Governing the Hollow State

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ABSTRACT

For the past ten years the authors have conducted a concentrated research program on the dimensions and impact of the hollow state. The hollow state is a metaphor for the increasing use of third parties, often nonprofits, to deliver social services and generally act in the name of the state. The types of structures, incentives, and mechanisms used to control third-party providers have been the focus of this research. The empirical thrust of this research is on how effective various types of mechanisms, structures, and incentives are at promoting the effectiveness of contracted services. The normative question this research has raised, but not answered, is, What effect does government contracting with third-party providers have on the perceived legitimacy of the state?

This article is a summary of the theoretical development and the empirical findings from the authors' research on the dimensions and impact of the hollow state in the domain of health and human services contracting. Elements of this article have appeared previously in this journal and in many others as well. The article's purpose is to integrate the authors' research on the hollow state. This is a summative article that seeks to bring together in one place what the authors have learned. In addition, new directions are explored for future research on the hollow state.

Command and control mechanisms associated with bureaucracy are being replaced by much more complicated relationships for the delivery of health and human services. Nonprofits, firms, and governments all play a role in the new world of devolved public policy. This means that public services are jointly produced. No one organization is able to produce all the services that individual clients need. In a world where services are provided to vulnerable populations with multiple problems, the need for cooperation and coordination is acute. Because of this, networks of organizations often provide the array of services for children in foster care or the homeless.

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Networks, while less stable than firms or governments, have stable features whose contours are shaped by law, funding structures, and ideological presuppositions.[1]

This article will lay out the elements of a new approach to governing networks of public agencies, nonprofit organizations, and private firms that deliver taxpayer funded services. The governance problem is this: How can effective institutions be designed in a world of shared power where few organizations have the power to accomplish their missions alone? In health, mental health, children's services, drug and alcohol prevention, and welfare, responsibility for policy design has been devolved to state governments, and policy implementation has been decentralized to a network of local government agencies, nonprofit organizations, and private firms.

Over the past ten years we have conducted research on networks of largely nonprofit organizations that jointly produce mental health services in communities around the United States. These services are either produced under contract with public agencies or are once removed from government with private nonprofit authorities who operate under a master contract with the state.

NONGOVERNMENTAL GOVERNANCE

In common usage, *government* refers to the formal institutions of the state—the executive, legislative, and courts—and their monopoly of legitimate coercive power. *Governance* is a more inclusive term, concerned with creating the conditions for ordered rule and collective action, often including agents in the private and nonprofit sectors as well as within the public sector. The essence of governance is its focus on governing mechanisms (grants, contracts, and agreements) that do not rest solely on the authority and sanctions of government (Stoker 1998, 17). These mechanisms, or tools, are used to connect networks of actors, who operate in various domains of public policy such as child welfare, health, or economic development. A critical empirical question concerns the degree to which they operate autonomously or are steered by the state.

Modern governments by their scale and scope are complex and highly differentiated. Complexity has been compounded by the trend toward establishing principal-agent relations with private firms and voluntary agencies as a result of purchaser-provider relationships. At the same time, the central government has become *hollowed out* as power is devolved to state and local governments (Stoker 1998, 19). Thus, a variety of government

[1]This article focuses on the elements of governance in the hollow state; a companion paper, Milward and Provan (forthcoming), emphasizes interorganizational relations between the network of providers and those who govern them.

agencies have chosen to share their authority for collective action with nonprofit agencies and private firms in a network of mutual dependence.

For many reasons, governments around the world have chosen networks of providers—some governmental, some nonprofit, and some private firms—to deliver taxpayer funded services. What is so astonishing about this worldwide movement away from government provision to government procurement of these services is that there is little evidence that governments or academics know much about how to govern or manage networks. General Accounting Office reports, headlines in newspapers, and special television reports on fleecing the taxpayer regularly report failure of federal government agencies to effectively monitor and control their contractors. Our fondness for decentralization and local initiatives may be fueled by the fear that huge national programs, like Food Stamps, Medicare, and Medicaid, are too bureaucratic to manage efficiently. Ironically, these national programs are hardly monolithic bureaucracies. They are mixtures of governmental and third party administration. In the Medicare program, the Health Care Finance Administration (HCFA) is severely constrained by Medicare's authorizing legislation, which creates a classic principal-agent problem for HCFA. The legislation does not allow HCFA to contract with any claims processing intermediary it wishes. Instead, these intermediaries are chosen by professional associations of hospitals and certain other institutional providers on behalf of their members (David Frederickson 1999, 6). Thus, the principal, HCFA, is responsible for the behavior of agents it might not willingly choose.

