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The Transactional and the Relational Approach to Contracting Out for Public Services: How Do They Work?

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Abstract

This article aims to investigate how the role of the purchaser is exercised by local governments (LGs) when they contract out the delivery of public services. In particular, the article tries to identify which practices are applied when public services are contracting out. In achieving this it employs a framework developed by MacNeil for investigating how the role of “purchaser” is managed in contracting out for public service delivery. The study is based on the analysis of two services (waste management and home care services for the elderly) offered by three LGs in Italy. Transactional and relational contracting may be described as two poles of a continuum; accordingly, the crucial issue becomes identifying which is the right point (or the right mix) in a unique continuum for every outsourcing situation and is dependent on a balance of various factors, such as the type of service, the type of provider and contextual factors. The paper demonstrates with empirical evidence that the relational and transactional approaches are not substitutes for one another, but are both useful for contracting out.

Finally further research is needed in order to investigate the effects on the quality of service due to different governance systems used for contracting out and the evolution of the life cycle of the contract in relation to the different application of the transactional and relational approaches.

Keywords: contracting out, public services, transactional contracting, relational contracting, local government.

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Introduction

Local governments (LGs) have traditionally produced public services in-house. However, New Public Management (NPM) reforms encouraged them to improve their efficiency and responsiveness. In this context, contracting out has become one of the key practices used to cut costs and for stimulating the efficiency and quality of public service delivery (Ferris and Graddy, 1991; Barlow and Röber, 1996; Kettl, 1993; Savas, 2000).

Contracting-out, also referred to as outsourcing, is defined to take place when a local government purchases services from a private firm under contract but retains accountability for the service (Savas, 1987; 2000). Contracting out entails a change in the functions carried out by public organizations, which are now required to plan and monitor. Osborne and Gaebler (1992) refer to this change in public functions as “steering not rowing”, suggesting that public organizations are not always the best-equipped providers.

Some authors have shown that contracting out is not always a successful choice for public service delivery (Hirsch, 1995; Boyne, 1998; Lavery, 1999; Kakabadse and Kakabadse, 2001), since it may raise many shortfalls, such as the potential loss of control and accountability in service delivery, difficulties with monitoring the contractor’s performance, and the possibility of corruption, waste and political favouritism when contracts are assigned (Donahue, 1989; Kettl, 1993; Sclar, 2000; Fernandez, 2007).

Some experts suggest that the successful contracting out of public service delivery entails an effective management of the contracting process (Donahue, 1989; Kettl, 1993; Prager and Desai, 1996; O’ Looney 1998; Kelman, 2002; Brown and Potoski, 2003; Van, Slyke, 2003; Van Slyke, 2007).

Indeed, once public organizations decide to contract out a service, it is critical that they develop appropriate tools and managerial skills in order to negotiate, monitor and communicate their expectations and technical information (Kettl, 1993; Van Slyke, 2003, 2007).

Accordingly, the aim of this paper is to investigate how the role of “purchaser” is exercised based on a framework developed by MacNeil (1978, 1985) that identifies two ideal types of contractual relationships (transactional vs. relational).

More specifically, the research aims to contribute to the debate on the type of relationship existing between transactional and relational contracting.

The paper is organized as follows: section two reviews the theoretical background. The third section focuses on research methodology. Results are presented in section four and discussed in section five. Issues and conclusions emerging from the study are discussed in the last section.

Theoretical background

According to MacNeil (1978; 1985), the contractual relationship between the purchaser and the provider of public services can be interpreted as having either a transactional- or a relational approach.

A transactional approach involves a situation marked by conflicting goals, whereby the main effort required of the purchaser is to contain any opportunistic behaviour on the part of the provider.

This approach is based on the agency theory (Jensen and Meckling, 1976; McAfee and McMillan, 1986). This theory posits that the agent (who executes some tasks on behalf of the principal) does not necessarily share the same interests of the principal and, therefore, will try to discreetly pursue his own goals to the detriment of the principal.

