Section 2: When Do You Contract, When Don't You Contract, and How Do You Find the Right Contractor?

Chapter 5: When Should You And When Shouldn't You Contract Out?

The first contracting issue that public managers must face is the make or buy decision. This chapter focuses specifically on that issue. The issue of contracting out is one part of the role of the modern network manager. The manager asks: To what degree to we do this in-house? To what degree do we try to mobilize our network to take on this task? If we decide that the work should **not** be done in-house, is a contractual relationship needed? In our view, network management is an essential tool of the effective public manager (Cohen and Eimicke 2002). Learning when and how to obtain goods and services to help achieve your organization's mission is a key to success in an increasingly competitive and complex public marketplace. Without contracting, networking and the use of market forces, you may hire too many people, use those people inefficiently, spend too much and not be able to produce the highest quality goods and services. The profit motive of the private sector helps to ensure that the most efficient number of employees is hired and that they are used in the most efficient manner, helping to temper what could otherwise be an inefficient public sector. Sometimes the private sector can be brought in through a policy reform that provides them with incentives. We leave a discussion of that aspect of network management for another day, and will focus this work on government contracting. Contract poorly or inappropriately and you will spend too much, not be able to produce the highest quality goods and services and possibly fuel corruption.

Contracting is a complicated process. Managers must learn how to write contract requirements and elicit bids that obtain important services and products at the best possible price and quality. They must learn to work with, manage and measure the performance of these outside private and nonprofit organizations. This two-way sharing of information is essential to decision making in a networked organizational environment. Managers must also learn how to participate in teams that include both public and private sector partners.

This chapter begins by acknowledging these realities and then explores the critical strategic managerial issue of when to do it yourself. Under what conditions is the task best performed directly by your own organization? When should you develop the capacity in-house instead of purchasing it from another organization? The most striking recent example of this issue took place in the early days of the war in Iraq. This war involves an extraordinarily large number of private contractors in the war zone, probably more than at any other time in recorded history. Yet, at certain times during the war, private vendors refused to deliver services that might have placed their employees directly in harm's way. More problematic has been the presence of contractors in combat situations. This issue reached a crisis when the Blackwater security firm killed 17 Iraqi civilians in September, 2007. The contractors argued that they were acting in self defense, but the central issue for this analysis is the work that brought them into harms way and weather or not that work should have been done by U.S. military troops, IN addition to the issue of military policy and practice, there were also allegations of systematic overcharging for products such as gasoline and abuse of prisoners by employees of these contractors.

One of the reasons for the high level of contracting by the Defense Department (DOD) was a desire to keep the number of U.S. government troops as low as possible. Contracting allowed DOD to provide services privately, instead of using military personnel in some traditional support functions. The military deployment could then appear to be smaller than it was; an image that was sought for political benefit.

There are, of course, many other examples of contracted efforts that do not succeed and are replaced by development of in-house capacity. Our objective is not to argue against contracting, but rather to enhance our understanding of the factors that limit it.

We strongly believe that contracting is a tool that managers must learn how to use effectively and that it is an important method for improving organizational performance. As Peter Drucker (1999) notes, a substantial and growing minority of the people who do the work of most organizations work for an outsourcing contractor. The scarcest commodities in organizational life are the time and brainpower of the organization's management. It is important for top management to take great care in allocating that time and choosing areas of focus.

What are the political, strategic, organizational, financial, cultural and other factors that make it difficult to contract out a function? Are there any patterns to contract failure that can be identified and known in advance? Our goal is to give managers faced with "make-or-buy" decisions a more sophisticated tool for making this key strategic decision.

The Make-or-Buy Decision and the Development of Distinctive Competence

In a private organization, the make-or-buy decision is mainly a matter of organizational strategy: What type of organization do we want to be? Chester I. Barnard (1938) wrote that the development and maintenance of distinctive competence is the core definitional decision that management must make in any organization. This involves addressing the following types of questions: What do we do around here? How should we do what we do around here? What skills and competencies should we develop in-house, and what should we rely on vendors to produce?

