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Government Contracting with Faith-Based Providers: An Economic Perspective

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Abstract:

This article analyses the policy debate surrounding the possible expansion of government contracting with faith-based providers of social services, from the perspective of recent developments in the economics of contracts. It presents a non-technical introduction to the economic tools used in the study of contracts, in particular the decision faced by governments of whether to provide services in-house or to contract out to a private nonprofit organization. In particular the paper looks at the problems of monitoring the quality of service provision and ensuring fairness in the procurement process. When the analysis is applied to the question of faith-based provision, the conclusion is that monitoring the terms of the contract is less of an issue than the debates that will arise over the distribution of contracts across different faith-based organizations.

The challenges and outcomes arising from the increased scale of government contracting with faith-based providers of services in the US, especially since the Charitable Choice provisions of the 1996 welfare reform, have generated a significant scholarly literature: on the interpretation of constitutional provisions protecting free expression and non-establishment of religion; on whether allowing faith-based providers to be exempt from some of the usual government regulations on contractors enhances or lessens equality of opportunity amongst potential contractors; on whether faith-based organizations are efficient or cost-effective relative to secular providers or government agencies; on the administrative challenges for the parties to these new forms of contracting; and more.

Policy issues on contracting with faith-based providers have also arisen at the state level. For example, Georgia is one of a number of states whose constitution contains a “Blaine Amendment”: a provision that “no money shall ever be taken from the public treasury, directly or indirectly, in aid of any church, sect, cult, or religious denomination or of any sectarian institution.” In 2004 Georgia Governor Perdue proposed amending the state constitution to add to the existing Blaine Amendment the phrase “except as permitted or required by the United States Constitution, as amended”. The stated goal was to put the state’s ability to contract with faith-based organizations at the same level as the federal government. Despite the efforts of the Governor, Georgians did not see this amendment put to referendum. Georgia’s Blaine Amendment, like those in other states, was introduced at the end of the 19th century in an effort to preclude Catholics from making a claim to public funds for the establishment of parochial schools. Of course the public school system at the time was religious, with students educated in a generic

Protestantism and reading from the Protestant Bible. In 2004, even though the proposed changes to the state constitution were aimed at loosening restrictions on what organizations could contract with the government to deliver social services, it was, as in the 19th century, the fate of schools that determined the outcome of the debate; opposition to the Governor's proposal were centered on whether it would enable school vouchers.

This paper levitates away from some of the details of contracting, at the federal and state levels, with faith-based providers, so that we can view this contracting from the broader perspective of government-financed services and the possible means of their delivery. An aerial view of the forest might tell us some things about the trees that are hard to detect from ground-level.

The "economic perspective" taken will be to look at the possibilities of contracting for service delivery in the presence of transaction costs and necessarily "incomplete" contracts. Thus by "economic" I do not mean that unfortunate characterization whereby all participants in a contract would have perfect knowledge of everything relevant and would be motivated by whatever actions would maximize a narrowly-conceived self-interest. Instead, parties are motivated not only by their own well-being, but also to varying degrees by what they believe to be in the interests of their clients, and the organizations, secular or faith-based, for whom they work. Contracts are incomplete because it is impossible to fully specify what actions are to be taken under every possible contingency (thus contracts must allow for discretion on the part of the service-provider), and because there are aspects of the *quality* of service provision that are inherently subjective, and cannot be verified by an external adjudicator, in the way that the *quantity* of service provision can be verified. In such a world, when does it make

sense for a government to contract with a private-sector service provider? And, the motivation of this paper, how does the answer change if some of the private-sector providers bidding for contracts are faith-based organizations?

The Economics of Incomplete Contracts

Much of the literature on incomplete contracts relies heavily on sophisticated mathematics, which is important for clarity in establishing the assumptions of the models and how the results are derived, but which carries the cost of making the analysis inaccessible to many interested readers. This section summarizes the key aspects of the models and their results without the use of mathematics.

Suppose the government has determined that it wishes some service to be provided to the public. We can imagine possibilities for delivery of the service: it could be administered through a department of the government; there could be a contract with a secular or a faith-based nonprofit organization; there could be a contract with a secular or faith-based for-profit firm; or there could some combination of these possibilities. Which is the best choice? A surprising result is that *if* it were possible to write *complete* contracts, that specified precisely what was to be done, and not to be done, by the service provider, and every aspect of contract performance could be verified by the government, and by an external adjudicator should a dispute arise, then it would not make any difference whether the government provided the service in-house or contracted out to a private provider, whether nonprofit or for-profit.