This opportunistic behaviour comes from exploiting asymmetric information (Alchian and Demsetz, 1972; Eisenhardt, 1989a; Jensen and Meckling, 1996). Asymmetric information depends on contingent factors, such as specific features of the service in terms of uncertainty and measurability (Williamson, 1981; Eisenhardt, 1989a).

Many experts supporting the transactional approach identify the following elements as being critical for the success of outsourcing services: the development of precise and detailed contracts; careful monitoring of the contractor's performance; the use of legal means to sanction an unresponsive contractor; limiting the contractor's power of discretion (Wesemann 1981; Marlin 1984; Savas 1987, 2000; Kettl 1993; Lavery 1999).

The notion of the completeness of contracts is a controversial issue: it has been seen that limited rationality and asymmetric information have a negative impact on the degree of contract completeness.

Moreover, incomplete contracts may even be considered more desirable when some elements are unverifiable (Bernheim and Whinston, 1998). In this situation, a complete contract could lead to the paradox outlined by Kerr (1975): the contract implies paying for A, when B is what the principal would actually like to receive.

Lou (2002) suggests that contract completeness is a multidimensional concept, including both term-specificity and contingency-adaptability. Based on this perspective, an outsourcing contract is complete if it details the terms and identifies the actions for managing future disputes, conflicts and contingencies.

Contingency-adaptability refers to the need to define in advance which actions will be carried out as a result of any potential event that could occur during the contractual relationship. To date, great emphasis has been placed on contract-specificity: on the one hand, a high level of contract-specificity leads to the definition of clear and understandable expectations on the part of the contracting parties (service attributes); on the other hand, it facilitates effective contract monitoring (Fernandez, 2007).

Furthermore, a high level of detail helps to clarify the local government's expectations for contractors and public officials, as well as holding the contractor accountable for his performance.

As far as term-specificity is concerned, we can distinguish between performance- and regulatory contracts (Donahue, 1989; Behn and Kant, 1999).

Performance contracts specify which services should be offered in terms of outputs and outcomes and make vendors responsible for their performance; regulatory contracts define how things should be done, making vendors responsible for processes based on a more legal and bureaucratic approach (Borgonovi, 1996).

The existence of a detailed contract is linked strictly to the monitoring of the contractor's performance. Rigorous contract monitoring is considered a key element in improving the success of outsourcing, as it helps identify any opportunistic behaviour on the part of the contractor and reveals his final performance.

Hefetz and Warner (2004) have shown that the absence of a good monitoring system leads to higher levels of contracting back-in.

Finally, the transactional approach includes the need to rely on legal means for resolving disputes, especially sanctions in cases of breach of contract by the contractor. This mechanism includes financial penalties and resolution of contract.

In contrast, the relational approach is associated with the idea that goal convergence exists between the contracting parties. This approach is based on the stewardship theory, defining situations where the contractor is not motivated by his own individual goals but has goals in line with the objectives of the principal (Davis et al. 1997).

In order to achieve good performance, relational contracting puts the focus on communication, collaboration and altruism, and does not involve recourse to legal means in case of dispute.

Literature on relational contracting highlights the importance of flexibility achieved by means of regular communication and joint effort by both parties in order to identify and solve problems throughout the life of the contract (Macneil 1974, 1978; Williamson 1985; Sclar, 2000), such as the alteration of certain service attributes during the life of the contract if necessary.

This approach does not resort to legal means in case of dispute because of their tendency to worsen conflicts and prevent mutual adjustments. Trust plays a central role in this approach and appears to have a positive effect on contractor performance (Arrow 1974; Macneil 1980; Williamson 1985; Sclar 2000). Trust is supposed to play a deterrent role: on the one hand, contracting parties seem less prone to behave opportunistically; on the other hand, transactional costs tend to decrease. What's more, trust is considered a sufficient factor for reducing transaction costs. Detailed contracts generate negative effects on cooperation development (Macaulay, 1963, Ghoshal and Moran, 1996; Bernheim and Whinston, 1998).

