Democratic Accountability and Governmental Innovation in the Use of Nonprofit Organizations

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As nonprofit organizations perform many of the duties formerly discharged by government, the issue of democratic accountability becomes relevant. This article shows that governments are unwilling and, in some ways, unable to control such organizations completely. Moreover, we demonstrate how the innovative features of nonprofit organizations can directly serve to undercut democratic accountability.

Nonprofit organizations are performing more and more of the activities formerly conducted by government. Proponents of this shift in responsibility cite cost savings, flexibility, and better service as advantages of using private, nonprofit organizations rather than government agencies. Yet, as private agencies perform more of government's tasks, critics increasingly ask to whom these private organizations are accountable. Indeed, it becomes unclear in this context as to what is meant by accountability. Since elections and appointments are irrelevant to private groups, we evidently need a more general definition. To this end, we will use this definition: Accountability is the need to hold those making or implementing public policy responsible for their actions and choices. We include procedures that inform the public of these choices and actions as part of this definition.

The problem with making nonprofit organizations accountable to the public goes beyond defining the term. Consider that elected officials have a variety of tools to control governmental organizations to which they appoint members and delegate power. These organizations can be held accountable to elected government or disciplined in several ways: their budgets can be cut, their tasks and the way they carry out their tasks can be altered by legislation or by governor's order, or the authorization that allows their very existence can be rescinded.

However, the tools used for controlling government agencies are not as easily applied to private nonprofit organizations. Private nonprofit organizations are not dependent upon legislatures for their legal existence and, hence, have a greater degree of independence. Unlike government agencies, which must surrender surplus funds at the end of the fiscal year, private nonprofits organizations can retain their surplus funding. Since nonprofit organizations are not part of the government, they are subject to less red tape and civil service restrictions. By not having the same restrictions on procedures, nonprofit organizations are able to be more innovative than government agencies. Their independence is reason for many of the improvements in efficiency that make nonprofit organizations advantageous alternatives to government, but it is also a basis for concern about accountability since it means they will be harder for elected officials to control.

The problem of making nonprofit organizations accountable becomes clearer when we consider that democratic accountability can be problematic even in the more easily controlled world of government bureaucracies. Like employees of nonprofit organizations, civil servants are not directly accountable to a democratic public and yet possess considerable discretionary power. The popular media is often filled with complaints that bureaucracy is out of control and must be reined in by elected officials. Often accompanying these complaints are suggestions to privatize services or contract private agencies to provide services.

The irony here is that the solution of contracting out or privatizing may aggravate the control problem. If issues of democratic accountability and control affect government bureaucracies, these problems will be equally or more evident in the nonprofit organizations that replace them. In this paper, we discuss problems of accountability in nonprofit organizations. We begin by describing the general problems of democratic accountability and oversight. We contend that the primary issue is information asymmetry—elected policymakers who know less about a program than those implementing it. We will then look at competition as a means of controlling nonprofit organizations. Control through competition is offered as one of the principal arguments for using nonprofit organizations, but we demonstrate that, even with a highly competitive marketplace, controls are inadequate. Faithful implementation of legally authorized and specified directives cannot be guaranteed even if governmental oversight is able to attain control of nonprofit organizations. We conclude with a discussion of the comparative costs of using nonprofit organizations as opposed to government bureaucracies.

MORAL HAZARD AND ADVERSE SELECTION

Two central concepts help us understand democratic accountability and oversight: moral hazard (hidden actions) and adverse selection (hidden information). These two concepts help define a well-developed body of research known as the principal-agent theory. Asymmetric information between a principal and an agent is the central problem analyzed by such models. A principal (an elected official or body such as a legislature, board of supervisors, or council) is unable to monitor the actions and information of the agent (a government agency or nonprofit organization) assigned to carry out policies the principal created. The agent's effort is difficult to monitor—the interdependence of a team's work makes it nearly impossible to identify who is shirking and who is working. Since it is so difficult to ascertain whether shortfalls in productivity are due to a lack of effort as opposed to some random factors, monitoring becomes even more difficult. Because of these monitoring problems, agents have an opportunity to misrepresent the information that is conveyed to the principal. Accordingly, principal-agent models often focus on such issues as incentive mechanisms and whether it is possible to get honest appraisal of information and assessment of hard work.