That whether there is contracting out doesn't matter in the perfect world sketched above is a variant of the insight by Coase (1937) arising from his study of the "make-or-

buy" decisions of private firms: with perfect, costless contracting it makes no difference whether the manager of a firm directs one of her own employees to perform a task or hires someone from outside the firm to do it, since the costs to the manager (whether in wages to her employee or in payments to the outside contractor) and the quality of the performance of the task will be the same in each case.

The point of discussing this abstract case of perfect contracts is to narrow the focus on what *does* matter. Coase found that the boundaries of an individual firm will be determined by the relative effectiveness of in-house or contracted services as a result of the costs of forming and monitoring employment contracts and contracts with agencies external to the firm. The modern literature on Coase's problem emphasizes the incentives of the owner of the relevant assets to invest in innovation, given the discretion allowed by incomplete contracts, and thus derives the most efficient ownership structure of assets – i.e. whether two firms ought to merge, or contract with each other as independent entities – and is often known as the "property rights" theory of the firm (Grossman and Hart, 1986; Hart and Moore, 1990; 2003; Tirole, 1999). There are subtle differences between the transaction cost models of Coase and Williamson and the property rights models (Whinston, 2001), but they are not an important factor in the questions raised by this paper.

Applying the result to government contracts, we would say that in a perfect world the government could completely specify the service it wants provided, with instructions on what is to be done under uncertain contingencies, to the manager of a government department or to a private agency, and the government could monitor the outcomes, and the contract would specify what net payments would be made by the government to the

service provider under each contingency; in this case whether there is contracting out would not matter. But contracting out *does* matter because we do not have the ability to form such complete contracts, and the imperfections in real world contracts will play out differently in different contexts.

In the rest of this section of the paper we look at two spheres where our imperfect ability to specify and monitor performance are important in government contracting: the inability to perfectly contract over the quality of service provision; and the inability to perfectly monitor the procurement process.

Monitoring the Quality of Service Provision

I will use "quality" to refer to what the government contractor of the service regards as quality, the outcome that the government contractor wants. It is not usually going to be a single variable. In the privatization of prisons, for example, quality would include the rehabilitation of inmates, their safety, humane conditions in terms of how they are housed and fed, and so on. For counseling services for those with addiction problems, quality includes success at getting individuals to overcome their addiction, but also whether they are treated with due respect.

Problems in contracting arise because, first, quality cannot be perfectly monitored by the government funder, and second, the incentives for the provision of quality by the service provider are in general unlikely to be a perfect match with what the government funder would hope for. We can generalize by thinking about two kinds of incentive problems.

First, it may be the case that the service provider would not dispute the government contractor's definition of "quality" in service delivery, but the service provider is able, and has the incentive, to provide lower quality than promised as a way of lowering costs, and to keep the fact that quality was low hidden from the government funder. Even with detailed measures of outputs or outcomes applied to the service provider, it will not be possible for the government to perfectly determine whether an observed poor outcome is due to the contracted service provider's behavior or random bad luck in external factors affecting productivity. For-profit service providers would find a strategy of cost-saving quality-cutting could increase profits, and nonprofit providers, although they are constrained to some degree from cash distribution of the gains from cost savings (Hansmann, 1980; Glaeser and Shleifer, 2001) might also benefit from the potential increase in net revenues as it could allow the potentially-preferred cross-subsidization of other activities undertaken by the organization.

Second, it may be the case that the service provider does care about quality of service provision, and is committed to providing as high a level of quality as is feasible, but that it has a different definition of quality than that held by the government funder. In such a case, with incomplete contracting and imperfect monitoring by government, the service provider uses the funds to provide services in keeping with its own definition of quality rather than the government's. For example, in a contract to provide services helping individuals find steady employment, the government funder might define "quality" as getting the highest number of individuals to move from being unemployed to being employed, while the service provider might define "quality" as directing the bulk of its efforts to the individual clients with the least potential for employment in the

absence of assistance, even if this means that the overall effects on employment of the client base are lower than they could have been.

