Outsourcing by Nonprofit Organizations

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Abstract

This chapter examines the issue of when nonprofits should choose to employ their own staff or house their own operations, versus contracting out tasks and activities to other suppliers. Various examples are offered of nonprofits decisions that may be outsourced or retained in-house. The concepts of specialization, comparative advantage and transactions costs are used to explain the logic of outsourcing, how it applies to various circumstances encountered by nonprofit organizations, and the desirability of this strategy in each case.
I. Introduction

Outsourcing or contracting-out is the organizational practice of purchasing some services or products from other organizations, rather than producing or generating them within the organization itself. From the early 1980s until the late 1990s a trend of increased reliance on outsourcing took place in the United States, resulting in the downsizing, breakup and divestiture of companies. Several factors contributed to the rise in the importance of outsourcing, including improvements in information technology and communication, developments in transportation, deregulation, and legal decisions in favor of competition. This trend started in the for-profit sector, but it soon affected also government operations and many nonprofit organizations.

Outsourcing has generated substantial savings for many firms, government agencies and nonprofit organizations by allowing them to shed operations that are done more effectively and economically by specialized firms that have better expertise and larger scale of operations in a narrow activity, and that can pay undivided attention to that activity. There are also many examples of outsourcing gone awry: IT services being too expensive as well as unreliable when the contractor takes advantage of an organization’s ignorance of the area, government agencies spending a lot of resources on monitoring and enforcing contracts with private contractors for a total cost that exceeds the cost of running the contracted function in house, nonprofit organizations outsourcing activities to companies with connections to board members resulting in dubious savings and appearances of conflict of interest, and so on.

While outsourcing may clearly generate better services and savings, it can also cause decline in services and escalation of costs. But where does the line between useful and counterproductive lie? As parents know, or should know, one can outsource some of the care for children, but one cannot outsource loving while also remaining a responsible and functional parent. This chapter examines the issue of outsourcing from a theoretical and practical perspective, seeking to provide a solid understanding of what are the fundamental drivers behind the decision to outsource a certain activity versus keeping it in house.
The chapter first identifies general principles that should guide outsourcing decisions, juxtaposing the principles of specialization, economies of scale and division of labor with the problems of managing activities and people within an organization and across organizations. It is clear that some activities, particularly those concentrated in narrow niches that require a lot of expertise to produce but can be readily evaluated, can be more efficiently and economically executed by contracting companies that specialize in those activities rather than generated within organizations that have other primary products. Such activities often include complex computer programming, routine cleaning, infrequent filing activities, temporary need to satisfy peak demand, and so on. However, there are some activities can be more effectively managed and controlled when they are subject to managerial authority rather than to the terms of an agreement or contract between two organizations. This includes even some of the types of activities listed just above; routine cleaning of areas that contain sensitive information may be subject to security breaches, doing routine paperwork on behalf a government agency such as processing visa requests may tilt the tradeoff too heavily in favor of savings at the expense of accuracy, and so on.

The balance between these two considerations (and a few others) may tip in favor of outsourcing or of in-house production, depending on the nature of the activity, its centrality to the organization, the ability of executives in the organization to write and enforce contracts with other organizations, availability of competing suppliers, and so on. It is impossible to come up with a list of activities that should be outsourced. Clearly, activities that are central to the operations of an organization should not be outsourced; everything else is a candidate for outsourcing, but the decision has to be weighed carefully against various contingencies. The chapter develops these ideas, and the idea that nonprofit organizations should not outsource anything that is central to their being not-for-profit.