The two forms of contracting are considered differently in literature. Some studies on economics and sociology have considered them to be general substitutes: the presence of one obviates the need for the other (Larson, 1992; Gulati, 1995; Dyer and Singh, 1998; Macaulay, 1963). Other authors see them having a complementary relationship (Sitkin, 1992; Lorenz, 1999; Poppo and Zenger, 2002), emphasizing how cooperation allows the rigidity of outsourcing contracts to be overcome.

In this study, we use the transactional- and relational approaches to examine how LGs manage their relationship with service providers.

NPM literature tends to support the transactional approach (Pollit & Talbot, 2004) but there is evidence that public organizations are often incapable of building and using contracts, especially performance contracts (Ryan, 1999; OECD, 2004; Proeller, 2005).

Indeed, public managers seem still reluctant to apply performance indicators to measure outcome and public value (Beh and Kant, 1999; Ryan, 1999): according to literature (Pollitt and Bouckaert, 2000; Osborne 2000; Smith and Grinker, 2003; Longo, 2005), this is due to the difficulty in observing service performance and to the strategy whereby the expected performance is concealed in order to avoid the possibility of ex post failure.

Methodology

This article aims to investigate how the role of purchaser is exercised by LGs when they outsource public services. In particular, the article tries to identify which practices are applied to the contracting out of public services.

In this way, we can analyze the coherence of the practices adopted with the characteristics of the two main approaches outlined in literature.

Our research strategy is based on multiple case-studies: according to Yin (1984), multiple case-studies are useful as a basis for comparison and replication. Accordingly, we selected three Italian municipalities (which will be called S-Town, P-Town and B-Town in order to safeguard their anonymity). For each municipality, we focused our attention on the contracting out of two public services (waste-management and home care services for the elderly).

The reasons for this choice are explained as follows:

- focusing on a single level of government facilitates comparison by controlling the effects of historical, legislative and cultural differences among different levels of government;
- the local level is the most active in the contracting out of public services, especially for those services used directly by citizens;
- waste management and home care services for the elderly differ in some of their characteristics, such as the level of measurability and programmability, which literature (Brown and Potoski, 2003) has identified as having an impact on outsourcing. Consequently, investigating these services will enable a better understanding of whether the differences in the kind of outsourced service affect how providers exercise their role as purchaser.

The cases were selected in two stages (Patton, 2002; Flick, 2002). Firstly, LGs were chosen in order to minimize the differences resulting from their normative, institutional and dimensional (25,000 – 40,000 people) characteristics (Powell, 1985).

Following this criterion, LGs in the same Region were selected – Lombardy – after a telephone interview designed to understand how they offer public services. A second selection criterion was availability (De Masi, 1985): we analyzed three LGs where managers were interested in the research and agreed to be interviewed.

S-Town is a medium-sized Italian city with 16,000 families, totalling about 37,458 citizens, located in the Province of Varese; senior citizens represent 21% of the population.

P-Town has 33,965 inhabitants, of which 15% are senior citizens. The Town is located in the Province of Milan. The Town has experienced a population boom over the last fifty years due to migratory movement from the South of Italy and from other countries. Finally, B-Town has 27,052 citizens, of which 22% are senior citizens. Local industrial growth has caused a rise in the number of inhabitants and buildings since the Fifties.

Data was collected through original documents and in-depth interviews (Flick, 2002) with the relevant actors. Firstly, primary documents (such as budgets, reports and outsourcing contracts) were analyzed in order to collect background data. Secondly, we interviewed the managers in charge of waste management and social services at each LG. Each interview lasted about 90 minutes and all the interviews were conducted asking questions and taking notes.

The combination of these two data sources improves the likelihood of an accurate and reliable theory (Eisenhardt, 1989b). Finally, the data was analyzed and coded based on the three steps of data storing, managing and processing according to Glaser and Strauss (1967) and Miles and Huberman (1984).