At the same time, there is little evidence that we know much more about how to manage decentralized programs effectively at the community level. There is very little empirical evidence that integrating human services, community policing, urban enterprise zones, public-private partnerships, or community coalitions to build social capital have a consistently positive effect on community level outcomes. Good things do happen at the community level; however, it is unlikely that they can be traced back to any particular approach to solving community problems. First, what happens on the ground is very complex, and it is not always possible to determine why, for example, the crime rate fell. It may fall in an area with community policing and also fall in an area with no community policing. Second, evaluation is time consuming, expensive, and often bears bad tidings. As James Q. Wilson points out, foundations—and we would add governments—prefer to fund causes, not research.[2] This is why so many new program initiatives are based on one or two success stories.

[2]Wilson made this remark at a 1996 Washington meeting of university grantees.

THE HOLLOW STATE[3]

We have referred to the current fashion of contracting out government services to networks of largely nonprofit organizations (with some private firms included) as the *hollow state*. Hollow is a an adjective that has described many of the problems of the twentieth century—from T.S. Eliot's poem "The Hollow Men" to "Hollow Politics" (*Economist* 1996). "The Hollow Corporation" (*Business Week* 1986) introduced managers to a new organizational form that replaced internal production with a network of subcontractors. The hollow corporation provided the inspiration for our use of the term, hollow state, as a metaphor to describe the increasing reliance of the public sector on contracting with nonprofit agencies and for-profit firms for the delivery of taxpayer funded goods and services (Milward 1996; Milward 1994; Milward and Provan 1993; Milward, Provan, and Else 1993).[4]

By the hollow state we mean the degree of separation between a government and the services it funds (i.e., the number of layers between the source and the use of funds). For instance, the Arizona behavioral health system has four layers between the federal substance abuse and mental health block grant and the client; no services are provided until the third or fourth layer. Eligibility determination, contracting, monitoring, and all clinical services are provided by nonprofits or private firms.

In a general sense, the hollow state refers to any joint production situation where a governmental agency relies on others (firms, nonprofits, or other government agencies) to jointly deliver public services. Carried to extreme, it refers to a government that as a matter of public policy has chosen to contract out all its production capability to third parties, perhaps retaining only a systems integration function that is responsible for negotiating, monitoring, and evaluating contracts. Obviously, a great deal of territory is between these two extremes, but while hollowness varies from case to case, the central task of the hollow state does not—this is to arrange networks rather than to carry out the traditional task of government, which is to manage hierarchies. The International City Management Association is in the process of drafting a set of core beliefs. One of the core beliefs is: We believe in partnerships and collaborations to advance the cause of effective local government.[5] This is an acknowledgement by the oldest of the public management professions that things are getting very fuzzy at the local level, and a city manager cannot do his or her job without partnerships with special districts, voluntary agencies, and the private sector.

[3]This section closely follows Milward (1996, 193-95)

[4]Mosher (1981) and Salamon (1981) first identified the scope and scale of federal government contracting. It has been called "third-party government" (Salamon 1981) and "government by proxy" (Kettl 1988). As it applies to government and nonprofit contracting it has been called "the hollow state" in our work and "the contracting regime" (Smith and Lipsky 1993) The key point in all these formulations is that governance occurs whether or not a government agency is directly involved.

[5]ICMA, Draft Core Beliefs, December, 1998

The term hollow state is also used to denote that public policy choices under this type of relationship center on governance rather than on government (H.G. Frederickson 1996). Osborne and Gaebler (1992) describe governance as the supplying of collective services to citizens through various tools, government provision being only one of them. Thus tools like contracts, quasi markets, and franchises allow the government to "steer rather than row."

The main difference between the hollow state and direct government provision of services lies in the presence of a bureaucratic mechanism. The hollow state has very few command and control mechanisms; public managers find themselves involved in arranging networks that may enable them to gain the advantages of scope and scale without the negatives associated with bureaucracy (i.e., redundancy and rising costs). These networks are used to deliver services under contract, proving that a government-provided service does not necessarily have to be administered by a large body of civil servants. There is potentially a great deal of flexibility to change and adapt as the need arises. Also, less risk is involved because when needs change, contracts can be terminated so that downsizing is not an intractable problem.