Two prominent works demonstrate that no budget-balancing scheme can be created to overcome these problems. Holmström (1982) deals with moral hazard problems while Groves (1985) focuses on adverse selection. The fundamental dilemma is that the costs of monitoring and supervising make it infeasible to devise an incentive mechanism that can overcome these two problems.

What does this mean for implementing democratic accountability programs for nonprofit organizations? The implication is that information asymmetries make complete oversight not feasible. This is true in any setting with a political principal and a public service-producing agent, whether it is a public bureaucracy or a nonprofit organization.

COMPLIANCE AND NONPROFIT ORGANIZATIONS

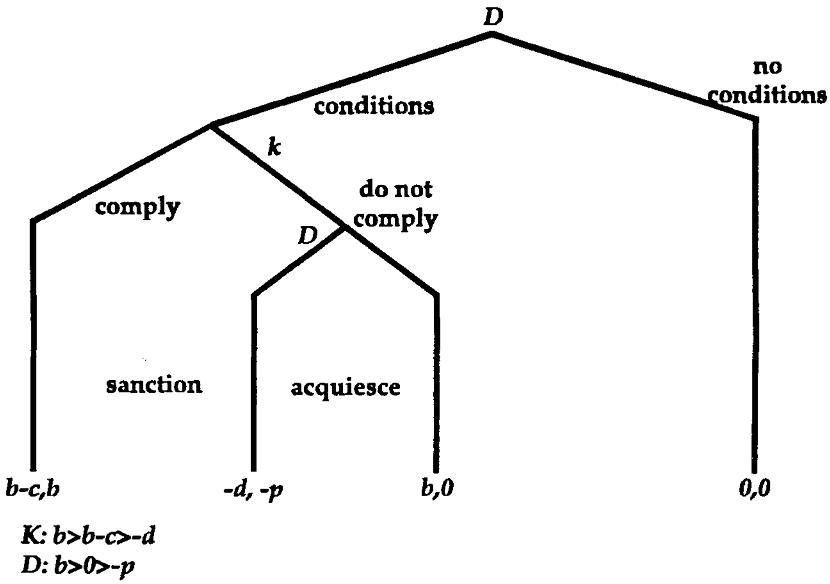
Advocates of nonprofit organizations often suggest competition can be used to ensure control and accountability. We examine this idea in this section. Recasting Selten's chain-store game (1978) as an oversight game, we show that complete control and accountability may still not be attainable, even with competition between nonprofit organizations in the delivery of public services. The oversight game is based on recognizing that punishment has serious costs for both those doing the punishing and those being punished. Because these costs are high, the government is put in the paradoxical position of finding it cheaper to ignore noncompliance, thereby encouraging less compliance in the future. The government could give the contract to a different agent, but the game remains the same. Another agent will have the same opportunity not to comply and the government will have the same incentive not to monitor performance, in addition to the search costs incurred in selecting a new organization. Thus, it does not matter if there is competition; some amount of noncompliance will occur.

The oversight game involves several players: a governmental decision-maker (*D*) responsible for oversight and a set of nonprofit organizations (players, $k \in \{1,2,...,m\}$). Each period of the game involves a different nonprofit organization (k). The payoffs for a single period are shown below in Figure 1 in an extensive form representation of the game.[1] Note that this is a game of perfect and complete information. In this way, we assume away the principal-agent problem of asymmetric information. What we demonstrate here is that, despite complete and perfect information, complete oversight is unattainable.

In the oversight game, a nonprofit organization's highest payoff is receiving government fees for providing contracted services without paying the cost of full compliance. This payoff is represented as b.[2] Their second-best outcome is acquiescing to the demands of the government. In this case, the nonprofit organization still receives the benefits of the relationship, but must bear the costs of full compliance. This payoff is represented as $b - c$. We set the payoff at 0 when no contract is granted. The least desirable payoff for the nonprofit organization occurs when it does not comply with the government's conditions and is subsequently sanctioned. This payoff is designated as $-d$.

