

## Theory to Practice

**Trevor L. Brown**  
Ohio State University  
**Matthew Potoski**  
Iowa State University  
**David M. Van Slyke**  
Syracuse University

# Managing Public Service Contracts: Aligning Values, Institutions, and Markets

**Trevor L. Brown** is an assistant professor at The Ohio State University, where he teaches public management and organizational theory. His research focuses on contracting out and contract management, performance measurement and management, intergovernmental relations, and democratization.

**E-mail:** brown.2296@osu.edu.

**Matthew Potoski** is an associate professor at Iowa State University, where he teaches politics, policy, and administration. His research studies public management and contracting, environmental policy, and public organizations.

**E-mail:** potoski@iastate.edu.

**David M. Van Slyke** is an assistant professor of public administration at Syracuse University's Maxwell School of Citizenship and Public Affairs. His research and teaching focus on public and nonprofit management, privatization and contracting, policy implementation, and strategic management.

**E-mail:** vanslyke@maxwell.syr.edu.

*The contracting of public services has been an integral part of public managers' work for a long time, and it is here to stay. This essay sums up current research on the topic for busy practitioners and scholars. Where are we today with respect to the problems and pitfalls of contracting out, from balancing equity with efficiency to confronting the frequent problem of imperfect markets?*

Contracting proponents, who often have roots in public sector economics, champion contracting as a way to reduce service costs through competitive efficiencies and economies of scale. Contracting critics, who often have roots in traditional public administration fields, counter that contracting tends to sacrifice key public interest values (e.g., equality of treatment) and reduces service-delivery capacity. In the midst of this discussion, several things are clear at this point in the evolution of the contract state:

- Contracting is and will continue to be a major task facing public managers.
- Public managers do not always have a choice about contracting and may be required by elected officials to do so under less-than-optimal market conditions.
- Public managers charged with contracting operate in politically charged environments that put a premium on balancing competing stakeholder values.
- One-size-fits-all judgments about contracting are generally unrealistic: Contracting can improve service delivery or it can be a disaster, depending on the underlying market conditions and management efficacy.

So what are managers to do? The prescriptive literature on contracting to date tends to offer step-by-step procedures for managers to identify service delivery decisions and apply contract management techniques, but it fails to provide a strategic foundation for managing the complicated and often politically charged trade-offs of contracting. Meanwhile, strident ideological debates have crowded out discussion of how

rigorous, theory-driven, multidisciplinary analyses of contract management can inform service delivery. Yet the lessons discerned from these analyses may allow public managers to reframe the debate over contracting in their political jurisdictions.

With this in mind, we take up Kettl's (2002) charge to offer public managers and scholars a more comprehensive strategic framework for practicing and studying contract management than has been offered to date. Our approach is founded on the interaction of three central factors culled from the strategic management and planning, public law and institutions, and economics literatures. These are, respectively, public values, institutions, and service markets. In our framework, (1) stakeholder preferences and democratic processes establish the values to be optimized in service delivery; (2) public law and organizational arrangements determine the contracting tools available for balancing competing values; and (3) the characteristics of service markets influence which contracting tools and vendors are best suited to achieve stakeholder values.

In elaborating our approach, we illustrate what the existing research suggests about how managers can use the lenses of stakeholder and public interest values, institutions, and service markets to improve service delivery. We examine the interaction of these factors in three key stages of contract management: (1) deciding whether to "make or buy" the services, (2) selecting vendors to produce them, and (3) deploying monitoring tools for overseeing the implementation of contracts. We conclude by suggesting areas for future research that can advance both practice and theory building on this important service delivery component of the hollow state (Milward and Provan 2000).

## The Foundation of Government Contracting: Public Values, Institutions, and Service Markets

We start from the premise that contracting is an economic exchange among actors in which the

government's central management challenge is to align public values, institutions, and service-market conditions across the three contracting phases. Public managers operate in a crucible of swirling and often political values: effectiveness, efficiency, accountability, responsiveness, equality of treatment, and service quality, to name a few (Frederickson 1997; Moe 1996; Rainey 2003). Managers experience these values as pressures from internal or external stakeholders that they must balance or optimize as they deliver services. In some cases, these values are codified through the political process into institutions, public laws, and organizational arrangements that determine the range of tools and resources that public managers can employ for service delivery. The services themselves and the character and composition of their markets influence the ability of public managers to optimize or balance competing values through service delivery. In particular, transaction costs—"the comparative costs of planning, adapting, and monitoring task completion under alternative governing structures" (Williamson 1981, 552–53)—make achieving values such as effectiveness and efficiency through contracting more challenging for some types of services than for others.