An example of the make-or-buy decision is the decision of Columbia University to out source much of the food preparation for the university. Columbia management decided that the university was about achieving world class performance in the classroom and the research laboratory. In the kitchen, they needed help. Private, outside vendors were brought in, and food service improved almost immediately. In making this decision, the university decided not to allocate scarce management time to managing food operations. It made a decision about the areas of distinctive competencies they choose to develop and those they choose to purchase in the market place.

Making or buying is not the only way an organization makes decisions on distinctive competence. IBM for example sold off its PC business to focus on servers and U.S. Steel has evolved into a company mainly focused on energy. New York City's fire department has increased its focus on fire response, and the U.S. EPA has increased its emphasis on the human health impacts of environmental pollution. All of these changes in emphasis are achieved outside of any consideration of the make or buy decision.

This chapter focuses on the relationship of the make-or-buy decision to the development of distinctive competence. Organizations can also make broad strategic decisions to develop new capacities due to emerging trends and opportunities. Such issues are important in defining organizations, but outside the scope of this work.

The decision not to contract, to make rather than buy, is, at its heart, a decision to retain and emphasize an area of distinctive competence**. An organization must ask itself the question: What work is so central to who we are and what we do that we must maintain the ability to do it ourselves?**

One issue contracting poses to an organization is whether the organization should retain enough expertise in the functional area to properly manage the work that is contracted out. In this sense, the organization maintains enough competence to manage, if not perform, the function. The decision to contract is not an “on-off” switch for the development of in-house capacity but rather a continuum. The competence needed to manage a contractor may or may not differ from what is needed to directly manage the work. Municipalities around the world have attempted to accomplish this by contracting out certain services by district, while at the same time keeping at least one district directly served by public employees. This was the case with solid waste disposal in Bogotá, Colombia, and Phoenix, Arizona (Osborne and Plastrik 1997; Eimicke, Cohen and Perez-Salazar 2000). Or, as Steel and Long concluded from their study of road maintenance and construction by Oregon counties, “it is important for counties to maintain an independent capacity to provide maintenance, improvement, and construction of roads to insure both least cost and quality service” (1998, 250).

The decision to contract a piece of work rather than perform it in-house affects the organization and also the capacity it retains. So, in deciding to contract, it is essential to project the impact of contracting on the organization. One reason an organization develops distinctive competence is to compete for and obtain resources. An organization gains market share in the private sector, or missions and turf in the public sector, because they do something better than anyone else and can convince customers or elected officials to “purchase” the outputs of their organization. A danger with over-contracting is that an organization can lose its capacity to deliver outputs by becoming too reliant on the work of other organizations. These other organizations can develop quasi-monopolies and raise their prices and/or lower their quality and reliability. They can also become your competitors. Over time they may be able to obtain their own resources without relying on the funds provided by your organization, or they may offer to take over the policy-making and coordination functions that you perform.

Therefore, the issue of contracting must be viewed in light of the issue of organizational capacity. It may well be that an organization seeks to get out of the direct business of delivering service and simply wants to set policy and manage contracts. In the 1980s, nearly all the homeless shelters in New York City were run directly by government. In 2004, the reverse was true--most of the homeless population lived in shelters run by nonprofit contractors for the city. The direct management of these facilities is no longer a core function of the city’s government. The nonprofit contractors deal with the problems related to day-to-day shelter operations, while the city agency addresses overall policy issues. While implementing policy through contractors and networks can be difficult, freeing capacity from running the day-to-day operations of service provision the organizations is able to focus its resources on the creation of sound public policy.

Why did New York City choose to get out of the direct homeless service business? As in many other circumstances where government opts for nonprofit service providers, the decision is often "guided by both ideological and utilitarian considerations" (Schmid 2003, 308). The advocates and media generally view nonprofits as mission-driven and thereby more likely to do a better job of delivering social services than civil servants could. The contracting mechanism can also enable the public manager to "bypass bureaucratic constraints that would apply if they delivered the service directly" (Sharkansky 1989; Framer 1994; Schmid 2003, 308). In fact, many observers view the trend to contract with nonprofits as a means to use public funds more efficiently and make services more responsive by moving services and decision making closer to the consumer through the use of community-based nonprofit organizations (Bingman and Pitsvada 1997; Else et al. 1992; Hanly 1995; Ryan 1999). Overall, the city's altered capacity in assistance to the homeless did not impair service delivery, and was, in the end, seen by practitioners as a positive development.