The government's most preferred payoff is associated with the payoff occurring when the nonprofit organization complies. This payoff is represented as b. Since there are costs incurred when the nonprofit organization is punished, the worst outcome for the government takes place when the nonprofit group does not comply and sanctions are imposed. Such costs entail

FIGURE 1



monitoring, sanctioning, and selecting a new organization to provide these services. The cost of administering such a sanction (and all associated with it) is *-p*. A payoff preferred somewhere between these two outcomes occurs when a non-profit does not comply and the government acquiesces or ignores the transgression. Since the government avoids the costs of imposing a sanction, this payoff is *0* for the government. This game is then repeated for each player.

Given the structure of the oversight game, equilibrium for each period of the game lies along a path whereby a contract is granted by *D*; *k* does not comply; and *D* responds by not sanctioning the noncompliant nonprofit organization. The equilibrium then can be expressed as: *{(grant contract, do not sanction), do not comply}.*[3] As long as the costs of sanctioning (as well as monitoring and selecting a new service provider) make $-p < 0$ (as long as punishment is costly), then the government has an incentive to ignore noncompliance and, by backward induction, nonprofits have an incentive not to comply. This equilibrium is maintained with or without competition between nonprofits in the delivery of services.[4] Such competition does not affect the costs of monitoring or sanctioning. Competition is irrelevant as long as sanctioning is costly.

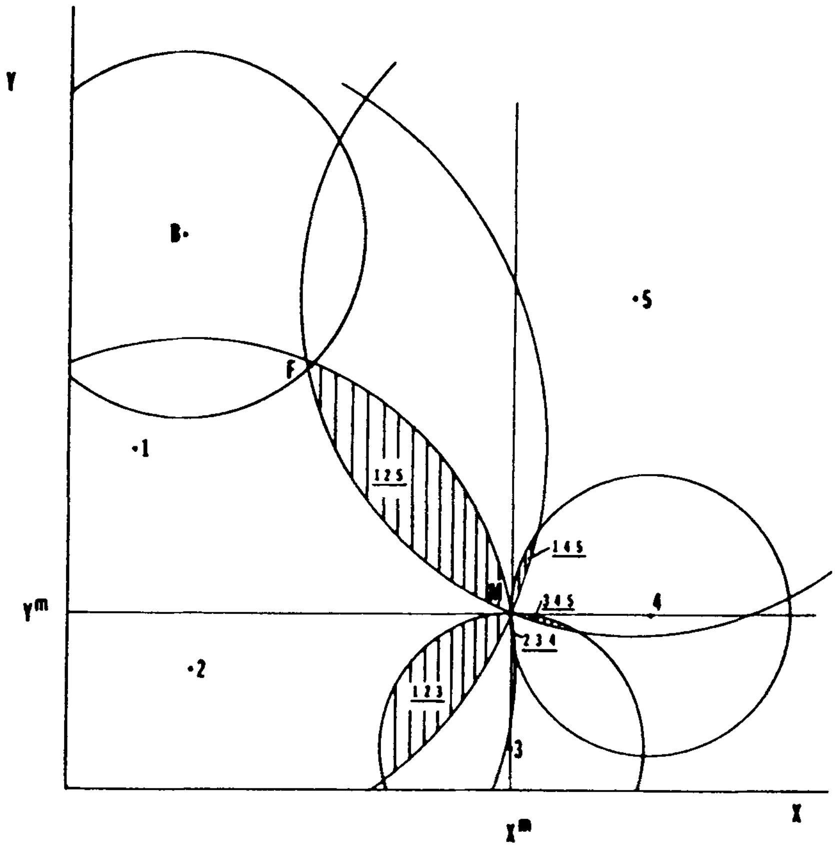
As with the chain-store game, the outcome of the oversight game is paradoxical. The government decision-maker (*D*) ought to be able to do better by being tough, but cannot. By sanctioning the first noncompliant nonprofit organization, the government could deter further noncompliance. When noncompliant organizations are not sanctioned, others are more likely to view noncompliance to be relatively risk-free. Yet the costs of sanctioning and monitoring make it difficult for the government to commit itself to a policy of strict oversight and sanctions, making noncompliance and a lack of enforcement the best choices for agent and principal respectively.