Findings

Contracting out waste management services

Two LGs (S-Town and P-Town) have outsourced waste management to privately-owned businesses; while B-Town has outsourced it to a joint-stock company owned by a neighbouring Municipality.

All three Towns have adopted outsourcing contracts¹, which define the attributes of the waste management services in terms of inputs, processes and outputs. S-Town and P-Town have defined intermediate standards, such as the recycling rates that providers must guarantee.

The outsourcing contracts define sanctions that will be applied to providers when they fail to meet the service standards, whereas incentives are not contemplated.

Despite this, S-Town has never applied sanctions to its provider. This is the result of a clear strategy, as the manager of waste services claimed: *"We don't sanction our contractor because we don't want to make the contract relationship inflexible"*.

All three Towns control the invoices received from the provider in order to check that the amount of money demanded matches the services actually rendered. Performance is monitored weekly by means of inspections carried out by municipality employees and by the collection of user complaints. S-Town collects users' complaints separately and then requires the vendor to act in compliance with the terms of contract. The contractor collects user complaints on behalf of P-Town and B-Town. P-Town asks its provider for a report indicating the number and the object of complaints. None of the LGs we interviewed do any analysis on customer satisfaction levels.

The contracting parties also employ mechanisms associated with the relational approach, even if they were unaware of the principles and logics of the stewardship theory. They communicate daily, as P-Town's manager of waste services pointed out *"We phone and mail each other 10 or 15 times a day"*.

Communication can have two different reasons. On the one hand, it is a consequence of monitoring the activities, with the aim to increase the level of contract compliance. As the managers in B-Town and P-Town asserted: *"We try to communicate as often as possible, because we want to be sure that providers are executing the contract properly"*. We can, therefore, ascertain that the relational approach was employed in our cases not because there was trust between parties, but actually for the opposite reason.

On the other hand, communication between LGs and providers represent a tool used by the LGs in order to drive their providers to adjust service delivery in line with new situations that arise in itinere and need to be managed in order to safeguard overall effectiveness.

In this regard, the managers of waste services in S-Town and P-Town pointed out that providers are driven to accomplish the municipalities' goals by the desire to enhance their organization's reputation (*"Reputation is important for contractors because public managers assess past performance in order to identify future providers. Neighbouring municipalities invite us to pass judgment about our provider if they are bidding for a contract"*, according to the manager in charge of waste services at S-Town).

Reputation enhancement appears to be a contract enforcer. Since being acknowledged as a good performer facilitates the renewal of old contracts and the stipulation of new ones, providers have incentives to try to meet the goals of the principal (Brook and Smith, 2001; Grimshaw et al., 2002)

¹ Such contracts define the service delivery characteristics. In general, this contract should define the exchange conditions, the outputs and the quality standards of the service.

Previous studies have also highlighted the importance of reputation, pointing out that “competition is not as important as reputation” (Van Slyke, 2007).

In B-Town, the contractor is not only required to be flexible, but is also actively involved in any decision-making processes affecting the service.

On the one hand, the development of a wider cooperation is facilitated by the nature of the provider (a joint-stock company owned by another municipality): “*Relationships with the current provider are more collaborative than with the previous one, namely a privately held company*”, according to the manager of waste services. This result seems to support the claim that principal-agent problems appear to be greater with business contractors than with non-profit and inter-municipal contractors, as pointed out by Brown and Potoski (2003).

On the other hand, since user complaints are collected by the service provider and not reported to the LG, managers try to prevent any loss of control over user needs and perceptions by obtaining information by involving the contractor in relevant service decisions.

This adds a new insight, since it suggests that the use of more relational-based mechanisms is the consequence of efforts to overcome weaknesses in the outsourcing governance system. In other words, what happens is that an aspect of monitoring, which the transactional model says should be done autonomously by the LG, is actually carried out by the contractor. As a result, the LG attempts to remedy its lack of control by involving the provider in the co-design of the features of the services delivered.