The fact that a hollow state relies on networks is a weakness as well as a strength. Markets and hierarchies are both strong forms of social action. A market leader can drive competition to the wall; a monopoly producer has a very powerful position. Because of hierarchy, bureaucracies are more predicable and stable over time. Networks, the mainstay of the hollow state, are inherently weaker forms of social action. Because of the need to coordinate joint production, networks are inherently unstable over time. Managers are continually faced with problems that can lead to instability—negotiating, coordinating, monitoring, holding third-parties accountable, and writing and enforcing contracts—all for organizations that are relatively independent of the funder.[6] Agency problems also arise due to the asymmetry of information involved between the principal (government) and the agent (the firm or nonprofit). The third-party agents may also organize themselves politically to pressure elected representatives to intervene in disputes between the government agency and its network of nonprofits and firms.[7]

While it is unrecognized in the literature on principal-agent theory, the delegation of authority to nongovernmental agents can lead to a potential loss of legitimacy of government action accomplished at arms length. "Political principals can transfer

[6]Governing a set of contractual relationships demands specification, negotiation, monitoring, and perhaps litigation. Studies of the comparative cost of contracting versus government directly producing services are needed to settle this important issue. (See conjecture by Michael Barzelay and query by L.R. Jones in *International Public Management Journal* 2:2.)

[7]For a discussion of principal-agent problems in networks see Milward and Provan (1998). Ferris and Grady (1997) discuss principal-agent problems related to public management.

power to their agents, within limits set by law, but they cannot transfer legitimacy in the same way" (Majone 1997, 13).[8]

As Phoenix turns its mental health system over to ValueOptions, a private for-profit provider, and as George W. Bush seeks to turn the Texas welfare system over to companies like Lockheed Martin or EDS, it is well to remember the words of the late Fritz Mosher (1986) who said, "One does not diminish one's responsibility by paying someone else to do the work as the Challenger disaster shows." Robert Kuttner (1989) echoes these sentiments and extends them:

> Privatization only changes the venue, not the public responsibility. And if government pays the freight, government necessarily has to police the contractor. Yet the more reach contractors have under a privatized system, the less capacity government is likely to retain. The claim of hopeless government incompetence becomes a convenient self-fulfilling prophecy.

While flexibility is a strength of the hollow state, coordination is complex and accountability can be difficult to determine. Is the hollow state better or worse than the bureaucratic state? This is a question that at present cannot be answered. The blending of funding and responsibility in networks of public, private, and nonprofit organizations makes these issues very hard to evaluate.

The hollow state does not come from conditions found at the local level where governments are fragmented and authority is widely diffused. It flows from the central problem of governance in the United States—its separation of powers and wide diffusion of authority. Allen Schick (1985, 125) captured the implications of our institutional design on the problem of governance:

> Consider the implications for the conduct of government of the fact that three-quarters of the federal budget is transferred to outsiders. This country has functioned for almost two hundred years with the notion that as chief executive the president presides over an executive establishment that constitutes the U.S. government. But the president is not chief executive of the fifty states and thousands of local governments that obtain $100 billion in federal grants, or of the 36 million Americans who receive Social Security checks each month. . . . Until we comprehend what is involved in governing a government of political networks rather than a government of administrative compartments, we will not know how to manage. . . .

THE ELEMENTS OF GOVERNANCE

What do we know about governing the hollow state? Nowhere near as much as we would like to know; however, in our research a number of elements of governance seem to be

[8]The legitimacy of the state might increase if the reliance on community-based networks of service providers led to the empowerment of citizens and an increase in responsiveness to clients. Thus, if performance increased, so would the legitimacy of the hollow state. (Comment on an earlier draft of this article by Joerg Rabb, University of Konstanz.)

associated with effective governance and, in some cases, positive outcomes for clients of human service systems.

Clear Principal-Agent Relationships

The focus of our 1995 study (Provan and Milward 1995) was on the relationship between funding, network structure, and client outcomes. Institutional design was added to the study by chance when each of the four networks in the study had a different institutional structure—a quasi market, a private franchise, a public franchise, and a monopoly—for the delivery of mental health services. One mental health network was dominated by a powerful organization that functioned like a monopoly and had much higher levels of client and family satisfaction than the other networks. The structure of this network closely conformed to principal-agent theory. It also was a network that was characterized by centralized integration among the providers. Thus, clear principal-agent relationships existed between the state government agency and the local mental health authority and also between the mental health authority and the other providers in the network. As Gary Miller describes the theory (1992, 2), ". . . agents are perceived as having distinct tastes (such as the desire to limit risk taking or costly effort), which they pursue as rational maximizing individuals. The principal's job is to anticipate the rational responses of agents and to design a set of incentives such that the agents find it in their own interests (given the incentive system) to take the best possible set of actions (from the principal's perspective)."

While this theory has wide acceptance in economics, it is at variance with almost all the best practice literature in community mental health and the human services generally. The findings reported in Provan and Milward (1995), and explicitly reinterpreted in principal-agent terms in Milward and Provan (1998), run counter to much of the conventional wisdom on public-sector service delivery. This literature asserts that service integration through public authorities that concentrate local funding in one set of hands and arrange for the provision of community-based services by a network of providers will be more effective than other alternatives (Kagan with Neville 1993; Shore and Cohen 1994).

