that raises the potential for opportunism (“self-interest seeking with guile,” in Williamson’s terms), resulting in a greater need to monitor (higher transaction costs). When there is a great deal of uncertainty surrounding contractual performance on either side of the bargain, ex ante bargaining costs as well as ex post monitoring costs will be higher. Finally, when exchanges between the parties are infrequent it becomes easier to judge the quality of the product or service being produced. When transaction costs make market mechanisms too costly, organizations will internalize the economic exchanges into their hierarchies (vertical integration).

The benchmark arm’s length contract, is the most obvious and easily understood contractual relationship. It is a highly legalistic relationship generally operating on a relatively short time frame. The complete contract is characterized by infrequent exchanges between the parties, low asset specificity, and little uncertainty surrounding the exchange. Complete contracts are typically short term projects with no underlying assumption of repeat contacts. The terms are highly transparent the deliverable product is discrete. All contracts are necessarily incomplete—no one can foresee

every contingency in performance—though those having more of the characteristics of the complete contract are certainly common in both the public and private sectors.

Much of the evidence of success of public sector contracts emerges from this low transactions cost environment. Savas (2000) reviews numerous privatization initiatives, mostly custodial services and those employing unskilled labor, finding that when contracts are awarded to non-public organizations via a competitive bidding process, the contractor performs more efficiently than the public agency and of equal quality. Hodge (2000) conducted a meta-analysis of contracting studies comparing public and private service delivery. He found cost savings associated with contracting, but the savings were limited to a few types of services such as garbage collection, cleaning and maintenance. Intriguingly, though, he found no appreciable difference in cost savings between contracting with a private organization or another public organization.

Central to the argument in this paper is the incomplete contract, characterized by frequent transactions, high levels of uncertainty, and asset specificity. Incomplete contracts often govern long-term relationships, and it is relationships such as these that we argue are the basis for both the efficiency gains in the performance of more complex tasks in the spirit of NPM as well as the prevalence of public management networks.

In a long-term relationship with asset specificity, the supplier looks to subsequent sales but the market for his or her good is extremely narrow, inclusive, in the limit, of only the buyer. It is unsurprising that in such relationships, the supplier is not in a position to easily exit the relationship. Without a broader market for the good, the seller must hope for a long-term relationship with the buyer such that the start-up investments he or she made to produce the first saleable quantity of the good such that investment will yield dividends. Thus, the relationship between buyer and seller becomes the linchpin for profitability.

What arises is a principal-agent problem from the ability of the seller (agent) to manipulate the relationship. The seller, after all, produces the good or conducts the service, and thus knows the guts of the operation much better than the buyer (principal). Certainly this is why the principal pays for the service, to take advantage of the expertise and skill of the agent. In any agency relationship, two problems generating loss for the principal (and economic rents for an opportunistic agent) are theoretically possible. Moral hazard occurs when the agent sacrifices the goal of the principal by taking actions, hidden from the principal, that are not in the interest of the latter. The archetypal example is insurance: with it, the insured person takes more risks than without it. Adverse selection is a problem of screening, the true abilities of the agent to produce the good or perform the service are hidden from the principal at the time of contract. Consider a principal who chooses an inexperienced agent offering the best price during the bidding phase. Scrutiny of the potential agents is expensive and difficult for the principal inexperienced in the subject matter of the contract. Moreover, the lack of agent experience is only observable if and when a “lemon” is delivered in fulfillment of the contract. As a consequence, the ex ante screening and ex post monitoring costs are high for the principal.

The theoretical solution to the moral hazard problem is to design a fee schedule such that the agent is rewarded for producing the good or service in line with the expectations of the principal, i.e., quality, promptness of delivery, and so forth are rewarded over and above some base level of performance. The theoretical solution to the screening problem lies in what information economists call “mechanism design.” The principal designs a game—say, a bidding procedure—for the potential agents to play. When they bid in this process, agents have the incentive to reveal their true type to the principal, thus eliminating the asymmetry of information on the agent’s capability of fulfilling the contract to the principal’s expectations and, by extension, the production of lemons.