II. What to outsource? Principles underlying the make-or-buy decision

Production requires many inputs. These inputs may be produced, owned or directly controlled in the organization, or they may be purchased or hired from other organizations or individuals. Examples of the two alternatives abound. A car manufacturer can produce its own engine, car
bodies, and several thousand other parts, or it can purchase them from other firms; it can sell the cars through its own dealerships, or it can use independent dealers; it can even buy fully assembled cars from another company and only attach its brand name before selling them to customers. Parts may be purchased from suppliers who are steady partners, or from occasional suppliers that are chosen as needed from a list of potential suppliers. A nonprofit hospital can employ staff physicians, or contract with physicians for their services; it can own its own laboratories, or it may purchase laboratory services from other firms; it can operate its own laundry services, or it may purchase them from other companies; it can sterilize its medical instruments, or it may purchase these services from others; it can use its own staff to transcribe physician dictations, or it may contract with another firm. Some software companies outsource help-line services, many clothes retailers use suppliers that manufacture clothes according to the retailers’ design, or buy clothes designed and manufactured by other companies, some counties and states have contracted out to private firms the operation of their prisons, and some nonprofit organizations pay for-profit firms to raise funds for them. Most organizations have the option to do their own payroll, operate their mailroom, perform public-relations functions, and so on, or buy the relevant services from other companies.

What kind of services should an organization purchase from outside suppliers: common, non-specialized, standard services, or rare, unusual, specialized services? What are the criteria for choosing which activities to outsource? What are the contingencies that make outsourcing desirable in one situation but not in another? Do the principles of outsourcing decision differ between nonprofit organizations and for-profit firms? Should nonprofit organizations outsource to for-profit firms or to nonprofit organizations?

Consider an input used by an organization in the production of its own final product. The input in question can be mail services, fundraising, laboratory tests, car engines, payroll services, marketing, and so on, whereas the organization’s final product may be health-care services provided by a hospital, cars delivered to consumers, services for the elderly, museum services, and so on. The production, ownership or control of the input can be kept in house, a decision referred to as ‘make,’ or else it can be outsourced to another company, the option often termed ‘buy.’
Under the in-house alternative, responsibility for the activities of the input rests with the same authority (management) that is in charge of production of the final product. Management’s responsibility extends of course also to oversight over additional activities, as well as for their integration with the input in question in the production of the final product. For example, a nursing home may hire its own nurses, and make sure that their work is coordinated with other activities necessary to provide adequate care for patients. Clearly, for effective patient care, the nursing home’s management must be proficient at hiring and managing the activities of nurses and of other groups of employees, as well as integrate their activities to provide good patient care.

An organization may outsource inputs to other organizations, that is, to enter into a purchaser-supplier relationship. In this event, some decisions about the outsourced input are made in the supplying organization, and other decisions are made in the purchasing organization. In the nursing home example, nurses would be hired by an employment agency (‘temps agency’ or ‘contract house’) who decides, perhaps in consultation with nursing home representatives, what kind of nurses, and sometimes which specific nurses, will be deployed. But the ultimate decision on hiring of nurses, including what their qualifications and experience should be, is in the hands of the employment agency, whereas the decision regarding the deployment of the nurses rests with the management of the nursing home, as is the responsibility for their integration with other employees and activities in the care of nursing home patients. It is also the employment agency that collects information about the behavior and performance of its nurses and then chooses what information to share with the management of the nursing home.

Is ‘making’ (e.g., hiring and employing nurses directly) more economical than ‘buying’ (using the services of the employment agency), or is it the other way around? The answer depends on (1) the magnitude of the benefits of specialization and economies of scale, (2) which organization can control better agency problems that arise within it (obtaining employees’ cooperation), (3) how easy it is to control agency-type problems between the purchaser and the supplier, and (4) its centrality of the input in question to the production of the organization’s final product and its mission. Adding, for example, a specialized computer engineer or
programmer to a nursing home's staff in order to maintain the agency's web site, create forms, maintain patients' records and link them with hospital records, and so on, requires that the manager spend time understanding the alternative software solutions on the market, benchmark the programmer's work for purposes of supervision and compensation, and so on. This entails sacrificing time that otherwise could be spent on managing the organization and developing staff tied to the core activities of the nursing home.