The solution to the problem of whether to contract out service delivery under the first kind of incentive problem begins with comparing the incentives facing a private service provider and a government in-house provider. In general, public employees have "low-powered incentives" (Tirole, 1994); that is, there are relatively low rewards paid to the public employee who discovers an innovation that leads to either improved quality of service provision without increasing costs, or lower costs without diminishing the quality of service. Further, there are no rewards at all for implementing practices that lower costs but at a cost of lowering quality. Private service-providers have higher-powered incentives, in that innovations bring higher rewards: cost-saving or quality-improving measures allow the organization to win more contract tenders, and in the case of for-profit providers generate personal monetary rewards. If there is contracting out for service delivery, the higher-powered incentives in the private sector give government the benefit of an increased pace of innovation, but at the cost of a higher incentive for the service provider to mislead the government by promising a higher quality per dollar than is actually to be delivered. The higher the potential for innovation, and the harder it is to mask cuts in quality, the more favorable is the contracting out option. Provision of government-funded services in-house is preferred when the potential benefits from innovations are low, and where cost-saving, hidden cuts in quality are hard to detect, and carry possibly severe consequences. (This is the central conclusion of Hart, Shleifer and Vishny (1997); also see Shleifer (1998) and Hart (2003)). Indeed, Williamson (1999) argues that situations where the government must be able to have absolute confidence in

the provision of a service explain *why* government employees have low-powered incentives: it is preferable to the risk of having the service provider, whether within government or in the private sector, taking risks in search of rewards for being an innovator. Using the foreign service as an archetypical example of a situation where probity is crucial, he applies the apt dictate of Tallyrand: “above all, no zeal” (Williamson, 1999, p. 323).

An interesting turn on this model is provided by Francois (2000). Suppose government managers have low-powered incentives and private sector managers have higher-powered incentives. Then front-line service providers might be more motivated in the public sector. The reasoning is that if the service providers care about the quality of service provision, they will know that if they shirk on their duties the private sector manager will work hard to shift inputs to rectify the problem, but the government manager will not. So in the public sector, workers know “if I don’t get the job done, no one will”. This gives the counter-intuitive result that low-powered incentives for government managers induce higher performance from staff.

But Francois’ model is still open to the second type of incentive problem, where the service provider’s notion of quality differs from the government funder’s definition, but where quality by either party’s definition cannot be completely specified in a contract. The problem here is different from the first case, since even though public sector employees have low-powered monetary incentives, they still have personal goals and ideals which might cause them, if they can do so in way that can be concealed from their managers, to direct their efforts in service provision in a slightly different direction than their managers have asked for. In other words, the employees care about the quality

of service delivery, but define quality differently than their managers. In this case it is not clear that in-house service provision or contracting out are very different, except to the extent that monitoring of in-house provision *might* be easier than monitoring an outside agency. But that is not necessarily the case. For example, suppose a middle-manager in government is assigned the task of reporting on the performance of the service delivery staff. While this person could be in a better position to observe the effort and methods adopted by in-house service delivery staff, she might also be more reluctant to report questionable performance of in-house staff to her senior management, owing to the various motives she might have for promoting harmony between herself and her staff. In other words, a contracted agency might be more difficult, or less difficult, for senior management to observe. Does a Dean receive more accurate information about faculty performance from the department chair or from an external review committee? The answer depends on the relative importance of measures of such things as faculty effort in department service and teaching, which the chair will know better than the external reviewer, or on factors like publishing, where a chair could give a more generous, and less accurate, interpretation of the faculty research record than an external reviewer would provide.

With contracting out we generally observe in any relationship a series of contracts, periodically renegotiated. At each renegotiation either party has the option of leaving the relationship and looking elsewhere for someone with whom they can do business. But during the relationship there will typically have been much investment in relationship-specific assets that have no value elsewhere, and so what might have begun as a contracting relationship set in a competitive environment becomes a bilateral

monopoly – a "thin market" (Williamson, 1975). A common theme in the contracting-out literature is that nonprofit organizations who develop relationships with government funders can find themselves somewhat "trapped"; if the nonprofit has made many investments in the particular relationship but government can more easily switch suppliers, the government gains bargaining power in subsequent renegotiations.