One often observed solution (see also Myerson 1982) is vertical integration, creating a hierarchy, rather than maintaining the horizontal relationship between firms tied together through contract (Alchian and Demsetz 1972; Grossman and Hart 1986). An inefficient, but likewise common, response to dissatisfaction with performance on a contract is to shape the contract to look more like a complete contract—adding ex post penalty clauses, incentive clauses, performance standards, arbitration options that would have been efficient in combating moral hazard if originally included. Remaining with the same agent may well be the problem, and such ex post remedies leave the adverse selection problem untouched unless the costs of developing an informative bidding mechanism are undertaken.

### **Relational Contracting, Public Management Networks, and the New Governance**

Relational contracting represents a different approach to dealing with these contractual difficulties in practice (e.g., Kirkpatrick, 1999; Sclar, 2000; Jones, Hesterly, and Borgatti, 1997). As an alternative to renegotiation and the redesign of bidding processes, managers work beyond the boundaries of their organization to nurture relationships based on trust and cooperation. Relational contracts occur both between organizations (horizontal) as well as within an organization (i.e. between managers and employees, or vertical). Some important new theory regarding the optimal choice of horizontal versus vertical relationships will be reviewed shortly, but the point to be stressed at the moment is the value of *repeated* interaction to the effectiveness of the contract. Mutual trust arising from the simple fact that the contracting parties will be involved with each other in a long-term relationship increases truthfulness over spot transactions, lessening moral hazard. Since the business relationship is long-term, the incentive for the seller to admit to ineptness in a particular job increases, mitigating adverse selection. Knowing that the relationship is valuable—as a continuing market for an asset-specific good or service—the seller would rather not take on a task

that is likely to produce a “lemon” and damage the relationship (see generally Goldberg 1977; McNeil 1978). Over time and across substantive areas, relational contracting produces a “network” of trusted agents for a principal, significantly lowering transaction costs in long term contracts surrounded by uncertainty (Jones, et al, 1997).

Scar (2000) uses the example of home remodeling to illustrate the nature of a relational contract. When bidding for a job, a remodeling contractor solicits bids from his stable network of “reliable” subcontractors. Based on past experiences, he knows he can trust both their bids and products to be of satisfactory quality. Likewise, the subcontractor trusts that the contractor will effectively coordinate the project and meet his fiduciary responsibilities. The network nature of the relationship results because the contractor would waste resources by engaging in a search across all relevant craftspeople in the market; nor is it efficient for him to vertically integrate craftspeople into his organization to eliminate the subcontracts. This networked relationship, held together by relational contracts, makes a good deal of sense.

Clearly the point thus far is not to suggest that in every instance a relational contract between organizations is warranted. However, it is equally short sighted to argue that every exchange should gravitate either to the market or be internalized into a hierarchy based on the transaction costs. Such a dichotomy is too rigid (Holmstrom and Roberts 1998). Scholars have argued that relational and formal contracts are both substitutes and compliments. Klein (1996) has argued that the use of formal (incomplete) contracts to structure a relationship in its early stages creates incentives for the mitigation of opportunism that become elements of trust between parties as the relationship matures. Alternatively, Macaulay (1963) argued that formal contracts can reduce trust in a relationship, either in its emergent or mature state. Trust, moreover, reduces transactions costs by this very mechanism—eliminating the need for a formal contract. Nonetheless, relational contracts require enforcement mechanisms. Levin (2002) integrates incentives into the relational contracting

framework to uncover two optimal enforcement regimes. When performance on the contract can be measured and is observed by both parties, all that is required for efficiency is a contract identifying a performance target with lower performance getting minimal reward and any performance over the target triggering the maximum reward. When performance is too subjective for precise measurement and joint observation, the optimal contract rewards performance at or above the target but the relationship is terminated in the case of any lower performance (Levin 2002).