(1) Specialization, comparative advantage, and economies of scale

An effective production process requires skills of employees, knowledge of production techniques, awareness of innovation in product and process, and management practices that may be specific to the product. The more specialized a production process is, the greater the specific investment that it requires. This means that if the production or control of the input entails a different set of management skills than the production and control of other inputs used in the organization, then the organization will have to invest in different tracks of specialization for the various inputs. If the scale of operation is sufficiently large, this will allow the organization to reap the benefits of investment in the specialized production or control of the input. However, in the absence of economies of scale, the investment will not pay off as compared to investment by an organization with a larger scale production or operation of the input in question. For example, an organization that makes only little use of audio-visual presentations should not invest in either a specialist who is specially trained in such presentations, nor in expensive equipment. All other things equal, organizations benefit from specialization. This consideration favors outsourcing.

The concept of comparative advantage emphasizes that specialization is the consequence of one firm having a lower opportunity cost in the production of one good than other firms. The notion of lower opportunity cost implies not that a firm should produce all those goods that it can produce more effectively than other firms can, but that is should specialize in the production of the goods that entail a relatively lower sacrifice of inputs than for other firms. This consideration is particularly apt when there are important constraining inputs, such as management’s time, span of control, and expertise. Thus even a very talented manager of a small organization should
be wary of adding many activities that he or she could manage well because such additions may reduce the manager’s opportunities to devote time to the organization’s mission; in other words, the organization could produce more of its main product by buying some services from other organizations rather than overseeing them in the organization itself. The comparative-advantage consideration militates in favor of outsourcing many activities, and focusing on what is often termed ‘core competencies.’ We return to this issue later.

The production of different products may be complementary in that some skills, equipment, management or other factors may be utilized in common, preventing duplication of effort and other investments and therefore generating savings. For example, selling season tickets for a theater and soliciting donations from certain groups of theater goers may be complementary, as are information technology services for maintenance of donor databases and for Internet registration to events. This consideration suggests that products benefiting from complementarily should be produced together.

(2) Comparative agency costs in organizations

Every organization has the obvious need to obtain the cooperation of its employees towards the attainment of organizational goals, and every organization faces difficulties in accomplishing this goal. Whereas some individuals may always do what their superiors request, most people will seek opportunities to pursue their personal objectives when they can do so within constraints of legality and their personal values. This means that employees may work less hard than their employers would like them, or that they may pursue projects that are of interest to them but are not considered to be optimal from the point of view of the organization. Problems of this sort are called principal-agent or agency problems. Owners and the board of directors are usually thought of as principals, whereas managers and employees are thought of as agents; however, for the purpose of examining the relationship between management and employees it is useful to
think of management as principals (while they are agents for the board of directors), and
employees as their agents. Membership directors in various organizations fall probably into this
category. Nonprofit organizations typically pursue multiple objectives, whereas for-profits
pursue primarily one objective, profit. The existence of multiple objectives that are not easily
weighted by relative importance and the fact that some objectives are not quantitative makes it
difficult to offer executives and many managers a simple financial incentive scheme that ties pay
to desirable outcomes. In for-profit firms, the compensation of upper management and even line
employees may be linked to the one overreaching goal of the firm, profit.

To obtain maximum cooperation, organizations institute incentive schemes that align the
interests of the agents with those of the principals, monitor and supervise agents, use the threat of
dismissal, and engage in other means aimed at getting agents to act in ways that promote
principals’ interests. Generally, the larger an organization the more severe are the agency
problems it faces because of the greater distance between principals and their agents and the
difficulties in exercising effective discipline associated with such distance. As a result, larger
organizations have to spend disproportionately more resources for coping with agency problems
than smaller organizations; that is, the costs of agency per unit of the final product are greater the
larger the organization. And the more an organization produces internally (rather than outsource)
the larger it will be, and therefore it will face more severe agency problems. Hence, all things
equal, outsourcing is desirable from an agency perspective.