In sum, contracting out services changes the nature of the organization's own work, and it may have a positive or a negative impact (or a little of both). Before deciding to contract, an organization must determine if it is willing to accept this change in capacity. A negative impact on a capacity that the organization wishes to retain and develop is the first reason not to contract.

Contracting and Accountability

The fact that the New York City Department of Homeless Services does not directly run its own shelters may make it more difficult for them to control what goes on in the shelters, but it does not shield them from responsibility for actions that take place there. By separating policy formulation from implementation there is a possibility that the control of implementation becomes more difficult. Government agencies must be certain to retain the capacity to manage the work of contractors, must ensure that contract provisions permit effective management. In situations where the contracted organization holds a monopoly, effective management is nearly impossible,

Making a service available through the private marketplace is not the same as providing a government service. Government administrators must be authorized by law before they can act. An elected legislature and executive must provide authority and resources before a government agency can perform a task. Those that authorize this work are responsible to the electorate for its effective performance. Those that perform this work are responsible to the elected officials who authorize it.

The chain of accountability stretches from authorization to actualization. The “chain of command” typically will include people in many different locations. The degree of administrative discretion can vary widely as can the very definition of the work being performed. When government uses a nongovernmental contractor to perform a task, the chain of accountability may be broken. On the other hand, if accountability is the degree to which a worker can be held responsible for the performance of a task, the issue of accountability may not be so clear-cut. If a government worker is a life-time, permanent employee of the government, it may be difficult to punish that worker for failure or provide a reward for success because of civil service protections and lifetime tenure. A contractor, on the other hand, could be subject to both termination and bonus clauses. The increased motivation could also be used to ensure that the contractor reports results and accepts direction from the public. In contrast, a government worker might simply ignore the public.

Therefore, the issue of accountability in many functional and program areas may be ambiguous. Other times, the issue may be quite clear. Furthermore, there very well may be program or functional areas where the issues of accountability are so profound that the work truly must be performed by government officials in a direct and meaningful chain of command. Issues of intelligence, national security and law enforcement are prime areas that require further exploration.

Issues of chain of command and accountability are less important when we are trying to find out why a park bench was not painted than when we are trying to find out who allowed a terrorist into the country. Speed and a clear chain of command may be a matter of life and death. The ethical and moral authority to place an employee in harm's way is another example of a management function that does not belong in the private sector. While some tasks may involve some degree of risk, such as working in a location where weather or other conditions may pose danger, this is different from a war situation in which a worker might be shot at. In all cases of private work, workers can and must be given the opportunity to remove themselves from risk. In the case of work that is performed by government, such as fire and police protection or military service, the situation is reversed; those on these front lines can be punished for desertion or dereliction of duty if they refuse to face danger.

A more complicated situation arises when government contracts with nonprofit organizations to provide critical human services, such as home health care and foster care for children. Here, government officials are challenged to “hold nonprofits accountable without micromanaging them” (Buchanan and Snyder 2001, 13). The issue of accountability is one that recurs whenever we examine contracting. No matter what other issues are raised in a case of contracting, accountability seems to emerge as well. As a general rule, a reduced ability to ensure accountability, in an area where accountability is critical, is a second reason not to contract.

Contractors Without Capacity

When an organization finds itself without the capacity to perform a task, it often makes the assumption that this capacity exists elsewhere and can be purchased. In the case of some military equipment contracts, the agency knows that capacity does not exist and pays a contractor to develop this capacity. For example, to develop new weapons systems, the capacity purchased is the Research and Development infrastructure needed to build that new system. The military has decided that private firms are better suited to develop and maintain that capacity. The government then attempts, with a history of mixed success, to prevent the contractor from selling the capacity to foreign governments.

We are not arguing that one should not contract in the hopes of developing new capacity. The way that the military explicitly contracts to develop new weapons systems may very well be the best option available to develop such cutting edge technology. Our concern arises when a contract is let out of desperation in the hope that the contractor can fix something the government has failed at providing. Cause for concern is heightened when an agency thinks the contractor knows how to do something, when in actuality, the capacity has not even been developed. The classic case of this type of contracting was the New York City Parking Violations Bureau under then Mayor Ed Koch in the 1980s. The city let a contract for a hand-held computer device that would permit parking enforcement agents to write and print tickets on the spot, as well as download such records to a mainframe computer. The “prototype” that was delivered to the city was a plastic box with nothing inside. As a result of the scandal that followed, the Queens Borough President killed himself, and a number of other people went to jail.

