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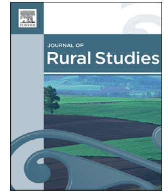

Assessing the impacts of transaction costs and rapid growth on local government service provision and delivery arrangement choices in North Dakota

Andy Hultquist [a], Dana Michael Harsell [a, *], Robert S. Wood [a], David T. Flynn [b]

[a] Dept of Political Science and Public Administration, University of North Dakota, 293 Centennial Drive, Stop 8379, Grand Forks, ND 58202-8379, USA
[b] Dept of Economics and Finance, University of North Dakota, 293 Centennial Drive, Stop 8369, Grand Forks, ND 58202-8369, USA

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ABSTRACT

Local governments pressured by fiscal stress have long privatized public service provision to decrease costs or maintain service levels (Greene, 1999). While considerable research has considered contracting behaviors of 'mature,' urban and suburban communities for services which they already are, or are capable of, providing (e.g. Brown and Potoski, 2003), what happens in small communities faced with a rapid influx of population and resources? Do factors shaping contracting in larger, resource-constrained locations apply to expanding cities under conditions of opportunity? Are growing cities' service options limited by a lack of existing capacity, or expanded by additional resources to allow innovative delivery arrangements?

Western North Dakota is currently experiencing an oil boom, doubling local populations in half a decade and dramatically impacting demand for public services. Using original data from over 100 North Dakota cities and counties in 2014, this paper models the impact of service and market-specific transaction costs, changes in resources and service demand, and other community factors on public officials' choices among delivery arrangement modes when contracting out for local services.

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1. Introduction

One of the core functions of local governments, and one of the activities which they most frequently engage in, is ensuring the delivery of a wide range of public services to local residents. As such, the means through which those services are delivered is one of the most important choices which local governments can make. While the range of local governments' service delivery mechanisms has increased in recent years as taxpayers and advocates of administrative reform have asked governments at all levels to do more with less in managing the increasingly scarce resources available to them, two of the most common modes of service delivery available for cities and counties are internal service production, using a city's own employees and capital assets, and contracting with external vendors to provide the service directly to citizens in lieu of direct local government provision (Kettl, 1993; Greene, 1999; Stein, 2003). In contracting out for service delivery, local governments hope to take advantage of a variety of efficiencies present in competitive service markets, such as cost minimization, economies of scale, and a greater possibility of innovation, factors which may not be present, or as pronounced, when services are produced by governments in-house (Ostrom and Ostrom, 1977).

The literature surrounding the decision to provide services in house or to contract externally for their provision – the 'make or buy' decision – has received considerable attention from scholars in recent decades, especially as the practice of contracting out has become more popular with, and more widely adopted by, local government administrators and elected officials. This literature has resulted in an extensive examination of multiple aspects of, and questions surrounding, contracting for local government services, including the role of risk in contracting, monitoring, and vendor choice, and the relative advantages and disadvantages in contracting to certain types of vendors. In particular, considerable effort has also been devoted to understanding how aspects of services and markets impact the choice of when and to whom

* Corresponding author.
E-mail addresses: dr.andy.hultquist@gmail.com (A. Hultquist), dharsell@business.und.edu (D.M. Harsell), rwood@business.und.edu (R.S. Wood), david.flynn@business.und.edu (D.T. Flynn).

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municipal governments contract services when contracting does occur. In addition to these efforts, social scientists are also refocusing attention to an "ascendance of free-market oriented, 'neoliberal' governance" (Lobao et al., 2014, p. 644). Studies of contemporary neoliberal governance assume, at least implicitly, that recent economic contractions in state and local governments foster a favorable environment for local austerity responses such as downsizing and contracting out (e.g. Peck, 2013).

Related scholarship has also provided an important counterpoint to the promise of local contracting, identifying conditions under which market efficiency assumptions break down. This literature raises concerns that gains in cost savings may be offset by important, potentially negative changes to the role of local government, and the essential nature of the public services it provides, when those governments outsource an increasing number of their core functions to the private market. Analyses of 2002 and 2007 ICMA data support this conclusion, suggesting that historical efforts to contract out municipal services may be a 'two-way street,' with other scholars (e.g. Warner, 2006) identifying a number of instances where municipal governments have reintegrated services previously contracted out back to local public sector management.