### Values

Whether government provides services directly or through contract, effectively optimizing value trade-offs and executing core management functions are the central management imperatives in public service delivery (deLeon 1995; Van Slyke, Horne, and Thomas 2005; for a review, see Boyne 1998). The challenge is that values sometimes conflict, particularly in politically contentious arenas. Consequently, managers must either frame the trade-offs for key decision makers to consider or, as is often the case, use their discretion to make these trade-offs as they make service delivery choices and implement them (Moe 1996; Seidman 1998).

In practice, the degree to which managers can achieve values through service delivery is likely to vary across circumstances. Some conditions lie beyond a manager's control. For instance, managers typically have little influence over the laws and rules governing service delivery, such as those that allow the use of some management practices or service delivery approaches but prohibit others. Still, all things being equal, services with inherently lower transaction costs are more favorable contracting targets, freeing resources to lower costs or to purchase more service quality. On the other hand, services with higher transaction costs pose greater contracting problems, consuming more resources and inhibiting a manager's ability to optimize competing values.

Nevertheless, managers have opportunities to optimize, balance, or trade off stakeholder values in each of the three contracting stages noted earlier:

- The make-or-buy stage centers on whether conditions are suitable for contracting (e.g., Donahue 1989). Managers decide whether market conditions are likely to support a competitive environment for contract service delivery (e.g., Sclar 2000) and identify the service-production and management components for outsourcing (e.g., Brown and Potoski, 2006).
- After deciding to contract, public managers need to structure and execute a competitive bidding process (e.g., Lavery 1999). Designing contracts is very complex, requiring public managers to make many public-value-laden decisions, including specifying a vendor's obligations and tasks, defining the contract's renewal provisions, and specifying its incentive and performance-measurement systems (e.g., Shetterly 2000).
- After a vendor has been selected and the contract awarded, public managers must shift focus and manage the contract, which includes monitoring vendor performance, communicating with service recipients, and executing incentive programs (e.g., Kelman 2002a, 2002b).

An important first step for either practicing or studying contracting is identifying and prioritizing the often politically contentious stakeholder preferences at each stage. In this way, public managers can weigh relevant values (e.g., equity and efficiency) against one another in the context of externally imposed constraints (e.g., disagreements about contracting among city council members). Service recipients and their interest groups may be concerned primarily with equality of treatment, elected politicians may focus on political accountability and responsiveness, and managers may be most attuned to cost efficiency. Yet effective management requires going beyond passively receiving value signals from stakeholders and instead actively reaching out to identify broad stakeholder preferences and frame trade-offs among them regarding services.

Identifying and balancing stakeholder values are politically challenging tasks. Fortunately, a rich literature describes how public managers can gauge and manage stakeholder values (Kraft and Clary 1991; Serra 1995; Thomas 1995). Surveys can reach large numbers of people, for example, but they are quite expensive. To reach stakeholders with more intense and deeply held preferences (e.g., interest groups, service recipients, elected officials), public managers can rely on public meetings and hearings, requests for comment and information, advisory committees, and focus groups. Recently, managers have invited stakeholder participation in developing service delivery goals prior to beginning the contract process to help prioritize competing values and preferences. Several techniques, such as stakeholder value mapping (e.g., Bryson 2004), "backward mapping" (e.g., Elmore 1979/80),

and balanced scorecards (e.g., Kaplan and Norton 1996) can be used. (The extended version of this article on the *PAR* Web site discusses these techniques more broadly in terms of substance, process, and transaction costs.)

### **Institutions**

As managers identify stakeholder values, they also need to identify the tools, resources, and constraints that define the range of action they might take in delivering services. Here, two “institutions” are central to the contracting process: public law and organizational arrangements. These define the “rules of the game” (North 1991) that both public managers and scholars ignore at their peril in practice and research. Public law sets the boundaries within which public managers must operate, thereby permitting, authorizing, or requiring a range of actions.