Of course, all things are rarely equal. Large organizations can often reap benefits of scale that
smaller organizations cannot enjoy, and these additional benefits may in some cases outweigh
the greater agency costs associated with larger size. Some organizations have a better ability to
deal with agency problems than other organizations, perhaps because they have more skilled management, or because their operations are such that agency problems can be dealt with more easily. This is the case, for example, when there are few possible hidden actions employees can take to benefit themselves rather than the organization without being detected by supervisors. Employees in many nonprofit organizations support the organizational mission and are loyal to their organizations more than employees in for-profit firms, hence agency problems in such organizations may be less severe. However, nonprofit organizations can rely less on financial incentives than for-profit firms to alleviate the difference between personal goals and organizational objectives, hence agency problems may be more severe.

The discussion of agency problems suggests that outsourcing is an important option to consider, particularly for nonprofit organizations that have difficulty in controlling such problems internally. However, outsourcing creates agency-like problems too, as the relationships between two organizations (purchaser and supplier) are not free of issues of alignment of different objectives. In order to decide which solution is better – make or buy – we must compare the agency costs incurred in executing a certain function within the organization with the agency-like costs born in purchasing on the market services from another organization.

(3) Agency costs across organizations: costs of transactions on markets

The relationship between a purchaser and a supplier can be regarded as an agency relationship, although neither is formally the principal or the agent of the other. An organization that contracts out a service to a supplier wants to make sure that its objectives are being met, just like a manager seeks to have employees act in accordance with the organization’s objectives. However, the arms-length relationship between two organizations gives rise to opportunities for one organization to seek to advance its interests at the expense of the other, generally more so than in the tighter relationship between a manager and employees within the confines of the same organization.

Several factors influence the magnitude of the costs of transacting with other organizations for the purposes of selling and buying a service. These factors include: the complexity of the
service, whether the service is a ‘private’ or ‘public’ good, the reliability of the supplier, trust between the supplier and purchaser, the competitiveness of the market for the service, the dependence of the purchaser on a particular supplier, the state of contract law, and the enforceability of agreements. We shall explore each of these factors in some detail.

Some services may be quite complex, with many dimensions that are difficult to assess, and with performance that is difficult to observe on the short run. In such cases it may quite difficult and expensive to write and enforce contracts. Furthermore, in the case of such contracts the parties have incentives to attempt to take advantage of each other in order to make additional gains. For example, a software developer may seek to extend a contract by claiming unexpected difficulties in implementing a web-based reservations system, or a search firm may want to convince a nonprofit organization that the candidates it has brought for a certain position are the best qualified people available in the market in order to obtain its fees quickly. As a result, complex services are more difficult to outsource than simpler services.

The service may be a private good or a public good (and everything in between). Publicness and privateness are measured on two dimensions: rivalry and excludability. Rivalry means that the use of one organization eliminates (or at least reduces) the possibility of use the same service by another organization. Nonrivalry means just the opposite, so that no matter how many organizations use a certain service, there is still room for more users without degrading the value of the service to other users. Advertising a product (but not a brand) or a cause is nonrival because all those who make the product or support the cause benefit from the advertising. Protection by a national military is also nonrival because it benefits all citizens. The treatment received by a patient in a nursing home is a rival good for the patient, but from the perspective of a community that cares about its elderly citizens the treatment in nonrival. A theatrical production of Hamlet is rival, because it displaces in any given point in time a production of The Twelfth Night, but once the production is mounted, it is nonrival with respect to the individual performances that can be delivered.

The second dimension is excludability, which refers to control over access. Excludable products are those to which access can be denied or conditioned upon payment. Examples include land,
property rights, copyrights, and patents, which typically involve payment for access or use. Nonexcludable products, such as advertising for a product or a cause as well as expired copyrights or patents, are in the public domain and require no payment. The treatment received by a patient in a nursing home is excludable, for nonpayers can be prevented from receiving it, but from the perspective of a community that cares about its elderly citizens, the treatment in nonexcludable for all who care about treatment for the elderly, whether they pay or not. Where nonrivalry and nonexcludability are prominent, the costs of transaction on the market are very high because it takes a lot of resources to prevent nonpayers from access, and it requires a lot of effort to identify the kind of products that will satisfy different groups of customers of nonrival goods. Consequently, there will be strong incentives for making nonrival and nonexcludable services in-house rather than outsourcing them.