We cannot prove that higher levels of client and family satisfaction are a result of clear principal-agent relationships. Our study consisted of only four mental health systems, and at most we have an association between performance and clear principal-agent relationships. However, no one has provided compelling evidence to the contrary.

Speaking in a heuristic sense, principal-agent relations are important for public and nonprofit managers. Just as multiple reporting relationships in organizations can lead to well-documented problems of unclear authority and responsibility, the same thing is true in networks. Taken to an extreme in a federal system characterized by separation of powers between executive, legislative, and judicial branches of government and with public, private, and nonprofit agencies delivering services, managers can drive themselves crazy trying to figure out all the potential principal-agent relations in a human service system that spans levels of government, branches of government, and multiple contractual relationships. However, some relationships are more important than others. Of importance is: Who is the principal's principal? What power and authority do they possess? Are they subject to influence?

Nonprofit agencies that act as local authorities to arrange networks of providers are particularly vulnerable under a system of contracting. This would include mental health authorities, economic development authorities, and housing authorities. All exist at the sufferance of government and have the right to organize a system of services in a local community or multi-county area. The legitimacy they have is delegated by the government agency that created them or tendered the contract they hold. Authorities operating under contract have a time-limited legitimacy. Because of pressure to engage in competitive contracting, the state will often rebid the contract every few years.[9]

Rebidding contracts frequently has several negative effects on cooperation among the set of providers who hold contracts with the authority. First, because the authority's legitimacy is conditional, it encourages end runs to the state legislature to try to loosen the bonds that the authority has over the providers. Legislators, who are popular candidates for a provider's board of directors and always need local support in their electoral efforts, will sometimes intercede with the state (the principal's principal) to pressure the local authority to demand less in terms of performance or more in terms of the money that flows to the provider under the contract. Second, because the authority will have to compete for the contract when it is rebid, the providers may fail to cooperate because they fancy themselves winning the contract from the current authority. Even if they don't, another bidder may win the contract, and long-term investment in cooperative endeavors and infrastructure may be wasted under a different "contracting regime" (Smith and Lipsky 1993).

[9]Advocates of privatization often blur a key distinction in their schemes for competitive contracting. What they say they want is competitive contracting for government services. The idea is that competition will bring down the price for contracted services. What often happens instead is competition for the market, with one party awarded a government-granted property right to be the sole purchaser of taxpayer funded services. This is competition for the market, not competition in the market (Thompson 1993). This process results in the government creating one authorized buyer (a monopsony). Because of the once-removed principal-agent relationship between the government and the agencies actually providing the services, prices are unlikely to drop unless the government diligently monitors and evaluates the cost of the services provided. There is no hidden hand to push the parties toward efficient outcomes.

For all these reasons we believe that the clear principal-agent relationship, which we termed "direct, nonfragmented external control," between a state and a large monopoly provider helps to explain why one mental health system was the best performing network in our study (Provan and Milward 1995). This agency, in addition to running the network, was a community mental health center that was the largest service provider in the community. It had the power to veto state contracts with other local agencies. Thus it had power as a principal and legitimacy as a provider. It could punish defection and, as the largest provider in the network, the state could hold it responsible for the type and quality of services it provided, not just what it contracted for with other providers. As a principal, the agency was in the position to evaluate the costs of many of the services it contracted for with the other providers, since they also produced many of the same services. Because those in the agency knew the cost of production, they were able to negotiate hard with providers. This, not the hidden hand of the market, pushed the network toward efficiency and effectiveness.

The second highest performing community mental health network in our study also had direct, nonfragmented external control between the providers and the state agencies they contracted with. The institutional design of this system was a quasi market; providers held contracts directly with several state agencies and with one county agency. The providers generally only had one contract with one agency, so there was a clear principal-agent relationship. The system made no attempt to promote centralized integration. While one agency was far larger than others and performed a broader range of services, it had no formal power or authority to integrate the system.

Our research on four community mental health networks shows that there is empirical support for the following propositions regarding the relationship between government and third party service providers.

- Effectiveness will be highest when mechanisms of fiscal control by the state are direct and not fragmented or indirect.[10]

- Effectiveness will be highest when the network is integrated, but only when integration is centralized through a powerful core agency. This structure facilitates both integration and coordination and is relatively efficient.

[10]A direct relationship is limited by the scale and scope of the network. If the network covers a city of 3 million rather than a city of 500,000, a direct relationship is likely to create impossible monitoring problems. All the cities in this study had populations between 369,000 and 667,000.