Procurement

Quality monitoring also raises problems in procurement. Let's take a crude criticism of the faith-based initiative: that it is simply a way to transfer public funds to religion. Is this plausible? There are circumstances where a group favored by the government cannot receive direct subsidy, as this would provoke a public outcry. For religious organizations there is, of course, the additional factor of constitutional law. But indirect support can occur.

Coate and Morris (1995) examine when procurement can be used to transfer funds to special interests without attracting public opposition: such a scheme works well (for the manager in charge of procurement and his interests, not the general public!) when its benefits are difficult for the public to evaluate. This is particularly true of social welfare programs, where most members of the public are not actual recipients of the service, (see Seabright (2002) for a study of how the separation of the funders of a program and its beneficiaries has implications for organizational design) and where there are enough unobservable random factors affecting outcomes that it is very difficult to evaluate the effectiveness of the design and implementation of the program.

Celentani and Ganuza (2002) add that more corruption in procurement – where "corruption" is not limited to bribery, but can simply take the form of a departure from merit as the criterion for awarding contracts – is possible when there are many "quality" aspects to bidding. Discrimination in the awarding of contracts is hard to detect. Consider, for example, the difficulties in determining in government contracting whether minority-owned businesses are not receiving the number of contracts one would predict (Celec, et. al., 2000).

Contracting With Faith-Based Organizations

What is "Charitable Choice" about? Since the 1960s there has been a great expansion in government contracting with (mostly) nonprofit organizations to deliver public services (Grønbjerg and Salamon, 2002; Smith, 1999). During that period of expansion there was certainly substantial contracting with organizations that are "faith-based" (Although we should perhaps distinguish between nonprofit organizations with an affiliation to a denomination, but which operate much the same as a secular nonprofit human services agency – what Smith and Sosin (2001) call a "faith-related" organization – and those institutions whose operations are more explicitly influenced by their faith, here we follow the common practice in the literature of simply using the term "faith-based" somewhat indiscriminately): "Religious mega-charities like Catholic Charities, Lutheran Social Services, Jewish Federations, and others have literally received tens of billions of dollars in public support. The only nonprofit organizations that have consistently been left out are grassroots religious groups" (DiIulio, 2004, p. 86). Charitable Choice, introduced through the welfare reforms of 1996, and expanded under

President G.W. Bush as the faith-based initiative, means to make eligible for government contracting the one group that had been left out. The large charities mentioned above are treated as "essentially secular organizations with a religious link or inspiration" (Carlson-Thies, 2004, p. 59), but there have been claims that smaller faith-based organizations have faced discrimination in contracting, even when their programming was purely secular. These faith-based organizations should be distinguished from congregations, which for the most part do not operate their own human services programs but instead contribute to service provision through coordinating the efforts of volunteers to work with other nonprofit organizations, which might in some cases be secular; Chaves (2004) points out that, for 1998, only 3% of US congregations received any funding from government.

The rules comprising Charitable Choice are that (1) no organization can be excluded from federal funding because it is religious, (2) the government must respect the religious character of faith-based providers, which includes allowing the institutions to maintain their religious character and can take this into account in hiring staff, (3) respect for the religious liberty of clients must be maintained, which means ensuring that alternatives are available for clients who do not wish to deal with faith-based providers, and (4) the public funds must be used for the public purpose for which they were intended, and cannot be used to fund inherently religious activities (Carlson-Thies, 2004, p. 61).

Are the services provided by faith-based organizations different as a result of the religious beliefs of the employees? Discussing the faith-based initiative, James Q. Wilson writes: "religion's chief contribution to morality is to enable people to transform their

lives. …We come to know God and through Him to know ourselves. And what we learn about ourselves is, I suspect, quite unsettling" (2000, p. 163). But Charitable Choice is not about getting human services clients to get religion, and while volunteers and staff at faith-based organizations might be motivated by their religious beliefs, they do not tend to deliver services markedly differently, or more "holistically," than secular organizations (Monsma and Mounts, 2001).

Based on what we have learned from the economics of contracting, what can we say about Charitable Choice, and, as discussed above, the efforts in some of the states to relax the current restrictions on funding of faith-based organizations?

Contracting out works best when there is more competition between potential service providers; competition forces providers to be more conscious of costs, it provides greater incentives to search for quality innovations, and it allows service providers to learn from the successes and failures of competing organizations. This is a benefit of extending the set of organizations eligible to contract with government to include faith-based organizations: a larger pool of service providers means more competition. But as an aside, remember that contracting with faith-based organizations *requires* competition, since clients must have the option of receiving a service to which they are entitled from a secular or state provider if they do not wish to use the religious-based provider.