The services of a purchasing agent or buying group provide an example of a nonrival and nonexcludable input, as all clients of the group receive the same service. The clients are interested in achieving lower prices associated with a larger purchasing pool. The purchasing group, if it is a loyal agent on behalf of its clients or if it is overseen well by the clients and is held accountable to them, will do its best to negotiate the lowest prices and keep its own costs low. However, the purchasing agent may have enough latitude to pursue its own interests at the expense of clients. For example, numerous hospitals have combined resources to own a purchasing company in order to achieve savings in the cost of various supplies they purchase. However, despite their ownership the purchasing group’s management has apparently succeeded in pursuing its own objectives at the expense of the hospitals objective. See Box 1.

Reliability has several facets. One is the ability to evaluate the service directly at the time of purchase: when the purchaser cannot examine or certify the quality of a service before purchase it, it will be weary of purchasing it from unknown or not trustworthy suppliers. Trust in the supplier can be grounded in the supplier’s reputation for prompt delivery of promised services and the credibility of its warranty. Reputation and trust are weak in the case of new firms and in markets with many firms and a high turnover, where it is hard to keep track of reputations. These circumstances militate in favor of make rather than buy. In contrast, the more competitive is a market, the easier it is to find alternative suppliers, which makes outsourcing safer (if one
supplier does not work out, it can be replaced with another) and therefore reduces the incentives for in-house production.

Purchaser and supplier depend on each other to various degrees. Frequently a purchaser wants assurance that the service will be available in the future, and the supplier wants to count on the purchaser's future business. Whereas the purchaser needs reliable delivery, the supplier needs reliable payment. Specificity of the service or customization can bind the parties, particularly if the purchaser invests in staff knowledge and skills, physical plant, and equipment or technology designed for use of the supplier's product, and the suppliers makes investments tied specifically to the particular purchaser's needs. Specificity of the relationship can affect the relative bargaining power of the two parties, and either can hold the other captive, generating a fear exploitation when investments connected to the particular relationship are high. For example, a supplier can raise prices or delay shipment to a dependent purchaser in order to engage in another lucrative activity. A purchaser can defend itself preemptively against opportunistic behavior by diversifying suppliers or, if diversification is not feasible or is too costly, making the product in-house. Contracts can be a fairly good substitute for trust because they provide remedies in the event of breach of the terms of the contract, and therefore allow the contracting parties to take the risk of depending one on the other. Thus the existence of a legal framework that supports complicated contracts that regulate relations between purchasers and sellers, and the enforcement of contracts, are additional factors that influence the make-or-buy decision.

In the United States during the late 1800s and early 1900s, for example, in-house production was extensive because levels of both inter-organizational trust and legal enforcement of contracts were low. In contrast, Japanese firms outsource a lot because the culture of dependability reduces the need to make rather than buy (and risk depending on others). Low levels of dependability in post-Soviet Russia due to lack of appropriate laws, weak enforcement mechanisms, and the absence of longstanding reputations have led companies to make a lot and buy little.

Enforceability of contracts depends not only external factors, but also on the ability of a purchasing organization to write, evaluate and enforce contracts in which it engages. To be effective in relying on a contract with a supplier, an organization must acquire familiarity with
the market in order to evaluate alternatives, legal knowledge or the ability to purchase it in order to write and enforce contracts, and monitoring the details of the fulfillment of the supplier’s responsibility arising from the contract. Thus outsourcing may require engaging lawyers, having a representative of the purchaser spend a lot of time monitoring the supplier’s work, sometimes on the supplier’s premises, engaging at times in legal action, and more. The execution of many of these functions may be quite expensive, to the effect that effective outsourcing may be more expensive than in-house production, particularly for small organizations.