At its root, a contract is a legal instrument, an “agreement by particular parties [who] accept a set of rules to govern their relationship, whether it is for the purchase of services or for a cooperative working agreement” (Cooper 1996, 125). As the law establishes what is authorized and prohibited, it also defines a manager’s zone of discretion, either through legal ambiguity or direct delegation. Discretion allows for considerable flexibility, creativity, and innovation in contracting, whereas legal fiat can restrict discretion to such an extent that managers have limited ability to manage contracts effectively. Managers clearly need a sound understanding of the laws, ordinances, and administrative statutes (e.g., the Administrative Procedure Act) governing both the contracting process in general and their particular services (Rosenbloom and Piotrowski 2005; Wise 1990).

Along with legal resources and constraints, organizational arrangements also define the capacity, resources, and transaction costs for managing service delivery contracts. If the goals are innovation and efficiency, then contracting with a private vendor may be more desirable, because private employees operate with higher-powered, compensation-based, and profit-oriented incentives. If the goal is more government control over service provision, then internal production may be preferred, because government employees’ motivations are typically better aligned with the agency’s mission. Yet as we will discuss later, even this basic trade-off is conditioned on the institutional and market context of the contracting decision.

Effective management is necessary to monitor how vendors *and* public employees are achieving service-delivery values (e.g., efficiency, quality, and equity). To this end, building contract management capacity includes acquiring and nurturing physical infrastructure, financial resources, and perhaps more important, human capital. Prior research (Brown and Potoski

2003a; Van Slyke and Hammonds 2003) suggests, for example, that building human capital for contract management involves developing basic skills in one’s workforce for the following:

- Planning and coordinating service delivery
- Negotiating with vendors
- Monitoring task completion and executing incentives
- Having specific technical skills, such as writing contracts

In many cases, ensuring sufficient capacity requires assigning these management responsibilities to public contract managers—a public service career track that has unfortunately received low priority in recruitment, training, and retention (Kelman 2002b). Weak contract management capacity, contentious political environments, and few career rewards for attracting the best and brightest managers not only increase the risk of failed contracts, but often result in embarrassing government scandals (Van Slyke 2003).

### **Service Markets**

A final set of factors in our framework for practicing and studying contract management involves determining whether service and market conditions favor contracting. Effective markets provide managers with important information about prices and service quality across vendors and facilitate disciplining vendors who fail to meet contract standards (Hart and Moore 1999; Niskanen 1971). Moreover, in well-functioning markets, competition for contracts can help overcome what are known in the economics literature as *principal-agent problems*. Such problems stem from relationships in which a principal (a contracting government) contracts with an agent (a vendor) for the production of goods and services in which the agent has expertise. The principal looks to prevent the agent from opportunistically exploiting its information advantages by carefully designing contracts, offering incentives, and monitoring the agent so that it performs according to contract specifications.

Strong and effective markets, however, require some fairly strict conditions. They need large numbers of buyers and sellers, participants need to be well informed about products and each others’ preferences, and actors must be able to enter and exit the market and exchange resources at low costs. Markets can fail because of high transaction costs, limited information, uncertainty about the future, and the prospect that people or organizations will behave opportunistically in their interactions (Coase 1937; Williamson 1981, 1991, 1996). In these instances, win-win voluntary exchanges are replaced by lose-lose outcomes.

Of particular importance for our purposes are the varying transaction costs inherent in different market

and service arrangements. In the case of contracting, because the parties cannot fully predict all possible future scenarios, contracts are typically underspecified (i.e., incomplete) and may allow opportunistic vendors to exploit contracts to their own advantage at the expense of the contracting government's goals. To minimize such opportunism, the contracting government must incur transaction costs by clearly specifying the values sought in performance measures, writing more detailed contracts, monitoring vendors' performance, and enforcing sanctions when necessary.

Consider two notable sources of transaction costs: asset specificity and ease of measurement. *Asset specificity* refers to the need for physical infrastructure, technology, or knowledge, skills, and abilities that can only be acquired through on-the-job experience or highly specialized investments (e.g., high-cost investments in computer technology). For winning and losing vendors, investing in an asset-specific service that cannot be readily translated to other economically valuable activities (i.e., used for other organizational purposes or marketed to others) leaves them vulnerable to a single (i.e., monopsonistic) service purchaser. This not only raises the costs for vendors to compete in the market, but more importantly makes it unlikely they will remain in the market for future rounds of contract bidding. Conversely, for contracting governments, asset-specific services can dangerously privilege vendors that win the first contracts, thus constraining future competition. Under such monopolistic conditions, the winning vendor can exploit the contracting government with impunity by raising prices or reducing service quality.