Resources

In our study of community mental health networks we assumed that, all other things being equal, well-funded systems would perform better than poorly funded systems.[11] Of the four systems we studied, two were in states among the most well-funded in the country and two were in states among the most poorly funded in the country. As one might have predicted, one of the best-funded networks was also the best performing. However, the other well-funded system performed as badly as one of the poorest. One of the poorest performed next best. Does this mean that funding doesn't matter? Funding matters, but clear principal-agent relations and, as we will soon see, stability also matter. When a reasonable level of funding is combined with an institutional design that creates incentives for agents to perform as promised, all other things being equal, reasonable outcomes are likely to result. This has led us to the following proposition:

- Network effectiveness is most likely in a resource-rich environment and is least likely in a resource-scarce environment. However, resource munificence alone will not result in an effective network, and resource scarcity need not mean an ineffective network (i.e., other factors matter more).

Stability

In the discussion thus far, the first three propositions hold, all other things being equal. Our fourth proposition will introduce time as a variable to our model—the length of time the contract has been in place. We have termed this variable *stability*. Stability is not a virtue that most economists would recommend as likely to promote performance. Their nostrum in recent years has been competitive tendering. Putting providers at risk, according to economic theory, should put them on their toes and make them more efficient and innovative in designing and delivering their services.[12] In some sense economists are right. A system can be too stable, too inward focused. If resources are not constrained, a stable system is subject to redundant and rising costs. There is, however, a key difference between the work of a social service provider and a private garbage hauler operating under a competitively tendered contract. The garbage hauler is responsible for picking up trash in a defined area of a town. The firm's success does not depend on thirty different trash haulers doing their jobs correctly for the town government to be pleased. What is to be produced can be clearly defined, and responsibility for seeing that the service performed can be fixed and measured. Trash hauling has a single production function.

[11] Well funded and poorly funded are ambiguous terms. No one knows how much it costs to meet the demand for mental health services.

[12] For a critical and interesting view of the role of governments creating quasi markets on both sides of the Atlantic, see the edited book by LeGrand and Bartlett (1993).

Contrast this with mental health service or with most other human services. One provider specializes in mental health treatment that uses talk therapy and drugs. A second provider specializes in day treatment that provides a place for seriously mentally ill individuals to congregate during the day and engage in hobbies and group therapy. A third provides group housing for the mentally ill. A fourth provides an inpatient psychiatric facility where a client who becomes psychotic can be treated. A fifth runs a suicide prevention hotline. A sixth runs a vocational training program. A seventh runs a crisis facility where clients are stabilized, psychiatric evaluations are performed, and, if they are eligible, clients are enrolled in the network and gain access to its services. If the network is to perform well, all these providers must do their jobs reasonably well and, in addition, refer clients to other providers for services they do not offer.

The point of the elaborate discussion of who does what in community mental health is to show that community mental health networks, unlike trash haulers, have a joint production function. As we mentioned earlier, the need to jointly produce services is one of the defining characteristics of the hollow state. Thus stability, up to some point, promotes effective performance. A system in flux will not be able to coordinate referrals or develop a stable system of services that clients need in a deinstitutionalized community setting. A stable system, even one that is poorly designed or inadequately funded, allows the individuals and agencies working in it the time to work out problems and agree on a division of labor regarding who should do what. It also allows the principal the time to learn how to govern.

Learning to govern is a process of trial and error. If a competition is conducted for the right to deliver services and a new organization wins the bid, it is almost a certainty that performance will decline in the short term. New infrastructure must be developed. The new authority must learn which agencies produce quality services at a reasonable cost and which agencies can be trusted to cooperate. Costs can expand quickly unless effective controls are in place to monitor and evaluate services. New and costly drugs can quickly increase costs far beyond projections. Public-interest lawsuits and new laws and regulations can quickly expand the client population who have rights to services. In an era when many state contracts for services are capitated, this can be a particularly difficult problem. All these problems must be reduced to tolerable levels if a new system is going to be reasonably stable.

One key finding of our research (Provan and Milward 1995) is that stable human service systems are more likely to perform well than are systems in a state of flux. Both of our highest performing community mental health networks were quite stable. Both of our lowest performing community mental health networks were unstable. By *stability*, we mean that the network has not been changed recently in any of its key structural components nor has the master contract with the state been rebid. In the case of our best performing system, it had been configured as a monopoly for twenty-five years and the executive director had been there for that entire time. In addition, there had been only four state directors of mental health during that twenty-five-year period. The next best performing system had been a quasi market for over ten years.