INNOVATION, SLIPPAGE, AND ACCOUNTABILITY

Nonprofit organizations may be even more difficult to control than government agencies. The attraction of nonprofit organizations is their ability to innovate and deliver services more efficiently. However, this ability to innovate is the source of still another threat to democratic accountability. Unlike the previous examples, this threat is not a matter of the costs of punishing or monitoring an organization. We will show that, even if the costs of both monitoring and punishing were insignificant, nonprofit organizations would still be able to ignore government directives and implement policy programs distinctly different from those authorized. The nonprofit organization will change the policy in a way so that elected officials will prefer the new result over the original.

To illustrate this point, we submit the example of a five-person legislature. (The number is insignificant as long as it is more than two people.[5]) The legislature votes to use a private nonprofit agency to deliver a particular service. This service involves a number of issues including the role of government and who will be served. Each issue and all possible positions on the issue is represented as a single line or dimension in Figure 2, which illustrates this example using two different issues and five committee members. Each legislator's most preferred policy, or ideal point, on both dimensions is represented by a single point labeled *1*, *2*, and so on.[6] The closer a policy is to the legislator's ideal point, the more satisfied is that legislator. The legislature agrees to provide the mix of services determined by

FIGURE 2



point M in the figure, and to have this set of services delivered by a private nonprofit organization. Note that this point does not coincide with the ideal point of any legislator. This decision may be the result of a compromise, or it may simply reflect how it was done in the past.

The organization that has agreed to implement these programs has its own preferences over these policies and these preferences, represented by point B. We do not assume these preferences to be illicit or unreasonable. Indeed, they can reflect a desire to lower costs, improve services, or some professional or ideological orientation. If possible, the organization would like to act on its preferences. But we assume that elected officials are able to monitor the organization's actions and punish it. Thus, the nonprofit organization would like to change these policies, but can only do so if the elected officials allow it.

Given this design, it appears that there should be no problem of accountability. We have created an example where control of the nonprofit organization is perfect. However, even under these perfect conditions, problems of accountability can still arise. The organization can alter policy only if the legislature allows it to do so. The question is whether this is possible. It is. The nonprofit looks for the policy points both it and a majority of legislators prefer to *M*. We can portray the points a legislator prefers to *M* as the area enclosed within a circle around the legislator's ideal point and through point *M*. Thus, the area within the circle around point 4 represents all of the policies legislator 4 prefers to point *M*. Circles have also been drawn through *M* around the ideal points of each of the other actors.

In the hypothetical five-person committee illustrated in Figure 2, a policy point is preferred by a majority of the committee if the point lies within the intersection of at least three of these circles or indifference curves (so called because a legislator is said to be indifferent between any two points on the curve). In Figure 2, the shaded lens-shaped area shows the points both the nonprofit organization and a majority of the legislators prefer to *M*. The lens pointing up from point *M* represents the policies preferred to *M* by legislators 1, 2, and 5. If the organization implements a policy point within this shaded area (instead of implementing point *M*), then the legislature could conceivably threaten the nonprofit organization with sanctions. They will not vote to do this, however. A majority of the legislature will not vote to sanction the nonprofit organization because they prefer the points inside the shaded lens. The nonprofit organization can choose its most preferred point within the lens, point *F*, and the legislature will not authorize sanctions against it.[7] Note the legislature does not have to vote to approve it. They need only ignore it.

We have shown that, even under conditions that should be perfect for controlling an agent, a nonprofit organization still has the ability to change the directives it was given and implement a different policy. If we drop these ideal conditions and recognize the costs of monitoring and punishment, then it only becomes easier for the nonprofit organization to alter the policy.

Three questions arise here: Why didn't the legislature choose the newer, better policy in the first place? Why is this ability to change bad? Is there any way to control innovation?

