

The Role of Nonprofits in the Delivery of Local Services

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A transaction cost framework is used to investigate what factors contribute to local government choices to subsidize or contract with nonprofit agents. A unique data set that combines information from the International City Management Association, Census of Government Finances, and the National Center for Charitable Statistics is used to estimate choices to contract with nonprofit organizations to deliver specific publicly funded services. Governments, like firms, desire efficient production (as well as political, electorally-oriented objectives). Production efficiencies in government however, can be lost when transaction costs are high, just as they can be in private firms. Williamson assumes that hold-up problems, non-cooperative behaviors, etc., can be more easily prevented within vertically integrated firms than between firms linked by contracts. Nevertheless, reneging occurs within firms as well as between them. The real question is whether internal governance mechanisms are superior to the diligent monitoring of a carefully written contract in dealing with this problem. Each alternative involves some transaction costs. We extend this approach to examine the use of nonprofit organizations to deliver municipal services. Transaction costs can influence the decision of local governments to utilize nonprofit organizations to produce services in subtle ways. The sources of transaction cost include: 1) the measurement characteristics of the service, 2) the characteristics of political systems that make commitments more or less credible, 3) the level of uncertainty of interpersonal relationships between government and nonprofits, 4) the diversity of target populations, and 5) the scope of the market of nonprofit alternative providers

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In many communities, nonprofit organizations play a prominent role in delivering government financed public services. Local governments have increasingly relied on nonprofits for service production (Kettl, 1988; Salamon and Lund, 1989; Dudley, 1990; Gooden, 1998). For example, the City of San Francisco contracted for over \$314 million in nonprofit services during the 2000 - 2001 fiscal year (City & County of San Francisco Non-Profit Contracting Task Force 2002). Despite the growing role of local governments in contracting with nonprofits for the delivery of public services (DeHoog, 1990; Boyne, 1998; Gooden, 1998, Stein, 1990; Ferris and Graddy, 1994), limited scholarly attention has been directed toward examining how the characteristics of communities and their local government structures shape the role of nonprofits in service delivery.

Local Government and Delivery

Local governments service delivery choices must balance efficiency and cost savings, control of the qualities of services, and the (transaction) costs of managing external relationships (Ferris and Graddy, 1994). A transaction cost framework is applied to investigate when local governments contract with nonprofit organizations, rather than produce services directly or contract with other types of providers.

The question of whether organizations should contract out for products and services or provide them internally (i.e., the make or buy decision) has concerned scholars of public and private organizations for decades. Beginning with Coase (1937), the predominant explanations for vertical integration in the private sector stress the concept of transaction costs -- the costs incurred in negotiating, monitoring, and

enforcing a transaction, contract or agreement. The Coasian framework, as expanded by contemporary scholars of new institutional economics (Williamson 1975, 1985; Klein, Crawford and Alchian 1978; Grossman and Hart 1978), views the organization of transactions within firms as contingent upon the relative costs of internal production and external exchange. When the costs of negotiating and enforcing contracts in the market are high, firms have an incentive to produce services and products themselves, rather than seek out external suppliers.

Governments, like firms, desire efficient production (as well as political, electorally-oriented objectives). Production efficiencies in government however, can be lost when transaction costs are high, just as they can be in private firms. Political scientists have applied Oliver Williamson's (1975) arguments about transaction costs to municipal service delivery choices by arguing that organizations become vertically integrated in order to control valuable specific assets that might be lost if outside suppliers reneged on a contractual agreement or re-interpreted a contract in ways detrimental to the interests of a firm (Stein, 1981; Clingermayer and Feiock 1997). Williamson assumes that these kinds of reneging--hold-up problems, non-cooperative behaviors, etc.--can be more easily prevented within vertically integrated firms than between firms linked by contracts. Unfortunately, reneging occurs within firms as well as between them. The real question is whether internal governance mechanisms are superior to the diligent monitoring of a carefully written contract in dealing with this problem. Each alternative involves some transaction costs, but Williamson presumes those costs are much greater when inter-firm relationships are involved.

This approach has been extended to examine the transaction costs of sector choice for service delivery and the use of nonprofit organizations to deliver municipal services (Ferris and Graddy, 1986; Stein 1993; Clingermayer and Feiock 2001; Feiock et al 2003). The make or buy decision reflects a tradeoff between bureaucratic inefficiencies of public agencies and the costs of managing external contracts (Sclar 2000; Clingermayer and Feiock 1997; 2001). Contracting the delivery of municipal services is attractive to local governments because it often promises substantial cost savings. In addition external agents may exercise greater flexibility, specialized skills, capital to support start-up costs, and have better knowledge of specific problems and target populations. These benefits are offset by transaction costs in service contracting.