A less dramatic, but more significant example of this phenomenon has been the contracting of the management of a public school system. In some cases, this is a positive affirmation of a desire to improve quality. In other cases, the elected leaders of a jurisdiction have given up the direct management of this critical governmental function in the hope that a private firm could do a better job. The resources to do the job may not be available, and/or the community itself may be in such a state of disarray that educators are asked to perform tasks that should be performed by families, religious institutions or other parts of the community. Contracting under these circumstances may create unrealistic expectations and may simply not work.

The decision to buy a capacity or product that has yet to be produced is inherently risky. The capacity may never develop, or it might develop in an unexpected fashion. The organization that develops the new capacity might then have a monopoly and may decide to charge an exorbitant price for the service or product. The strategic issue for the organization relates to the options available. What alternatives does the organization have to access the capacity it requires? How critical is development of this new capacity? Is there any way to develop this capacity in-house?

If the organization must contract to develop a new capacity, it should also develop a contract instrument that allows it to own what it has paid to develop. The organization should also ensure that an effective method is developed to assess contractor performance. In the absence of such a tool for performance measurement, an organization could end up with the portable computer bought by New York City's Parking Violations Bureau—the empty plastic case.

Critical and Non Critical Functions--Under What Conditions Can a Task Not Be Delegated?

One would assume that there are some functions so central to an organization's functioning that they should not be contracted out. For example, one might assume that a university cannot contract out instruction and an army cannot contract out fighting. However, we have examples of both forms of contracting. A fashion company like Calvin Kline not only contracts out clothes manufacturing, it also contracts out for design work. The organization's distinctive competence has evolved into branding and marketing and it mainly performs communication and quality control functions. Similarly, the military in Iraq has contracted out security functions that are traditionally the preserve of their own soldiers. Finally, universities are increasingly entering into consortium arrangements with other schools to provide instruction in areas they do not wish to cover.

The core function of an organization can change over time as an organization's strategy changes. Often, strategic change is a response to new technologies as well as change in society or patterns of economic consumption.

When Shouldn't You Contract?

There is no universal rule of when to avoid contracting other than a connection to organizational strategy and the presence of contractor capacity. An organization should not contract if capacity it deems essential is impaired or if the quality of a good or service will deteriorate below acceptable standards. We also suspect that in situations when an extremely high level of accountability is required, vertically integrated command and control hierarchies are more appropriate than contracted network relationships. The need for high levels of accountability tends to be common in life and death situations and in performing criminal justice functions.

Politically sensitive issue areas that require a high degree of confidentiality or the ability to modulate a response action to a fine degree of variation are also examples of situations where contracted relationships might be unwise. The difficulty that command communications have when penetrating complex hierarchies and the problems faced by expert advice as it works its way up the chain of command are well known management dysfunctions. Diane Vaughan identified this issue in her analysis of the Challenger space shuttle disaster when she discusses the difficulty that lower level but expert staff had in influencing decision making (1996). In his classic treatment of the Cuban missile crisis, Graham Allison discusses President John Kennedy's concern that his instructions to naval officers for modifications in standard naval interdiction and blockade procedures would be ignored or misunderstood (1971). We have no reason to believe that contracted relationships would eliminate these problems. In fact, we suspect that they would be exacerbated by the added impediment of organizational self-interest and distinct organizational cultures.

As we mentioned earlier, our deepest concern about the decision to contract is that some ideologically oriented decision makers have a bias toward the private sector--or to the public sector--that colors their thinking about this issue. The decision to contract is complex and requires a clear analysis of costs and benefits. In no case is the decision to make-or-buy cost free. Something is always gained and something is always lost. The issue is: are the gains more important to the organization and its mission than the losses?