Conversely, our lowest performing community mental health systems both had changed their structure recently. In the well-funded state, a model mental health law had passed slightly more than a year before our study. A new alcohol, drug, and mental health board had been given authority to govern the community mental health system. Several large community mental health centers went out of business and the board created a new mental health center that was wholly owned by the board. The head of the board, a self-described tinkerer, continued to fine tune critical relationships. Our research indicates support for the following proposition:

- Network effectiveness will be highest under conditions of general network stability, although stability is not a sufficient condition to produce effectiveness. This relationship will be greatest when a network is well funded, centrally controlled, and directly funded.

EXTENDING THE FINDINGS IN NEW DIRECTIONS

Our research on the four mental health systems concluded in late 1994. Since that time we have continued to conduct empirical research in mental health (Provan, Milward, and Roussin 1998), and we have continued to try to understand the relationship between our findings and findings in related areas of social science. Specifically, we have been reevaluating our theoretical approach—which is based on resource dependence and institutional approaches in organization theory—in light of rational choice approaches to collective action problems. Our first attempt to integrate a rational choice approach into our theoretical framework resulted in a reinterpretation of our findings in light of principal-agent theory (Milward and Provan 1998). Research on solving social dilemmas has been quite helpful in allowing us to work through some of the incentive problems in human service systems, although much remains to be done to integrate this approach into our theoretical framework.

Solving Social Dilemmas

A variety of problems that emerge over time must be solved if a system is going to become or remain stable. These problems arise from the interaction of individual actors in collective action situations. These types of problems are called social dilemmas. "Social Dilemmas occur whenever individuals in interdependent situations face choices in which the maximization of short-term self-interest yields outcomes leaving all participants worse off than feasible alternatives" (Ostrom 1998, 1). If individuals are to engage in effective collective action, it is essential to solve social dilemmas. Perhaps the most interesting current work in the social sciences is a variety of fields' attempts to discover the role that institutional design plays in either encouraging or discouraging collective action to solve social dilemmas.[13]

The mental health field provides many interesting examples of the failure to solve social dilemmas. Recently, a major conflict erupted in Phoenix, Arizona, a city of over three million people, between the community mental health authority and its provider network. Because of fluctuations in funding, the authority needed to cut $23,000,000 out of a budget of $170,000,000. A provider network of 135 agencies was affected to a greater or lesser degree by these cutbacks. The CEO of the authority met with the providers to explain the reason for the cuts and to urge that the providers and the authority cooperate to get through the difficult time together.

Many of the providers agreed that cooperation was necessary in the interests of the system. They also acknowledged that the provider network was too big and that the cuts would probably put some smaller agencies out of business because they were no longer viable in an era of managed care. They also agreed that whatever they thought of the cuts that the mental health authority thought it had to make to remain financially viable, the cuts were nothing compared to the cuts that a for-profit firm would make if it took over the system in the event that the authority failed and the contract had to be rebid.

This is a case where the social dilemma was not solved. Providers lobbied the state division of behavioral health against the mental health authority's actions, accusing the authority of mismanaging the system. At the same time advocates protested the cuts to the judge who presided over the system after the settlement of a class action lawsuit. This led to the state

[13]Elinor Ostrom (1998) published an excellent review of the literature on social dilemmas and collective action.

department of health services terminating the contract with the authority and running the system directly. The mental health authority sued the state to show cause and declared bankruptcy at the same time. A negotiated settlement led the authority to give up its claim to the contract in exchange for nine million dollars. This allowed the nonprofit authority to set up a foundation. The result was that the provider network was in a shambles, the state didn't have the capability to operate the system effectively, the advocates were still upset, and the taxpayers of Arizona were nine million dollars poorer. The state then issued a bid that required the contractor to hold a $26 million reserve in cash and bonds to gain the bid. In turn this led to a large, for-profit, managed behavioral health company winning the bid to run the system, as no local nonprofits were able to meet the dollar reserve requirements.

Thus the social dilemma was not solved even though the providers knew that it was in their collective interest to keep the system nonprofit; they were afraid that if they didn't lobby individually against the cuts, others would have their cuts restored and they wouldn't. Additionally, if the authority could force the cuts on the system, then the authority would gain in power and political clout at the expense of the providers.

The expectation that lobbying would have little effect and the state—except for serious problems with the treatment of clients—would leave the system alone, would increase the probability that, over time, cooperation would replace conflict, and the system would begin to operate more efficiently and effectively. Failing that, the social dilemma would remain between what is individually rational and what is collectively rational.

Stability promotes a belief that cooperation will have a reasonable payoff as it acts like clear property rights do for investors. It gives them a belief that if they invest in the long term, they have a reasonable chance of reaping benefits. Not putting a system of services out to bid every three years is a way to discourage individual behavior that may be rational in the short run but is collectively highly destructive in the long run. It gives the providers the incentive to solve collective action problems on their own (Ostrom 1990).