Transaction costs can influence the decision of local governments to contract with nonprofit organizations in subtle ways. The sources of transaction cost include: 1) the measurement characteristics of services, 2) the characteristics of political systems that make commitments more or less credible, 3) the level of uncertainty in interpersonal relationships between government and nonprofits leaders, 4) the characteristics of target populations, particularly heterogeneity in service preferences, and 5) the scope of the market of nonprofit and other alternative providers. Each is discussed in turn.

Measurement Costs

Transaction costs are frequently great when the qualities of a good or service are difficult to define and measure. These difficulties hinder monitoring and enforcement of contracts. In these instances, direct control of production and distribution activities within organizations may be advantageous, largely because it is believed easier to formulate

directives, monitor compliance, and modify instructions within organizations rather than re-negotiate and enforce contracts between organizations. It may also be easier to develop trust among members of the same organization (because of repeated interactions and intertwined interests) than to generate such a commitment among members of different organizations involved in arms-length transactions (see Barzel, 1982; Cheung, 1983; North, 1990). Many public services have dimensions which are difficult to measure. For example, human services contracts between governmental agencies making provision decisions and service providers tend to be more incomplete than those contracting decisions involving public works services because it is difficult to define meaningful measures of the services provided by human service professionals (DeHoog, 1984). Effective monitoring requires quantitative measures of what counts as an appropriate level of activity by a service provider or the extent to which the services achieve their desired impacts (Deakin, 1996; Lewis et al., 1996).

Institutions and Credible Commitment

Contracting has also been linked to the existence of a stable administrative environment for city relations with external actors. Political or administrative uncertainty reduces the ability of a municipality to make credible commitments (Clingermayer and Feiock, 1997; Feiock Jeong, and Kim 2003).

Potential opportunism on the part of either government or service delivery agents poses a transaction costs. Contracts may offer incentives for efficiency, but they may also motivate the parties to act opportunistically. For governments, this threat may be reduced when service responsibility is given to non-profit organizations because they

may be perceived more trustworthy agents than private vendors, more likely to share public interest goals, and monitored by a combination of donors, clients, and government officials (Young 1999). Nonprofits motivated by low power incentives do not face the same imperatives to skimp on quality, renege on promised service levels, or lower costs of production by homogenizing services (Young 1999; Steinberg 1997).

The cost of negotiating a complex contract is enormously simplified if both parties trust each other (DeHoog 1984). For nonprofits, the risks of opportunistic behavior by local government officials are constrained by the institutional environment of local political systems. The progressive ideology of separation of politics and administration institutionalized in the reformed municipal government allows administrators and elected officers to more easily resist opportunistic behavior. Progressive reforms such as council manager government and nonpartisan elections were institutional changes that replaced high-power incentives political with low-power bureaucratic incentives (Frant 1996; Feiock Jeong and Kim 2003).

Uncertainty resulting from political opportunism makes entering into relationships with local government risky. Elected officials who are wary of displeasing contending coalitions or alliances of constituents may not be able to make credible commitments to important stakeholders. Progressive reform institutions may constrain these incentives and reduce the risk of opportunism in dealing with government.

The progressive reform prescription has provided bureaucrats with a useful myth and protective ideology. The useful myth is that of the politics/administration dichotomy, and the protective ideology is the ideology of neutral professional competence. Together, these often provide a credible constraint on the efficiency-undermining rent-extraction activities of those in political power (Miller 2000, 314).

Conversely, the incentive structure of unreformed mayor-council government and partisan elections may create incentives for officials to act opportunistically and promote personal and political goals in service delivery choices.

Leadership Turnover and Interorganizational Relations

Uncertainty regarding a city's future expectations and commitments is heightened by executive turnover. Officials who come into office during the life of an agreement may not be satisfied with the provisions of the agreement and may wish to re-negotiate the contract. Government officials may not be willing to enter into agreements for lengthy periods that would lock them into a particular mode of service delivery and specify explicit quantities of service, quality characteristics, or distributive criteria. More open-ended and flexible contracts with nonprofit providers that would enable governments to modify service provisions are possible, but such arrangements impose transaction costs upon the contracting organization that can make them unwilling to work with government or demand a premium for accepting possible interventions. In such instances, the cost savings from contracting out quickly evaporate (Sappington and Stiglitz, 1987).

However, we argue that turnover in leadership positions within city government results in uncertainty that may cause difficulties in negotiating and monitoring agreements, thereby making contracting decisions more difficult and less likely. Furthermore, if the critical personnel responsible for making commitments may be out of office in a short period of time, commitments that the city makes may not be viewed as credible. If that is the case, potential contractors may not bid for service responsibilities.