However, the bulk of this literature, and especially of empirical examinations of the factors leading to choices in when contract out for service provision, and to what type of vendor, has tended to focus on contracting in moderate to large cities in urban areas, and under competitive, well-functioning market environments characterized by multiple potential service vendors (Greene, 1996; Brown and Potoski, 2003a; Brown et al., 2008). Less attention has focused on the opportunities and challenges presented by service production decisions in smaller locations, the factors influencing service provision decisions for more rural governments, and how and why these factors might differ from those associated with contracting choices in larger, more urbanized contexts. For these small communities, the provision of public services is just as essential a function, and the demand for these services from residents may be just as great. Yet the conditions under which very small communities provide these services may differ markedly from the service provision environment of their larger, more urban counterparts in terms of resource availability, potential contracting partners, and competitive markets.

As neoliberal governance policy and its market imperative become increasingly salient, small rural governments may be under more pressure to explore or revisit alternative means of service provision, and to shift their focus towards the 'buy' side of the 'make or buy' continuum. However, neoliberal governance also assumes that adequate private sector capacity to meet service level demand (both in terms of availability and scalability) exists. How do these small local governments respond, and what service delivery mode choices do they make, under these conditions?

It is these questions of what factors influence small local governments' choice of delivery mode when producing services, and how the determinants of this choice may differ from those found by the existing literature to describe service delivery choices in larger, more urbanized areas, which this paper seeks to address. Pairing data obtained from our original survey of 109 North Dakota local governments' service delivery choices for 51 publicly provided services with community-level demographic information from the U.S. Census and County Business Patterns data, this study investigates the role of a variety of service, market, and community characteristics on those governments' decision of whether to produce those services in-house or externally via contract, and on choices between different types of vendors when services are contracted out. Given its high number of local government units, their small populations, and their widely-spaced geographic distribution, North Dakota provides an excellent context for examining influences on the service provision decisionmaking of small, rural governments. At the same time, the context is also one which resembles other Great Plains states, and rural communities more generally nationwide, enough for our findings to have some degree of generalizability. Our work also investigates how these small governments respond to two additional influences currently impacting many North Dakota communities which introduce stress into, and increase uncertainty surrounding, market conditions and levels of local government service demand – growth in population and in economic activity associated with the oil and gas extraction industry.

Following the Introduction, Section 2 of this paper discusses the theoretical foundations of contracting in local governments and covers previous research into determinants of contracting behavior, as well as outlining this paper's contributions to this area of research in greater detail. Section 3 discusses the data used in this analysis, while Section 4 formally presents the regression model used in the paper. Regression results are presented and discussed in Section 5, while Section 6 concludes with the implications of the findings and suggests refinements and expansions for future research.

2. Previous research

While local governments have historically elected to provide citizens with public services through in-house provision using their own employees and resources, in the past few decades, the array of policy instruments and modes of production available to governments outside of internal production has increased dramatically (Kettl, 1993; Salamon, 2002). The consideration and ultimate adoption of many of these alternate service delivery approaches has been in direct response to an increasing scarcity of resources, including declining tax bases and intergovernmental transfers, increases in capital and labor costs to local government, and calls from taxpayers, academics, and politicians to improve efficiency and reduce the size of government at all levels (Osborne and Gaebler, 1992; Lynn, 1996; Greene, 1999; Barzelay, 2001). One of the most promising of these options for local government in potentially achieving cost savings is the contracting out of service provision activities to external vendors.

At its heart, the theoretical underpinnings of contracting out for service delivery, and of the potential efficiency gains which this activity represents, lie in the transaction costs approach to structuring the firm, or in this case, local governments. Transaction cost theory suggests that organizations choose how to structure themselves in terms of what production activities are internalized into the organization versus what activities are to be obtained through contract with external vendors (i.e. the market) based on the costs involved in those transactions (Coase, 1937; Williamson, 1981). If the transaction costs involved in obtaining a good or service from the market exceed those required to produce the good internally, the firm incorporates the production activity into itself, producing the good or service with its own employees and capital assets. Conversely, if means of production external to the firm represent a cost savings over internal production, the firm will contract with external vendors to supply the good or service in question. Transaction cost theory thus provides a guide to the size, scope, and activities of the firm or, in the case of local governments, to which service production activities make more sense to produce in-house in terms of overall efficiency versus those where contracting for external provision represents a cost savings.

Within the transaction cost scholarship, Williamson (1981) highlights two key service characteristics that determine the relative transaction costs involved in a particular production activity – asset specificity and service measurability. Services with high levels

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