*Ease of measurement*, in turn, refers to how easily and well public managers can assess the quantity or quality of services. Easily measured services have identifiable performance metrics that accurately represent either the outputs or outcomes of service quantity and quality. But even if performance outcomes are difficult to measure and observe, service performance can still be assessed if it is relatively straightforward to monitor the activities of the vendor, and these activities are reasonable proxies for desired outcomes.

As with asset-specific services, difficult-to-measure services make governments vulnerable to unscrupulous vendors who, as principal-agent theory suggests, may exploit their information advantage by lowering service quality and quantity. Under these unfavorable circumstances, managers would be wise to avoid the market altogether through internal service delivery. The advantage of producing difficult-to-measure services internally is that managers can monitor and reward their own employees more easily than vendors. Prudence aside, however, legal mandates sometimes require governments to contract for

difficult-to-measure services. In these cases, managers must ensure adequate management monitoring capacity to mitigate transaction cost risks.

## The Framework in Action

In this section, we map values, institutions, and service markets to the phases of contracting to illustrate how public managers and researchers can use the transaction cost lenses of public values, institutions, and service markets in their work.

### **Values, Transaction Costs, and the Make-or-Buy Decision**

Proponents of contracting argue that it is more cost-efficient and better stimulates innovation than direct service delivery. On the other hand, direct service delivery has been found to promote political accountability, stability, and equality of treatment (DeHoog 1984; Donahue 1989; Kettl 1993), although the relative strengths of direct versus contract service delivery appear to vary across circumstances (Brown and Potoski, 2006; Morgan and England 1988; Sclar 2000). For example, the returns from contracting versus direct service delivery depend acutely on legal requirements. Federal and state administrative procedure acts mandating whistleblower and other employee protections, as well as open records and meetings requirements, create both costs and constraints for government managers (Cooper 1996). Yet legal requirements can also restrict contracting practices (DeHoog 1997), such as those that require some percentage of contracts to be awarded to female- or minority-owned firms. Indeed, private firms and nonprofits sometimes avoid competing for public sector contracts because of time-consuming and procedurally complex legal requirements (MacManus 1991; Praeger 1994). Thus, legal exigencies can lower market competitiveness, thereby diluting the advantages of contracting relative to in-house service delivery. Consequently, examining the specifics of the legal and political context of make-or-buy decisions is critical for both managers involved in these choices and scholars studying contracting dynamics.

Other factors—notably, characteristics of the service market—can play an even more fundamental role in determining the returns from contracting. Political pressures, of course, may lead governments to retain what should be contracted and to contract what should be produced in house. Under the latter circumstances, managers again must either counter the lack of information and other problems such markets create or provide incentives and capacity for monitoring vendors closely to mitigate opportunism and failed contracts. Proactive managers, however,

need not be helpless victims to thin markets. They can follow several strategies:

- Recruit new vendors and thus engage in managing the market (Brown and Potoski 2004)
- Split service delivery into multiple contracts (Osborne and Plastrik 2000)
- Allow public employees to compete against private vendors (Goldsmith 1997)
- Employ “joint contracting” by retaining a portion of service delivery in house to provide information on service quality and cost while also ensuring there is an alternative provider of the service (Shleifer and Vishny 1998; Williamson 1991)

As a default option, where politically viable, direct in-house service delivery may be a preferable approach in thin markets.

### **Contract Specification**

Assuming that a government elects to buy rather than make the service in question, the contract specification phase is equally suggestive of public-value, institutional, and service-market implications that practitioners and scholars should heed. In specifying a contract, public managers decide on and implement a bid process, select a vendor, and craft contract terms. Within the contours of legal requirements, public managers typically have discretion in contracts to specify several features:

- Vendor tasks (e.g., the nature and scope of work)
- Outcome measures (e.g., performance-based criteria)
- Vendor qualifications (e.g., licensing or accreditation issues)
- Vendor compensation (e.g., time and materials versus cost plus fee)
- Payment schedules
- Contract duration (e.g., short versus long)
- Incentives and sanctions (e.g., rewards versus punishments)
- Renewal provisions
- Reporting requirements

Again, the extended Web version of this article explores some of these considerations in greater detail, but we focus here on one central contract specification decision: the type of vendor selected. Contracting governments can choose among three types of vendors: private firms, nonprofits, and other governments. Private firms, whether they are publicly or privately held, are motivated by profit, and consequently they may focus more on innovation and efficiency (Hart, Shleifer and Vishny 1997). However, achieving these goals may come at the expense of other public values and goals, such as service quality or equality of treatment (Moe 1996). For example, when private contractors are forced to choose between taking steps

to maintain or upgrade service quality and keeping costs low, public managers should be alert. Vendors may favor reducing expenses, particularly if this means pursuing their own (profit) goals at the expense of the government’s objectives.