A quite different kind of expectation about the consequences of turnover is drawn from the political science literature on legislative delegation of policy-making authority to administrative agencies. Fiorina (1982), McCubbins (1985), and McCubbins, Noll, and Weingast (1987) have all suggested that legislators seeking reelection under conditions of political conflict make vague delegations of policy-making authority to bureaucracies in order to avoid the blame for controversial decisions. If we presume that leadership turnover represents political conflict, we might expect that turnover would lead to more external service delivery, with certain strings attached so that policymakers could still exert control.

Target Populations and Diversity of Preferences

The characteristics of target populations have also been linked to the use of nonprofits in service delivery. The attribute given the most attention is heterogeneity. Weisbrod (1988) has argued “dealing with diversity – which is fundamentally a problem of information – is a major problem for government.” In socially heterogeneous communities service delivery responsibility may be contracted to nonprofit organizations because government is unable to adequately differentiate its services in response to heterogeneous preferences in the community. The information costs of government are minimized by allowing nonprofit service agents to customize service provision to specific constituency groups (Young 1999).

Service Markets

The market for service delivery is shaped by the number and size of enterprises that could supply services. The availability of nonprofit providers has transaction cost implications for government because efforts to impose accountability are made difficult where there is a monopoly in the supply of service (Kettle 1993; Kramer 1981). The supply of potential contractors can be critical to efficiency and the control of opportunism in contracting, but this relationship has not adequately tested. In metropolitan areas, there are frequently many potential providers of service (Bielfield 2000). With multiple providers of services available, competition for contracts may drive down costs and the possibility of a long interruption of service is unlikely if one provider fails to provide adequate service and must be replaced by another provider. The supply of potential contractors has been highlighted in the literature as central to the efficiency of service contracts (Stein 1993; Feiock et. al 2003), but this relationship has not been subjected to systematic empirical test. Extant research has examined whether a city is located in a metropolitan area as a proxy for potential contractors but has not directly measured the availability nonprofit service providers.

Design

Some of the best recent work on service delivery has focused on health and human services that are frequently delivered by both local government and external providers. These services provide more variation in contractor choice than most of the more traditional services examined in studies of municipal contracting.¹

¹ For an excellent overview of the studies done on service contracting done in municipal governments see Boyne, 1998.

Where transaction costs for government are high, we expect greater reliance on nonprofit organizations. Decision to contract with nonprofit organizations were estimated with a model that identifies the influence of the transaction cost factors described above while controlling for other political and institutional constraints (Clingermayer and Feiock 2001; Brown and Potoski 2001; Stein 1991).

The data set for this study are cities that responded to the ICMA 1997 Alternative Service Delivery Survey that were located in metropolitan areas (SMSAs). Isolating cities in metropolitan areas allows us to include measured of the number of potential nonprofit service providers and racial segregation that can be measured at the metro level.

Contracts with non-profit providers are estimated for three services that are commonly contracted to nonprofits but vary in their tangibleness and measurement complexity (Feiock, Stream, and Clingermayer 2003). The three services are day care services, elderly programs, and drug and alcohol treatment. The frequencies with which delivery of these services were contracted to nonprofits is reported in Table 1.

Table 1 here

Independent Variables.

The characteristics of political systems that enhance credible commitment will be examined by identifying cities with mayor-council government and partisan elections. The data derived from ICMA's form of government survey. If a city was not included in the 2001 survey, the institutional structures for the last reported year were coded. Disruption of interorganizational relationships due to government turnover was measured by the proportion of years that a new mayor or manager was in office for the period from 1990 through 1999. These data were coded from ICMA's *Municipal Yearbooks* from 1990

though 2000.

The characteristics of target populations includes city level proportions of the population that is non-Hispanic white in the 2000 Census of Population and a measure of racial segregation to capture heterogeneity of service preferences. According to Weisbrod (1997), the more heterogeneous a community is – the more diverse citizens' preferences- the greater the need for nonprofit organizations. Tract level data was used to identify differences in residential patterns of one racial/ethnic group in relation to another to construct an index of black white dissimilarity for the metro areas in which a city was located.²

The analysis also directly examines how the nonprofit sector influences the service and contracting choices of local governments. Rather than rely on an indicator of whether a community is in a metropolitan area, we measure the size of the nonprofit sector in the metro area. Following the methodology of Bielfeld (2000) we use data from the National Center for Charitable Statistics (NCCS) Core Files to identify the total number of nonprofit organizations per capita for the metro area in which each city was located.

We also control for a number of factors that have been linked to service delivery choices in extant research including whether municipalities operate under state imposed

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1. ² The segregation scores are dissimilarity indices that measures differences in residential patterns of one racial/ethnic group in relation to another. The following formula was used to generate the black/white segregation scores.

$$D = \left(\frac{1}{2}\right) \sum \left| \frac{B_i}{B} - \frac{W_i}{W} \right|$$

the property tax limits, median household income, the 2000 population in thousands, and local government taxes per capita.