Government contractors cannot perfectly and completely specify in contracts every aspect of service delivery, and neither can they perfectly and completely monitor what the contracting agency has done. An advantage of contracting with nonprofits rather than for-profits in service delivery occurs when the government is especially worried that the profit motive of firms might lead them to make unobservable cuts in quality. In

contracting with faith-based organizations, government has a goal of not tying service delivery to anything that would force the client to participate in religious services or to endure proselytizing he does not wish to hear. To a large degree restrictions on what service providers may or may not do in terms of religious content can be specified in a contract: for example, that the service provider cannot require attendance at religious services, but that the service provider is allowed to keep some religious symbols in the place where the provider meets the client. To the degree these factors can be put in a contract and monitored, we mitigate our concerns over contracting with faith-based organizations. Might some churches surreptitiously breach the provisions of the contract? Of course, but that is not unique to faith-based organizations – secular nonprofits, and government employees, can and do quietly depart from their contracted duties. Is the problem worse with faith-based organizations than with secular nonprofits? To this point there is little evidence (see Minow (2003) for a less sanguine view of the monitoring problem in contracting out).

Will contracting with government change the way faith-based organizations deliver programs that in the past were privately funded? We would expect so. James Q. Wilson (2000) writes: "Government aid tends to turn recipients into the organizational equivalent of the bureaucracy that supplies the aid. The essence of the religious experience is … not one that could be supplied under the aegis of the Federal Register and the United States Code." There is a vast amount of evidence on how contracting with government changes the nature of secular nonprofits, from the mission of the organization to the role of the boards of trustees, and it is hard to imagine that any

religious organization entering into a contract agreement with government would be immune to change. There are two things to say about this.

First, a change in the goals, strategies, and accountability mechanisms of a nonprofit organization in light of the possibility of partnership with government is not necessarily a bad thing. While we warn our nonprofit students about so-called mission drift, that is more a problem of changing policy without knowledge, reflection, and strategy. A conscious decision to pursue opportunities in the provision of public services where government is adjusting its priorities and policies is not the same as drift, and may well be for the good.

Second, if the leadership of a religious organization makes a decision to adjust its programs in light of opportunities for contracting with government, is it not their decision to make? From a public policy perspective, it is not clear that the government should say to any type of organization: "we won't contract with you, because you might change in order to meet our priorities." There are distinguished scholars of public policy, themselves religious believers, who strongly caution churches about entering into contracts with the government. It is a good thing for faith-based organizations to know what they would be getting in to, but it is not clear why from a public policy perspective we would think it alright for secular nonprofits to make adjustments in light of government contracts but feel faith-based organizations need special protection from such changes.

So far we have outlined why government contracting with faith-based organizations should be no cause for alarm, in the sense that we have not yet raised any critical differences, from the contracting perspective, between secular and religious

organizations. But now I will turn to what I see as a genuine concern. In the public policy textbooks the subject is outcomes: what policies and processes will efficiently and equitably deliver the goods. By equitably we mean on an equitable basis *to clients*. And as stated above, contracts with private agencies can specify what outcomes are desired and who is eligible to receive benefits. But if we leave the policy textbooks and open the newspaper, we see a different concern in the provision of government services: *who* is doing the providing? Who gets hired, and is any group receiving preferential treatment? Unfortunately, many people evaluate government programs not according to the quality of service provided to clients, but according to how many and who gets hired to do the service provision. Who would deny that this is a crucial issue in the vouchers debate?

If the government were to begin contracting with faith-based organizations to a great degree, even if it tried to award contracts on the basis of quality and cost of service provision, I speculate that it would not be long before there were investigations into the denominational distribution of contracts. There will be questions about the impartiality of the granting of contracts, whether denominations outside the mainstream are getting a fair chance to compete for contracts (and whether they deserve a fair chance), and ultimately to whether the government is favoring a particular religious view. These questions will be raised regardless of any protests by government that it is simply contracting for delivery of human services, with strict provisions in the contracts forbidding requirements of religious observance or beliefs by clients, or of proselytizing.