Let us return to the issue of accountability as a rationale for avoiding contracting. Later in this volume (in Chapter Nine) we will discuss the problems of military contracting in the War in Iraq, and we mentioned this issue in Chapter Two as well. Military action requires a clear chain of command and involves military discipline when orders from that decision chain are not obeyed. History tells us that military discipline breaks down during times of great stress, but is an essential means for operating during such times. The need for immediate decision and response and for a clear and direct relationship to public authority leads us to avoid interorganizational relationships and communication during war. This is difficult when services branches like the army and navy must cooperate. The addition of private organizations to this already challenging work environment makes it difficult to develop and maintain this type of discipline.

In addition to this issue of coordination, there is also the issue of the legitimacy of private action. If government, duly constituted, takes the life of a person under its jurisdiction, that is tragic, but in all likelihood a legitimate and legal act of government. A private organization is not authorized to take someone's life or liberty. Moreover, such authorization of private acts without the ethical rules and political norms regulating government's behavior opens the door to illegitimate acts by private parties. These are therefore instances when contracting should be avoided if at all possible.

Similarly, if there is a pattern of corruption and contract abuses in a particular program, it might be appropriate to perform contracted tasks in-house, until the corrupt practices are eliminated. Of course, the opposite could happen: a dysfunctional pattern of pay-offs by corrupt government officials can be disrupted by having private contractors replace public officials in implementing a program.

Developing a Contracting Strategy

Just as a manager decides the mix of skills and the level of experience needed within an organization to implement programs, so too should a manager develop a strategy for deciding when and what to contract. Not all of these decisions follow goal-seeking rational patterns. Sometimes there is an opportunity to hire someone with a unique mix of skills and you build your organizational capacities around the strengths and weaknesses of that individual. This can influence the mix of internal staff and contractor capacity that you put together. Sometimes you identify capacity in a contractor's organization that you would like to own within your organization—and we see many examples of parts of a contractor firm joining the government. At other times you find that the contractor refuses to join your organization, although that is your preference, and the only way to access that talent is through the private organization.

The obvious first step in developing a contracting strategy is to inventory all the capacity you need to implement your program. With that inventory in hand, you are then ready to decide which of those capacities you prefer to own and which you prefer to buy. There is a tendency for certain types of capacity to develop in the public sector and other types to develop in the private sector. Some capacities tend to be found in the nonprofit part of the private sector, while other capacities are more frequently found in the for-profit sector. These are tendencies and not absolute laws. Sometimes a capacity you would expect to find in the government happens to be present in a private firm. Sometimes you will find the reverse to be the case. A contracting strategy will take advantage of these opportunities and not allow preconceived notions to interfere with the development of needed capacity.

The development and accessing of capacity will change over time, and a contracting strategy should reflect this dynamic dimension of capacity building. Sometimes you incubate a capacity internally and then you devolve it to private firms. The development of the Internet followed this course. It began as an internal Defense Department project with heavy government leadership and implementation. It then became a contracted-out government function and eventually became a regulated private activity.

Conclusions

We are not “against” contracting. We think that, in many cases, it is a good way to deliver public services. Contracting is, however, a tool—a means and not an end. Just because we have a hammer, doesn’t mean we need to find a nail. There are situations when contracting should be avoided. One should avoid the mindset that contracting represents more advanced or sophisticated management. There are situations where bringing in outsiders is appropriate and necessary. There are also situations where contracting is a very bad idea. The purpose of this chapter is to introduce the notion that the make-or-buy decision should be left to managers and wherever possible removed from political decision makers. This is not an easy goal to accomplish. However, the key is to bring contracting into the routine tool box of the effective public manager. Political people don't typically try to influence the accounting system or the human resource management process used by the agency. The objective here is to routinize contracting and promote the concept that the make or buy decision is a routine management practice, not worthy of the attention of elected officials.

With this chapter we have begun our focus on the "nuts and bolts" of contracting. The first obvious contract management issue that public managers face is the make or buy decision. Our treatment of this issue began by delineating government functions that should generally not be contracted. We hasten to add, however, that most of government's work does not involve the need for extremely high levels of accountability or raise issues of life and death. For most government organizations, the make or buy decision is one that is amenable to analysis and strategy. While most government operations *could* be contracted out, that does not mean they *should* be contracted out. The next chapter makes the assumption that you have decided to contract out a service or function. Once that decision has been made, the public manager must identify potential contractors. In chapter 6, we ask: How do you find the right contractor?