Results

Table 2 estimates the likelihood of governments contracting out with non profits for the provision of day care, elderly and drug/alcohol treatment services. Form of government was an important predictor. Cities with mayor-council governments were less likely to contract out elderly programs and drug/alcohol treatment to nonprofits than cities with council-manager forms of government. On the other hand, partisan elections did not influence contracting choices. While turnover in the office of the manager turnover had little impact, turnover among mayors made contacting with nonprofits for elderly services less likely.

Table 2 here

Where there is great diversity in service preferences, Weisbrod contends that rather than having government provide services and contract out production, local governments may seek out community organizations to provide services. For this reason our estimation of nonprofit contracting includes the proportion of population non-Hispanic white and the black/white racial segregation measure described above.

We found no support for Weisbrod's contention that diversity encourages nonprofit production. The proportion of the population that was non-Hispanic-white was positively related to nonprofit provision of elderly services. Geographic segregation by race produced consistently negative coefficients as predicted, but they fall short of statistical significance.

The number of nonprofit service providers in the community increased contracts with nonprofits for elderly and drug/alcohol treatment services consistent with our expectations. Table 2 also reports that per capita taxation increased nonprofit contracting of daycare and elderly programs. Tax and expenditure limitations increased nonprofit contracting for elderly services.

Discussion

This project is only at a very initial stage and much additional work is to be done in terms of refining the design, data sets, and methods of analysis. Nevertheless, this preliminary work provides some interesting findings which, if they prove robust, have important implications for understanding the role nonprofits in the delivery of municipal services.

The importance of form of government to decisions to contract with nonprofit organizations is particularly notable. The conventional wisdom is that city managers are more oriented to efficiency concerns than their elected counterparts in mayor-council government systems. If this is the case it could lead to greater reliance on nonprofits in the delivery of services. An alternative explanation relates the political incentives of elected mayors in mayor-council government. Because private for profit organizations may be more likely to provide instrumental political resources to election and reelection efforts, elected officials may reward political support with government contracts. This is also consistent with the negative effect of mayor turnover on nonprofit contracting of elderly services.

The market of nonprofit providers has been assumed important to government contracting choices in much of the literature but this has not been adequately tested in extant research. Nonprofit contracting has been consistently reported to be higher in communities in an MSA than communities not in a metro area, but these differences could be do to multiple factors, not just difference in the availability of nonprofit providers. By isolating the number of nonprofit service providers in the metro area we are better able to test this proposition. We find that for two of the three services examined, a greater number of nonprofit organizations increased the likelihood on cities contracting service delivery with nonprofit community organizations.

For this project we are creating a unique data set that combines detailed information on forms of government and political institutions from various ICMA surveys and data bases, comprehensive data on the number and types of nonprofit organizations from the National Center for Charitable Statistics, and private delivery alternatives from the County Business Patterns. This will permit us to investigate our research questions at various levels of aggregation. Our inquiry into contractor choices will investigate alternative models and proceed at the level of individual service, aggregate service and contracting choices of cities and counties, and patterns of service delivery for metro regions.

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Table 1
Frequencies of Production Choice for Local Services

	Daycare	Elderly Programs	Drug & Alcohol Treatment
Nonprofit Contractor	44	98	11
Private For-Profit Contractor	73	30	38
Total Cities Providing the Service	173	472	167

Sources: Survey of Profile of Local Government Service Delivery Choices (The number of observations = 797). International City Management Association, 1997

Table 2
 Probit Estimations of Nonprofit Service Production Choices

NPO PRODUCTION	Daycare (n=145)		Elderly program (n=388)		Drug & Alcohol Treatment (n=134)	
	Coefficient	z	Coefficient	Z	Coefficient	z
Mayor-Council	.2571	0.76	-.5515*	-2.48	-.7089*	-2.12
Partisan Elections	.0004	0.00	-.2107	-0.80	.1092	0.27
Mayor Turnover	.5707	1.22	-.5933*	-1.96	-.2277	-0.46
Manager Turnover	.2759	0.45	-.0171	-0.04	-.7702	-1.15
Non-Hispanic white	-.0141	-1.70	.0123*	2.29	.0017	0.20
Black/White Segregation	-.0010	-0.11	-.0094	-1.63	-.0167	-1.79
Nonprofit Providers	-5.057	-0.52	23.98*	2.21	96.18*	2.33
Population	3.01e-06	1.59	5.81e-07	1.52	1.97e-06	1.95
Per capita Taxes	.0008*	1.98	.00062*	2.29	.00048	1.43
Per capita income	-.00001	-1.35	2.28e-06	0.49	6.39e-06	0.82
TELS	.5571	1.57	.5302**	2.73	-.2464	-0.79
Constant	-.4401	-0.44	-1.797	-2.86	.2272	0.23
LR Chi2	19.76*		38.64*		27.04*	

*p<.05,