(4) The centrality of an activity to the organization’s main product

*Core activities* are directly related to the organization’s product, mission and identity; the skills and knowledge that support these activities are the organization’s *core competencies*. The central function of coordination of activities required for the production of the organization’s final product is at the core of organizational activities.

The coordination of production by outsourcers may be the only activity that is carried out in-house, as the examples of clothes retailers and others at the beginning of this essay suggest. Similarly, in a nonprofit health care organization the management services should be carried out by those who are under the nonprofit umbrella rather than by a for-profit management company.

Thus an organization should not necessarily produce in-house the final product. However, activities that define the identity of the organization, activities that are critical to the maintenance of the organization’s reputation, and activities that are difficult to observe, should not be considered for outsourcing. For example, the selection of key staff in the organization, which requires detailed knowledge of the organization itself, and which is open after the hiring to problems, should not be outsourced. (Search firms can be used in identifying candidates). In the same vein, activities that entail great vulnerability for the organization (such as sterilizing of medical instruments), but are subject to substantial problems of monitoring because of difficulty obtaining information about the quality of the service (how well sterilization was done) and which are crucial to the performance of the organization should be kept in-house.

There are additional considerations specific to nonprofit organizations. A particular core
competency of any nonprofit organization is its ability to solve problems that for-profit firms cannot solve. This is the special advantage that the nonprofit form of organization enjoys. Nonprofit organizations exist because they can deal with problems that arise from the publicness of some goods and services, and the asymmetric information between providers and customers, or suppliers and purchasers. The problem with asymmetric information is that in the case of some goods and services, the purchaser cannot evaluate the full value of the product and the provider is tempted to take advantage of this fact. As a result, some purchasers will buy less than they would buy otherwise, they will be willing to pay less than otherwise, and therefore the market for the product in question may suffer. A nonprofit provider, particularly one that is controlled by purchasers, provides assurances to purchasers that the asymmetric information between them and the provider will not be used against their interests, and will entice them to engage in transactions with the provider. The interesting thing about the nonprofit form of organization as a superior solution to problems associated with public (nonrival and nonexcludable) goods and asymmetric information is that, in a certain sense, the nonprofit form is a rejection of pure market outsourcing of some products. This is so because some purchasers band together to supply themselves with the product rather than buying it on the market.

For a nonprofit organization to maintain its credibility it must ensure that it remains a solution to the problems for which it is uniquely suited to solve. It cannot therefore usefully outsource activities in which there are opportunities to exploit customers’ informational weakness, or other activities that define the organization’s special relationship with its stakeholders. For example, a nonprofit hospital that facilitates the provision of services of contracted medical personnel but has few staff physicians and nurses, a charity that uses for-profit fund raisers, a nonprofit health care facility that is run by a for-profit management company, a nonprofit research organization that distributes its net income to contract researchers, and a radio station that raises revenue primarily from the sale of advertising – they all risk the loss of their special advantage derived from their nonprofit status. Such core activities are best kept in-house; the same applies to the competencies that support these activities.

III. Outsource to nonprofit organizations or to for-profit firms?
Should a nonprofit organization care whether it purchases services from another nonprofit organization or should it prefer a for-profit trading partner? As noted in the previous section, nonprofit organizations occupy special market niches that are related to the nature of their final product. However, the problems that affect the final product often relate to the production process and the inputs that were used in it, and that was the basis for the recommendation that nonprofit organizations should not outsource activities that relate to their special advantages. But if trustworthy suppliers are available to provide some inputs, outsourcing becomes more attractive. Nonprofit organizations may be exactly such suppliers, particularly in a local context where nonprofit organizations may be linked through overlapping directorates, often enjoying overlapping customer bases, and have many other bonds that foster trust. For example, some organizations may avail themselves to fundraising administrative services sold by nonprofit organizations. See Box 2. However, a severely limiting factor is the fact that there are few nonprofit organizations operating in many areas in which outsourcing may be useful.