Additional theoretical work integrates the well-known incomplete contracting theory of Grossman and Hart (1986) model of vertical and lateral (what we have called horizontal) ownership into the theory of relational contracting. Grossman and Hart (1986) define two parties to a contract as the “upstream party” that uses some asset A to produce good X and the “downstream party” that uses good X in its production process in some way. Two ownership structures are possible in a transaction between these parties. A “nonintegrated” transaction occurs when the upstream party owns the asset A, while an “integrated” transaction is defined as one in which ownership of A is by the downstream party. These definitions are evocative. When the upstream party owns A, the principal-agent relationship gives rise to problems of moral hazard (and, to the extent that the upstream party is not a monopoly producer of X, to adverse selection). We focus our present attention on moral hazard. Of course, the integrated transaction simply defines a relationship between the parties after vertical integration.

Baker, Gibbons, and Murphy (2002) infuse this notion with the possibility of relational contracting. We can think of ownership of A, they note, as not simply ownership of the means of production of X, but also as legal title to X. Moreover, X can be used by the downstream party in production of some good Y or for any other use that it wishes. The good X has, by assumption, an alternative use—a use other than that by the downstream party. These generalizations, as we shall

discuss, broaden the appeal of their theoretical predictions for governance research. To establish the principal-agent relationship, Baker, et al. (2002) then assume that under either ownership structure—integrated or non-integrated—the downstream party would like the upstream party to take such actions that *improve* the value of the good X used by the former in producing Y or otherwise. This gives rise to moral hazard from the unobserved actions of the upstream party related to the production of X and the potential for additional shirking from actions that are observable but not verifiable by the downstream party. The latter actions produce non-contractible risk. The authors then note that if an incentive contract is designed ex ante to mitigate these information problems, it would likely include a bonus for any X of value over a certain threshold. It should be apparent that the story so far is similar to that of the preceding section.

Consider now that the incentive contract is part of a long-term relationship between the parties. For the incentive contract to produce the high valued X desired by the downstream party, the incentive contract would have to be *self-enforcing*, namely that the value accruing to either party from renegeing on the contract in the current period is larger than the expected value of the long term relationship (Baker et al. 2002). Were the contract non-self-enforcing the upstream party would have the incentive to make X a cheap lemon and/or the downstream party would have the incentive to renege on the payment of the bonus when delivered a high-value shipment of X. Thus, a relationship alone is insufficient to determine whether the ownership structure will remain non-integrated (i.e., outsourced).

Baker, et al. (2002) examine whether differences in ownership structure (dichotomous, integrated or not) can make the relational contract self-enforcing. Their principal proposition works as follows. With an integrated structure, a downstream party that reneges on the bonus still owns legal title to X and can use it, but when the ownership is non-integrated, no such use can be made (unless X is purchased on a spot market for its value in alternative use). Thus, non-integration

clearly benefits the upstream party in that it can sell X for its alternative use value if the downstream party reneges on the bonus. Extending the logic, the upstream party has the incentive to increase the value of X *in its alternative use* to improve its bargaining position. So, integration does effect the optimal *relational* contract that can be implemented by the parties.

Baker, et al. (2002) present three very important comparative static predictions for public sector contracting.

- When supply prices vary widely, integration is preferable.

Government should retain *in house* those services whose supply is subject to volatility. This has much in common with the concept of resource dependency in organizational sociology (e.g., Pfeffer and Salancik 1978). Supply markets present a volatile environment for a government demanding goods and services—they are volatile in the prices the government must pay for goods and services and in the product quality that is available. Scott (2003, 118-19) states that from the perspective of resource dependence, “managers scan the relevant environment, searching for opportunities and threats, attempting to strike favorable bargains and to avoid costly entanglements.” As we shall shortly discuss, the management function implicit in our relational contracting argument bears important similarities to that implied by resource dependence theory.

- “High-powered” performance incentives (tying performance to monetary bonuses) make the incentive to renege on the relationship greater under integrated structures. Thus, integrated relational contracts have lower performance payments in equilibrium.