In contrast, nonprofit organizations are thought to share similar missions with government, and thus may be more reliable contract partners (Hansman 1987; Salamon 1995). Rather than behaving opportunistically, a nonprofit might draw on its own private philanthropic resources (e.g., volunteers and endowments) to augment services it delivers under government contract. Yet nonprofits’ goals may not *always* be aligned with public objectives and may instead channel residual revenue from contracts into subsidizing their other programs (Van Slyke, forthcoming).

Finally, other governments also can be service vendors. Like nonprofits, other governments are thought to have values aligned with the contracting government because they share a similar public mission and a workforce more committed to public values. However, contracting with other government agencies for services is not without risk and transaction costs. Inter-governmental contracts may actually do less than private contracts to solve the inefficiency, lack of innovation, weak incentives, and other bureaucratic ills that can plague direct government service delivery (Niskanen 1971).

Institutional arrangements also play an important role in determining the relative superiority of these vendors in achieving different stakeholder values. Other governments, for instance, are often subject to the same legal requirements as the contracting government, such as promoting service quality and equity at the expense of efficiency and innovation. Nonprofits, in turn, are regulated as tax-exempt organizations and, as such, are prohibited from distributing profits to their employees or volunteer boards. Consequently, there may be fewer incentives for them to engage in opportunistic behavior, at least in comparison to private firms. Yet public managers should take into account that this may also curb their ability to be innovative.

Importantly, the type of vendor may be less important for low transaction cost services in competitive markets. This is the case because the risk that vendors will become monopoly service providers is low, performance can be easily measured, and contracts are easier to enforce. Indeed, prior research suggests that governments understand this already. They tend to contract more with for-profit vendors in such circumstances (Brown and Potoski 2003b), exploiting the latter’s competitive zeal and relatively lax legal requirements through contract specifications and enforcement mechanisms (Brown and Potoski 2004).

In contrast, the type of vendor becomes more relevant when contracting for high transaction cost services in thin markets—for example, when a small government needs to deliver a service that requires large asset-specific investments beyond what it can afford. In these instances, public managers would be wise to solicit bids across the three types of organizations and perhaps even favor nonprofits or other governments whose values best align with their own objectives. Again, the literature suggests that governments already understand this; they more frequently choose nonprofit and other governments when contracting for high transaction cost services and in thin markets (Brown and Potoski 2003b).

Yet even contracting with vendors that purportedly share the same goals is not without risks. Van Slyke (2003), for example, finds that governments often establish long-term contract relationships with nonprofits for social services, but then they neglect oversight and monitoring responsibilities. Nonprofits, increasingly reliant on public sector contracts, may begin to behave like conventional monopolists to maintain their resource streams. Perhaps more troubling are circumstances in which a government contracts in a thin market out of ideological, political, or nefarious motives and then neglects contract management (Romzek and Johnston 2002).

For governments that are willing and able to invest in sufficient contract management capacity, however, certain types of long-term contractual relationships can foster mutual support and sharing (Artz and Brush 2000; Hart and Moore 1999; Levin 2003). In so-called relational contracts, public managers work with vendors to build a long-term relationship based on trust, reciprocity, and joint involvement in developing and implementing the contract. To be sure, when compared to conventional arms-length contracting, successful relational contracting has higher short-term transaction costs for both parties. Over time, though, effective relational contracts may lower transaction costs through reduced bidding, monitoring, and legal costs (Hart and Moore 1999; Tadelis 2002). Nevertheless, public managers must balance the returns from building a cooperative relationship with a single vendor against the continued risk of opportunism and the perception that the vendor's long-term relationship stems from political favoritism. Once again, prior research is relatively silent on the conditions under which the choice of conventional and relational contracts is most likely to be effective.