Outsourcing of home care services for the elderly

The outsourcing of home care services for senior citizens has a particular configuration at the LGs studied, as the LGs have outsourced service delivery to charities, retaining the selection of service beneficiaries for themselves.

This service differs from waste management due to its individual nature and because the context of limited resources demands the selection of eligible service beneficiaries (Borgnovi, 1996).

This selection represents a key element in the provision of the service; what's more, it is an activity marked by a high level of political sensitivity. Therefore, assigning it to a provider in the absence of clear rules and criteria, could lead to a loss of control.

Generally, senior citizens who need home care must apply to Social Services. Social workers assess the needs of the elderly and design a personal targeted plan with the service provider that involves specific social activities for each senior citizen.

This agreement may be rewritten several times in order to meet the changing needs of the individual user. As a result, the parties exchange information continuously during calls and meetings. Flexibility and joint problem-solving are indicated by interviewees as key elements in contract management. They also pointed out that the contract signed at the beginning of the relationship acts as a general guideline for indicating the amount of outputs (hours of social work) that should be provided.

Thus, the contracting parties complete the terms contained in the outsourcing contract by adopting cooperative mechanisms throughout their relationship. The contracts did not contemplate bonuses in any of the cases but did specify sanctions, however only P-Town implemented the sanctions.

Sanctions were not implemented by S-Town because “*the charity that provides the services works well and our users are satisfied*”, according to the Manager of Social Services.

B-Town also never sanctioned the vendor, but in this case the reason was the lack of clear identification of the events leading up to the application of sanctions: “The outsourcing contract is not specific about this. It is difficult to apply sanctions on the basis of blurred criteria”, claimed the Manager of Social Services.

Complaints are not commonly used as a control mechanism, since “Elderly people prefer to express their needs directly to the assistants who take care of them, but do not send us complaints ” (Manager of Social Services at P-Town).

The monitoring of the contract is mainly focused on the number of hours of service provided because the amount of money to pay the contractor depends on this.

However, other, “softer” aspects (such as the level of quality of care perceived by senior citizens) are managed and controlled using relational tools (such as meetings and weekly briefings) with the aim of co-designing the type of services provided.

Discussion

Our empirical analysis shows that LGs exercise their role as purchaser by adopting mechanisms belonging to both the transactional and relational approaches.

If we look closer at the contracting relationships, they appear to be better explained from an agency theory perspective; our principal findings highlighted that public managers basically do not trust their contractors. However, it should be noted that typical mechanisms of the relational approach are actually used by public managers during contractual relationships, even if this is done in the spirit of the principal-agent theory. Mechanisms borrowed from the relational approach seem to be useful for integrating tools belonging to the transactional approach, such as contract- and monitoring systems.

The need for more relational-based tools seems to emerge alongside the evolution of the contractual relationship, whereas a more transaction-oriented approach emerges at the beginning of the contractual relationship.

Public managers devote attention to the writing of the contract terms in order to define what is expected from the provider and the mechanism for avoiding opportunistic behaviour. Contracts show differing degrees of completeness in this regard. Contracts for waste management are more specific than those for social services. Waste management contracts specify the characteristics of the services to be delivered in terms of inputs, processes, outputs and outcome. Contracts for social services, on the other hand, focus mainly on a general definition of the activities. It may be possible to explain these differences in the different levels of measurability of the analyzed services (Brown and Potoski, 2003).

As mentioned above, as the contractual relationship evolves over time, the transactional approach tends to be complemented by the use of tools described in literature as relational; they aim particularly to fill in any gaps in the original agreement and to improve the contractual performance.

Our results confirm the dynamic nature embedded in contract management and the need to map how the principal-provider relationship develops with the passing of time.

In conclusion, transactional approach tools are used for monitoring the compliance of what has been done with what was defined in the original agreement, whereas relational mechanisms are adopted to gradually perfect the specification of what is actually expected and modify this, if necessary.