Consider the difference between executive and quasi-governmental agencies. In executive agencies, such as Britain’s Thatcherian “Next Steps” agencies, the service provision functions of a government entity, i.e., distributing benefit checks, inspecting facilities, and so forth, are made separate “agencies” in a federated “parent department.” Each agency must provide the service with which it is charged, and it is accountable to the parent department for the satisfaction of

performance objectives. For example, the British Ministry of Transport (parent agency) has a Driver, Vehicle, and Operator Group that is subdivided into the Driving Standards, Driving and Vehicle Licensing, Vehicle and Operator Services, and Vehicle Services agencies. The Driving Standards Agency provides driver and vehicle testing. Its performance targets include benchmarks for customer satisfaction, waiting times, appointment cancellations, and telephone service. These performance targets are known and agreed to by the agencies, but the agencies are given broad discretion to achieve them. British Next Steps agencies typically possess no legal identity separate from the Crown, or, in other words, have no “legal personality.” The intent behind the largely moribund Performance Based Organizations movement in the executive branch of the U.S. government is a similar example. Accountability in executive agencies is enforced through an internal market mechanism, with incentives generated quasi-contractually through the performance targets.

British Non-Departmental Public Bodies (NDPBs), unlike Next Steps agencies, are not part of the Crown, nonetheless, they are publicly funded through budgetary allocations, taxes, or fees. The NDPB, then, is not a part of the government, as is a bureau or executive agency, but it is responsible for implementing public policies as articulated in legislation and the regulations of its parent department. It fulfills certain obligations, including the reporting requirements. The implication of our theoretical perspective is that the choice between an integrated next steps arrangement and the non-integrated relationship between the government and an NDPB is one that optimally has to do with supply volatility. Services for which there is greater supply volatility belong with the Next Steps agencies, while less volatile services can be “hived off” to an NDPB.

Wise (1997, 576) urges, “In public administration, thus far, more effort has gone into seeking out additional opportunities to contract for services and charting possible cost savings from doing so than has gone into specifying the management imperatives necessary to develop and manage the

contracts successfully.” The foregoing propositions imply an important characterization of the role of the public manager in the world of the contractor. Non-owner managers have a critical role to play in creating and nurturing relational contracts both under integrated and non-integrated ownership structures (Baker, et al. 2002). *They must skillfully terminate some relationships without losing the credibility to develop and enhance others.* Note that this idea is closely related to the optimal incentive contract for relationships (Levin 2002). In areas of service provision that require subjective assessments of performance—such as human services and myriad other areas of governance—the threat of termination is essential to optimal performance. The manager must make this threat credible.

In the following section, we relate these management imperatives to the literature on managing in networks.

### **Relational Contracts and Managing Networks**

Network research is of great interest to public administration scholars, yet there is considerable uncertainty surrounding the conceptual and even definitional nature of networks (O’Toole 1997). From a relational contracting perspective, networks expand horizontally from the state when the supply of a good or service to the government is stable enough for market transaction. Otherwise, relational contracts within the government are constructed. It is incumbent upon management to recognize the conditions whereby the performance of the network will be enhanced, and this means maintaining credible relationships given the hard fact of having to end others. Since the nature of relational contracts is typically characterized by long term relationships, stability over time—a product of these management choices on creation and termination—is the key determinant of managerial effectiveness. Kirkpatrick (1999) is prescient on the general task of network management. Given that trust is an integral component of success, he asserts that many

proponents of networks fail to incorporate the costs associated with building trust. Second, he suggests that many networks disintegrate after short-term gains have been achieved. Third, trust can potentially lead to abuse of trust – fraud, malfeasance, etc. Finally, he believes that networks can drift into “coalitions which resist innovation and which offer protection for under-performing organizations” (11).

*The Logic of Network Stability through Relational Contracts*

We believe that viewing network management through a relational contracting lens is not only consistent with much of the extant literature on network and collaborative management; it may be a more accessible as knowledge-for-practice in light of the perceived complexity surrounding networks. Many of the concepts applied to management in network settings involve establishing trust and credibility between the different network actors, and relational contracting theory suggests conditions under which trust can develop in relationships. The value of trust is substantial as it both reduces (expected) opportunism and transactions costs.

*Structural embeddedness* provides one perspective on trust and its characterization throughout the network (Jones, et al. 1997; Granovetter 1985). It is a measure of the coupling within the network in terms of direct, indirect, past, and future contact between the different parties. It is by way of structural embeddedness, social mechanisms (rules, norms, reputation, etc.) improve the exchanges between the parties in the network. The more accepted and effective the social mechanisms operating within the network the more likely trust will exist and the credibility of the manager will be enhanced.