What this means in practical terms is giving the principal time to learn to govern the system. Furthermore, it means giving the principal the right to exclude agencies that cannot produce acceptable quality services at the agreed upon price and also to exclude agencies that will not cooperate with the principal or the other agents. This works to further effectiveness in several ways.

First, the ability to exclude agencies decreases the amount of monitoring the principal must do, as the threat of sanctions should serve to keep agencies in reasonable compliance with their contracts. Second, dealing with a group of agencies over time increases the amount of interaction and the likelihood that strong ties will develop among the principal and the agencies, which, it is hoped, will lead to cooperation and effective problem solving. Third, having a group of agencies that interact frequently increases the probability of an iterated prisoner's dilemma game (Axelrod 1984) among the participants. The iterated game decreases the rewards of defection, since the same set of participants must interact with one another again and again to deliver a set of services. With the possibility of exclusion and option, the other participants can punish noncooperation by one party. When parties expect to interact repeatedly for the foreseeable future, it becomes less rational to behave in an opportunistic fashion. Repeated interaction among the same set of participants increases the probability of cooperation (Jones, Hesterly, and Borgatti 1997, 928).

Stability of a system is both a strength and a weakness. The key is to find a balance between flexibility and rigidity. Systems need to be changed and reinvigorated. However, in the public and nonprofit sectors change often is adopted for its own sake rather than to solve problems. New political leadership wants to throw out the old regime. Advocates are constantly demanding that more money be spent and the latest methods be adopted. Contractors often think that they would get a better deal in a new system. Public interest law types are constantly threatening to go or actually going to court to uphold their views of clients' rights. What we do know is that no system can be changed every few years and still produce quality service. Continual change increases the rewards for noncooperation in an existing system, creating the impetus for yet more change. Our research leads us to recommend that if you must change a system, do it infrequently and, if possible, incrementally. Our experience shows us that any new system will perform poorly until social learning occurs among the parties to the new regime. If a system is substantially changed, time must be allowed for it to evolve to the point where it has a chance to improve its performance.

Risk and Property Rights

A stable network of providers governed under clear principal-agent relationships is not the only institutional design that is likely to develop a common purpose and produce relatively effective services. Many new mental health systems try to balance risk and reward by shifting some or all of the risk from the authority that holds the contract with the state to the providers. If this agency gives the money to the providers in a risk-bearing contract, a major source of conflict has been eliminated. The providers, along with the authority, are at risk if the system fails. This type of model is now employed in Tucson, Arizona. Theoretically, this model should dampen political infighting between providers and the authority. The mental health authority has a contract with the state to arrange for the flow of funds to a provider network. The authority bids out part of its authority to provider networks with a strong lead agency that will take an at-risk contract based on a per member, per month case rate. The lead agency will then contract with other providers to form a network and provide a continuum of care for the clients assigned to the network by the authority. Because the lead providers develop their own networks of providers, unhappy providers can only complain about the lead agencies, and the pressure on the mental health authority is diverted to other targets. The lead agency, like the mental health authority, is both a principal and an agent. The lead provider is in a relationship with the providers in its network exactly like the relationship in our most effective mental health system (Provan and Milward 1995). The lead agency produces services, so it knows many of the costs of production, allowing it to contract with those agencies that produce good quality services at a reasonable cost. Whatever the reason, the past five years have seen very little political infighting in Tucson, and, more importantly, there have been no successful attempts by providers to go over the head of the mental health authority by appealing to the legislature. While the legislature itself may cut funds for the system, there are no incentives for individual agencies to try to cut separate deals. The cuts can either be absorbed or all the members of the network can engage in lobbying to try to get them restored. All other things being equal, the design of a risk-sharing model, with clear principal-agent relations, will promote cooperation rather than conflict among the providers.

Some institutional arrangements make the solving of social dilemmas more likely. If property rights are clearly specified and individuals have a good deal of confidence that a collective solution will be enforced by the governing regime and that a new regime is unlikely to come in and change the distribution of property rights in the near future, the incentive to cooperate will increase.[14] Stable or unstable property rights have a powerful effect on individual expectations.

Rules that govern what either economic or political entrepreneurs can do cannot be revised frequently without adverse consequences. North and Weingast (1996, 134) point out:

[14]This section follows Milward and Provan (1998, 219-20).

A critical political factor is the degree to which the regime or sovereign is committed to or bound by these rules. Rules the sovereign can readily revise differ significantly in their implications for performance from exactly the same rules when not subject to revision. The more likely it is that the sovereign will alter property rights for his or her own benefit, the lower the expected returns from investment and the lower in turn the incentive to invest. For economic growth to occur the sovereign or government must not merely establish the relevant set of rights, but must make a credible commitment to them.