#### ***Managing Service Delivery under Contract***

Once governments select a vendor and turn their attention to contract implementation, managers face more decisions regarding trade-offs among public, institutional, and service-market values. Perhaps the most central among these involves monitoring and evaluating the performance of vendors working under

contract (Kettl 1993; Praeger 1994). Well-monitored vendors are more likely to perform according to contract specifications, thereby improving returns from contracting, whereas legal, institutional, and service-market constraints can increase transaction costs (Brown and Potoski 2003a).

As is the case with other contracting practices, effective service monitoring requires a solid legal grounding. In some circumstances, for example, information from monitoring practices that are not contractually authorized may not legally be used to evaluate vendors. In others, managers may be authorized or required to establish formal systems for tracking and monitoring citizens' complaints about service delivery or to gauge public sentiment through citizen surveys (Miller and Miller 1991; Swindell and Kelly 2000). In these monitoring approaches, citizens can serve as "fire alarms" (McCubbins and Schwartz 1984), calling attention to occasional vendor transgressions without requiring governments to monitor vendors' activities constantly. In other approaches, managers may or may not be legally authorized to audit and analyze vendors' records and performance data or to do field audits.

These monitoring activities, of course, vary in their costs and efficacy depending on the nature of the service and existing service-market conditions. For example, in cases in which governments face vendor opportunism stemming from difficult measurement, managers cannot simply purchase and monitor service outcomes alone. Moreover, arms-length contract-monitoring tools such as reports and field audits may be less effective. One countermeasure is for managers to develop a deeper understanding of the service-production process. This can be an onerous undertaking, beginning with uncovering the logic behind the vendors' service delivery techniques and then identifying and monitoring each step in the service production process. Alternatively, public managers may rely on a more relational approach to contracting, in which each party learns experientially how the other conducts its work within the framework of the contract. As in the other cases noted previously, however, additional research on the comparative efficacy of these approaches is needed.

#### **Conclusion**

Our argument in this article has been straightforward. Effectively managing or researching the three stages of the contracting process requires an appreciation of the intersection of three factors: public values, institutions, and service markets.

1. Values, including public interest values, are the stakeholder preferences that public managers must balance or optimize as they deliver services. Throughout the phases of contracting, public managers should continually identify and prioritize

the often politically contentious public-value preferences of key stakeholders. To the degree that managers have discretion, these values or value trade-offs should guide the use of different contract management tools, as well as inform the research strategies of scholars.

2. Institutions, or the laws and organizational arrangements that frame service delivery, determine the range of tools and resources that public managers can employ to achieve stakeholder values. Public managers need to identify (and researchers need to consider) the legal architecture that governs contracting. Legal mandates define the boundaries within which public managers can operate to optimize and balance targeted values, whereas contract management and monitoring incapacity increase the risk of failed contracts.

3. The characteristics of services and their markets influence which contracting tools are best suited to achieve stakeholder values. Public managers should determine whether service and market conditions favor contracting. Of particular importance are factors that increase the risk of contract failure—thin markets and asset-specific and difficult-to-measure services. When these factors are present, public managers should internalize service delivery (if they can) or expand contract management capacity.

Importantly, we argue that these factors should not inform practice or research in isolation. Public values, institutions, and service markets are interrelated and should be viewed by practitioners and scholars as interacting to produce contracting outcomes. Thus, before applying prescriptive step-by-step approaches or developing propositions suitable for testing in future research, public managers and scholars should map all three sets of factors to determine value targets, the steps managers can legally take to achieve these targets, and the likelihood of success given existing market conditions.

Though the Web version of this article presents a more detailed elaboration of our agenda for future research, we focus here on three key points. First, we argue that to inform better the practice and study of contract management, scholars need a better understanding of economic theories about market and quasi-market failures, institutional theories about organizational design and behavior, and strategic management theories about how organizations adapt to changes in their environments. Second, there are still conspicuous gaps in our knowledge that seem worthy of pursuit, some of which we have noted already. For example, future research needs to consider the conditions under which contracting with nonprofits and other governments is more or less effective than contracting with for-profits. Finally, although contracts are a service delivery mechanism—and the most

frequently used alternative to direct service provision by government—they are not the only tools public managers have at their disposal (Salamon 2002). Given the theoretical foundation of our framework, the fundamental logic should hold for other indirect governance tools, such as vouchers, grants, franchises, and loans. Our call is for scholars to extend, test, and refine our framework to develop a more comprehensive, relevant, and theoretically grounded approach to managing service delivery in the hollow state (Milward and Provan 2000).

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