The answer to the first question is that the outcome of any vote in a legislature is only partly a function of the people's preferences. Rules and control of the agenda are among the influences affecting decisions (Krehbiel, 1988; McKelvey, 1976; Shepsle, 1979). If a different set of rules are provided, or if the alternatives are voted upon in a different order, then the result can be different. The rules that influence the legislative body do not apply to the nonprofit organization, however. Thus, the nonprofit organization is free to consider alternative policies that the legislature might prefer but which rules and prior agreements have eliminated from the list of alternatives to be voted on. Finally, while it is not contained in the illustration, the nonprofit organization may know more about the alternative policies than the legislature. Thus, it is possible the legislature members did not have to vote for an alternative because they were unaware of it.

The second question—why is ability to change bad—is more relevant to this paper. The situation we illustrated led to a policy that the theoretical nonprofit agency and at least three legislative members preferred to the original one. If this new policy is cheaper, more efficient, or in some way improved, then what is wrong with using it? Indeed, this kind of innovation highlights the advantages of relying on nonprofit organizations.

The problem is that this process of innovation completely ignores any consideration of democratic accountability. There is no procedure to inform the public; there is no way to hold elected officials responsible; there is no way to learn who made specific choices. The only difference between this policy and one made in a smoky back room is in its result. In both cases, the process is made in the "dark," with no opportunity for public input or debate. If voters disapprove of it, there is no elected official to hold responsible because there is no record of anyone approving it.

Finally, we reach the third question: Can this kind of innovation be regulated without destroying flexibility and inhibiting new ideas? The answer is yes. The key to regulating innovation is choosing an agent with preferences compatible with the originally agreed upon policy, an organization that already prefers the existing policy and has no desire to make radical changes. This ensures that any innovation will represent small improvements, not dramatic policy changes.

However, this answer raises a problem we explored earlier—adverse selection. To begin, there may be no agent whose preferences are truly compatible. Even more problematic, principals do not have complete information on agent's preferences and never know with certainty if their chosen agent really does prefer the original contracted policy. Thus, our seemingly simple solution—pick a compatible agent—only brings us back to the problem with which we began: lack of information.

CONCLUSION

How accountable are nonprofit organizations to a democratic public? Certainly nonprofit organizations are no panacea. As we have demonstrated, oversight and accountability issues are largely unavoidable. Nonprofit organizations will not let us get around principal-agent problems. Whether a public bureaucracy or a nonprofit organization, information asymmetries persist, making perfect monitoring unattainable. Likewise, the costs of monitoring, sanctioning, and searching for a substitute preclude complete oversight. Moreover, competition among nonprofits offers little relief from these problems. We also demonstrate that there is a potential tradeoff between nonprofit innovation and democratic accountability.

Given the general problem of monitoring output from any agency, government regulators instead can attempt to control nonprofit organizations by regulating inputs. The government may attempt to encourage accountability by prohibiting nongovernmental financing, imposing civil service guidelines, or regulating decision-making structures in nonprofit organizations. With enough input regulation, however, nonprofit innovation is sure to be diminished.

There is a tradeoff between innovation and accountability. The innovations and savings made possible by the use of nonprofit organizations have costs of their own. This is not to say that nonprofit organizations should be cast away. Not at all. However, we should question whether they are the answer to all of the problems that beset government. While the loss of accountability can be lessened, it should also be recognized that some loss of public control will be inevitable. This must be weighed against any improvement in service delivery.

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ENDNOTES

[1]Gates and Humes (forthcoming) discuss in detail similar games of oversight under different information conditions.

[2]We use letters to emphasize these payoffs are ordinal. In other words, the preference ordering of outcomes determines the equilibrium, not specific cardinal values.

[3]This expression of the equilibrium puts both of the decision-maker's equilibrium path decisions in parentheses paired in brackets with the nonprofit organization's.

[4]Competitiveness will also vary considerably across the types of services delivered. In many cases, one organization will be incapable of substituting for another.

[5]This example is based on the concept of voting cycles in committees (see, among others, Krehbiel, 1988; McKelvey, 1976; Riker, 1982; Romer and Rosenthal, 1978; Sen, 1970) as well as models of agency-legislative relations (e.g., Hill, 1985; Romer and Rosenthal, 1978).

[6]As long as the number of issues is two or greater, the number does not matter.

[7]That this is the most preferred point can be seen by the circle around *B* and through *F*. There is no point in any shaded area that is preferred.

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