	Transactional Approach			Relational Approach		
	High	Medium	Low	High	Medium	Low
Waste Management						
Home Care Services for Elderly						

Figure 1 - Outsourcing Waste Management- and Home Care Services for the Elderly

As observed in figure 1, the use of relational contract management practices presents some differences between the three LGs studied.

The development of relational mechanisms is promoted by LGs and is driven by different factors referring to the type of services, the nature of the provider and contextual conditions.

For example, the low levels of programmability and measurability of social services seem to impact the wider use of relational mechanisms. These services require the parties to cooperate and be flexible in order to determine the best solution for each user and adapt it to any shifts in the individual user’s needs.

Our data shows that, from the provider’s point of view, factors facilitating a positive reaction to the exchange of information and cooperation include their nature on the one hand and their pursuit for reputation on the other.

Previous studies have also shown that non profit and public joint-stock companies are generally more in line with the goals of LGs (Brown and Potoski, 2003; Van Slyke, 2006).

Reputation is a fundamental asset pursued by providers because they can make use of it in order to win other contracts. Providers can enhance their reputation by appearing more collaborative (waste management in S-Town and P-Town).

Moreover, relational mechanisms are considered useful tools for overcoming situations where the contractor has more information than the principal. As described above, LGs can reduce the asymmetry of information in this case by involving the provider in decisions regarding services (for example waste management in B-Town).

In the cases analyzed, the relational approach may consist of a bi-univocal dialogue between LGs and contractors who work together and exchange information in order to improve the definition of the characteristics of services; or it may consist of a non-adversarial response to local government requirements.

Conclusions

The article aims to investigate how the role of purchaser is exercised by LGs when they outsource public services. In particular, the article attempts to identify which contract practices are applied for the outsourcing of public services.

Our empirical results show that LGs exercise their role as purchaser by adopting both a transactional and a relational approach. These findings support previous studies that pointed to the coexistence of transactional and relational contracting (Sitkin, 1992; Lorenz, 1999; Poppo and Zenger, 2002).

The co-presence of these two mechanisms seems to be supported by different factors, such as the type of service, nature of the provider and contextual factors.

From a managerial point of view, transactional mechanisms appear to be insufficient in order to enable LGs to exercise their role as purchaser. The main transactional tools are represented by the outsourcing contract and by the activities put in place (e.g. performance management) in order to monitor it.

The contract is useful for defining some aspects of the contractual relationship (such as compensation), but there is a need for additional, "more relational" tools due to the difficulties for parties to anticipate every possible scenario that could occur.

Relational contracting lends the contract management process a certain degree of communication, cooperation and flexibility to this end.

In this perspective, it represents a way to improve services because it allows for better implementation and adaptation to the changing conditions.

According to our results, relational contracting is also a way for a contractor to gain reputation and for LGs to restore the balance of the control and power delegated to the contractor.

These findings are counter-intuitive because they highlight the use of relational contracting mechanisms when pursuing aims rooted in the agency theory framework. Therefore, this appears to challenge the assumption that the agency theory is linked to transactional contracting and the stewardship theory is linked to relational contracting.

Transactional and relational contracting may be described as two poles of a continuum (Grubnic & Hodges, 2003); accordingly, the crucial issue becomes identifying which is the right point (or the right mix) in a unique continuum for every outsourcing situation.

Our results show that each case have a peculiar mix in using transactional and relational contracting and that this mix expresses the equilibrium of different factors.

Future studies may investigate the longitudinal side of contract management more deeply, both in terms of using managerial tools for identifying the right mix of transactional and relational outsourcing and in terms of developing a life cycle theory of contract relationship management practices.

Finally, this study suggests some implications for public management education. Local government managers involved in outsourcing not only seem to need formal relationships based on numbers and contract details, but also frequent contact, collaboration, empathy and reciprocal knowledge. In other words, according to our study, critical assets in the management of outsourcing include the development of appropriate managerial tools and the development of “soft skills” for negotiating, monitoring and communicating expectations and technical information. Therefore, future public management programs should allocate more space to exploiting also the concept of managing by relations.

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