The institutions of government have been put in place to reduce the uncertainty of everyday life, even if it greatly increases transaction costs (North 1990, 3). This is exactly what credible commitments to property rights do for a society.

. . . [I]ndividuals must believe that they have reasonable control over their assets before they will risk them in exchanges across time and space. Economic development requires reasonably secure private and communal property rights. The expectation of arbitrary confiscation, either by the state or by fellow citizens, shortens the individual actor's time horizon, increases the subjective discount rate and creates disincentives for investment, specialization, and exchange (Alston, Eggertsson, and North 1996, 130).

What holds for economic growth also holds for network performance—a relevant set of property rights and a credible commitment to them so that individuals will be able to reap some of the benefits of their cooperative efforts, creating the climate where trust and a set of normative values emerge to support cooperation.

CONCLUSIONS

In this article we have discussed a number of elements of governance in the hollow state. We believe that the chances of effective governance are more likely to occur where these elements are present than where they are absent.

- A clear principal-agent relationship increases the probability that networks of providers will be effectively governed. This holds true where the governance structure is imposed rather than where it is emergent. In mental health, as in other areas of health and human services, contractual ties comprise an important but limited piece of the full provider network. Thus while the principal-agent model appears to fit the hollow state contracting relationship, it is less useful for explaining the more informal, trust based ties that also hold a network together.[15] When authority is granted to a principal by the state in an unclear or contingent fashion, it is difficult for effective governance to emerge.

[15]The distinction between contractual and emergent ties in networks is discussed in Milward and Provan (forthcoming).

- Principals that produce at least some services will be more effective at governing a set of providers than principals that only govern. In a monopsony, where the principal is the sole buyer of services, producing some services is the only way to learn about the costs of production. No hidden hand pushes the providers toward efficient outcomes. In addition, producing as well as providing services allows principals to defeat the tendency of a few agents to produce similar services so as to collude on pricing.

- Contracts should be rebid infrequently. Frequent rebidding of contracts is counterproductive as it discourages a long-run perspective on the part of the providers. Infrastructure development will be neglected if there is no expectation of continuity. Frequent rebidding encourages political jockeying aimed at making the principal look bad, so that one agent or a coalition of agents will supplant the principal in the next round of bidding. Frequent bidding not only will destabilize the system, it will not guarantee better prices, as the bidding is for the market rather than in the market.

- Resources are important, but only when they are combined with other elements of effective governance. Throwing money at a problem is almost never an effective strategy. Likewise, putting all the elements of governance in place and then drastically underfunding the system is unlikely to produce good results. A level of resources that is consistent with the degree of difficulty of the task of providing human services to vulnerable clients, when combined with the elements of effective governance, increases the probability of effective performance.

- Stability promotes a belief that cooperation will have a reasonable payoff. No system can be changed every few years and still produce reasonable outcomes. Stability increases the probability that individual actors will develop norms of reciprocity and learn to solve social dilemmas.

A summation of ten years of research on the hollow state, based on both empirical studies of mental health systems and theoretical work on third party governance, allows for the following limited conclusions: When a reasonable level of funding is combined with an institutional design that creates incentives for agents to perform as promised and the system is stable, reasonable outcomes are likely to result. Networks of human service providers aligned in this fashion are more likely to solve collective action problems than those that are not, especially if the state encourages cooperation by allowing enough time for networks to find ways out of social dilemmas. The expectation that lobbying would have little effect and the state—except for serious problems with the treatment of clients—would leave the system alone, would increase the probability that, over time, cooperation would replace conflict, and the system could focus on managing efficiently and effectively.

At the same time, much more needs to be learned about how the hollow state is governed. Can these findings be replicated in other human service systems that rely on third party governance? Are these findings perhaps time dependent? If we had done our research on these same systems at a different time, would the results have been different? There is a need for broad-based studies that will attempt to answer these questions.

In particular the role of stability needs to be better understood. In our view, stability is a function of principals allowing agents to learn from their mistakes. It does not imply that principals should not intervene or help agents cope with problems. It does mean that principals should play a positive role in allowing agents to solve social dilemmas. Solving this dilemma is always difficult when there are multiple principals. It is made even more difficult when the ideology of competition calls for the frequent rebidding of contracts. Agents acting in expectation of not being able to reap the rewards of long-term success will be reluctant to invest in building the infrastructure that would make that success likely. Finding a solution to the dilemma of wanting effective and efficient services while at the same time acting in ways that make this unlikely is a big challenge for the governors of hollow states.

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