It is in the inevitable requirement that government not be seen to be favoring some denominations over others, while at the same time trying to award contracts on the basis of merit in the effective delivery of services, that we might see the biggest

difference between contracting out with secular organizations and any expansion of charitable choice. It is difficult enough for cash-strapped government departments to muster the staff and expertise needed to manage contracts with secular nonprofits, but how to resolve this dilemma? If contracts on merit result in Methodist churches being much more successful at getting government contracts than Baptist churches, could the state justify the outcome in terms of fair, competitive processes for tenders? Consider this warning by Melissa Rogers, the general counsel at the Baptist Joint Committee on Public Affairs:

> If lawmaking is like sausage-making, then the appropriations process is akin to the production of the cheapest, most questionable sausage in town. Religion enters this political fray at its peril. There is simply not enough tax money to fund every religious group in this country. Thus, the government will have to pick and choose when it awards grants and contracts. Elected officials will find it almost impossible to avoid playing politics with religion. Houses of worship may compete against one another for government contracts, and, all too often, only majority faiths will prevail. While government cannot heal all of the religious divisions in our country, it should not be in the business of driving us further apart. As our founders recognized, passing out government tax money to churches will do just that. (Rogers, 2000, p. 142).

One way to look at the Charitable Choice initiative is that it would improve the effectiveness of the delivery of publicly-funded programs by employing the resources of organizations that had previously been excluded from this market. But an alternative

narrative is that Charitable Choice serves to "level the playing field" (Kennedy, 2003) in the procurement of services, where that in and of itself is the goal. But equality in opportunity for procurement is a highly contested concept. Is this where the real issues will lie, and not in the actual quality of service provision, or how that quality is monitored by the state? Also note that the issue of equality in opportunity to provide services appears not only with the proponents of charitable choice wanting a level playing field for bidding on contracts, but also through opponents of the design of Charitable Choice, who object to organizations receiving public funds having the right to discriminate in employment on the basis of religious belief.

Some Unanswered Questions

Does this discussion have implications for the debate over the use of vouchers? As stated earlier, the repeal of Georgia's "Blaine Amendment", which in essence is very much like the faith-based initiative at the federal government level, failed as a result of the fear that it would open the door to vouchers in schools, even though there is a reasonable amount of support for state contracting with faith-based organizations in human services. But if there is to be no discrimination against service providers in bidding for government contracts, why is there resistance to vouchers? The key change that arises from vouchers, once there is open bidding on service contracts, is that with vouchers the aggregated decisions of consumers of services directly determine the level of funding, rather than officers in the bureaucracy. With Charitable Choice, the only opposition to increased use of vouchers can be that the reallocation of funds and the

redistribution of case-loads that would result from the introduction of vouchers would be harmful. What is the basis of that charge?

The second unanswered question is how, in our analysis of public policy, we are to treat religious belief. Consider this statement by a proponent of Charitable Choice, defending the right of faith-based organizations to discriminate on the grounds of religious belief in employment:

> Given the history of discrimination in America's past (and present), it is neither surprising nor inappropriate that great attention should be devoted to employment practices in the context of the faith-based initiative. The key question is this: When a federally funded faith-based organization makes staffing decisions based on religion, is it acting like many prominent secular institutions did a hundred years ago in rejecting employment, enrollment or membership to Jews, Catholics, and other minorities? Or is it behaving like current Democratic members of the U.S. Senate, for instance, who presume a right to hire only true-believing Democrats? (Carlson-Thies, 2004, p. 69).

He doesn't answer the question directly, but it is surprising that through the large, and rapidly increasing, literature on the faith-based initiative there is so little discussion of what is the nature of faith. Of course there is understanding that "faith-based" individuals believe in God and that related to this belief is a motive to do good for those in need, while recognizing that those without such belief, who would see humanity as "robot vehicles blindly programmed to preserve the selfish molecules known as genes" (Dawkins, 1976, p. vii), might have the same motives, albeit from a different source. But

religious belief, in so many of our policies, is treated as a different *kind* of belief than belief of whether Democrats have better policies than Republicans. This has implications for the faith-based initiative. And it is a question that has perhaps been overshadowed by the efforts to interpret religion and policy through the lens of the First Amendment. But exploration of how, in a policy setting, we wish to treat religious belief, could help shed some light on the faith-based initiative.

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