*Multiplexity* measures the strength of ties among different actors in the network (Scott 1991). Network *density* is similar, though it measures the overall number of linkages in the network (Agranoff and McGuire 2003). Multiplexity is high when organizations are connected in multiple ways. For example, agencies that interact in both service delivery and planning have higher levels of

multiplexity than agencies connected by a single link. Provan and Milward (2001) suggest that in the early stages of network development “ties among most members tend to be relatively weak, or loosely coupled, as agencies test each other’s commitment and reliability. As the network matures, some of these links will completely dissolve as agencies discover which relationships work and which do not” (419).

Given our theoretical discussion, we should anticipate multiplexity to be most interesting when service provision is not likely to be volatile. Governance is provided through horizontal relationships with firms in the market. Over time, such relationships engender the structural embeddedness of government actors in a governance network. There are likely to be a plethora of formal contracting arrangements in such networks, and they should, where the relationship is more long-term than a spot contract for very specific services (i.e., the supply of a quantity of mobile homes to house evacuees from Hurricane Katrina’s wake), tend toward the Levin (2002) conditions: (a) identify a target quality, (b) provide bonuses for exceeding the target when performance vis a vis the target is observable to both the government and contractee, and (c) provide for contract cancellation in the event that a necessarily (due to the type of service provided) subjective performance target is not met.

*Interagency collaborative capacity* (ICC) is a concept developed by Bardach (1998) to tap public managers’ craft-like approach to collaborative problems. Bardach sees collaborative management as strategic and purposive where two of the main tasks in building ICC are developing a culture of trust and joint problem solving and managing. In a review of Bardach’s book, Agranoff (2000) suggests “talented people, flexible funding, breaking down of agency turf barrier, actors seeing the importance of overall purpose, and increasing cultures of trust will all contribute to increased ICC. These forces at work add value within policy networks.” (265)

Network *centrality* has been conceptualized several different ways in the literature. Klijn and Koppenjan (2000) contend that government actors represent the community interests and democratic values within the network. Therefore, public organizations may be central to the network as a network “builder” or “broker”. Provan and Milward (2001) suggest that centrality is better conceptualized in the form of a Network Administrative Organization (NAO). Moreover, they hypothesize that assessing the strength of the NAO is one way of evaluating the effectiveness of a network.

Given the logic of relational contracting, we believe that focusing on the actions of the manager as a network builder/broker is more useful. The kind of trust-building across organizational boundaries discussed by Bardach is precisely the public manager’s role implied by the relational contracting literature we survey. The brokering role of the network manager is credibility-preserving. The trust that the manager must build is based on commitment to measures of performance, and this indeed is the commitment to results that NPM wishes government to have more of. The manager’s place within the network must be central and connected such that contractees and potential contractees alike understand the policy message.

### **Conclusion**

Drawing from an array of formal results in social choice and game theory, Miller (1992, 225) concludes that “the most credible managerial commitments supplement personal leadership with what we might term constitutional solutions: permanent restrictions on the ability of managers to pursue self-interested behavior at the expense of long-term cooperation.” Through a very different logic, our managerial mandate—that managers must terminate some relationships while maintaining the credibility to begin and cultivate others—extends that argument in a particularly important way. Not all long term-cooperation is in the interest of the public. This is one lesson of NPM; services

should be provided by markets or hierarchies depending on the service. But, to fully appreciate the value of this claim, its theoretical justifications must be stronger than those generally offered in the literature. With recent theoretical advances in the economics of relational contracting, we provide a justification for the importance of relational networks of public and private sector entities to the efficiency claims of NPM. In this way, we connect contracting and network management in what we believe to be a useful way.

Public managers may indeed wish to tie their hands with "constitutional solutions" in our relational context. Since it is inefficient to create a relational contract in which provides no clear performance target, a manager might establish a rule requiring, for example, that once this target is agreed upon, the manager is powerless to change it. These kinds of decisions enhance credibility since they remove managerial whim from the relationship. A mix of personal leadership and such institutions is likely to be observed in practice if managers are indeed responding to the incentives we have described.

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