IV. Conclusions

The decision whether to make or buy is, according to Ronald Coase, winner of the Nobel Prize in economics, a matter determined by a comparison of the cost of carrying out transactions across external markets versus the cost of executing those transactions within the organization. From the perspective of an organization that considers how to best obtain a service there are costs and benefits associated with outsourcing. Outsourcing allows for specialization, and permits clear evaluation of the costs of various inputs by comparing prices on the market. It also allows for flexibility in adjusting the size of the organization and its production without hiring and laying off employees. However, outsourcing entails search and selection of suppliers, which can be costly. Also, the relationship with suppliers has to be managed through contracts, which entails costs of writing and enforcement of contractual relations, including the monitoring of performance by suppliers.

The relative costs and benefits of outsourcing have to be juxtaposed with keeping production in-house. But the more an organization produces internally, the greater the agency problem due to increased span of control. On the other hand, in-house production provides access to
information, monitoring and other beneficial activities that reduce agency problems and are available only through direct control.

Outsourcing clearly has a place in nonprofit organizations, but it has to be done in a way that does not harm the trust that its customers and other stakeholders place in it. To put it in an extreme form, a nonprofit organization should not outsource so many activities that it becomes a for-profit firm in disguise.

Nonprofit organizations can safely outsource many information services and most business services, including payroll, but this should be subject to a careful analysis of the organization’s ability to deal with the complex transactions that are often entailed by outsourcing. Small nonprofit organizations should outsource only simple-to-manage activities, where no complicated controls or contracts are required and where the opportunities for being taken advantage of by suppliers are minimal. In particular, nonprofit organizations should not consider only the price of an outsourced activity, but also the cost of managing the relationship with the supplier.
Selected Readings

A general guide to outsourcing, with theoretical development and examples, is:


Applied analyses of outsourcing can be found in:


Analyses of outsourcing, mostly from a theoretical perspective, can be found in:


General theory of nonprofit organizations, with some relationship to outsourcing, can be found in:


Box 1

In order to take advantage of economies of scale in negotiating prices of hospital supplies, nearly 1,500 nonprofit hospitals have partnered to combine their purchasing through a buying group, Premier Inc., that they own. However, the buying group has failed to provide the expected savings and hospital executives have expressed irritation at the high cost of Premier’s executive compensation and perquisites. (Mary Williams Walsh, “A Mission to Save Money, A Record of Otherwise,” *The New York Times*, June 7, 2002, page C1). The buying group represents an outsourcing solution with considerable agency problems between the purchasing organizations (individual hospitals) and the provider (Premier, Inc.). Controls by the hospitals over Premier seem to have been weak, despite the fact that the hospitals owned jointly the company, allowing the provider to take financial advantage of the situation; as a result, the savings enjoyed by the hospitals were lower than expected and than possible with stricter controls. The controls might have been too weak because of the free-rider problem each hospital executive faces: engaging in oversight of Premier is rather complicated and costly for the individual hospital whereas the benefits would be spread over the nearly 1,500 hospitals.

Box 2

Nonprofit organizations providing services to persons with disabilities in the Rochester, NY area are individually too small to provide themselves efficiently high-quality administrative services. In 1999, the nonprofit Al Sigl Center for Rehabilitation Agencies, Inc. formed Business Services, a unit that provides services in human resources, telecommunications, risk management, purchasing, management information systems, legal, public/relations/communications, accounting and finance, pension/403b, fundraising, and facilities management. These services are provide to the eight partner agencies of the Al Sigl Center (The Arc of Monroe County, Epilepsy Foundation of Rochester & Syracuse Regions, Mary Cariola Children’s Center, Medical Motor Service, National Multiple Sclerosis Society/Upstate NY Chapter, Rochester Hearing and Speech Center, Rochester Rehabilitation Center, and United Cerebral Palsy Association). According to the The Peter F. Drucker Foundation for Nonprofit Management (http://www.pfdf.org/innovation/innovation/innovation.asp?innov_id=131, viewed on July 20, 2002), “Business Services effected a 1999 cost savings of $143,348 for the partner agencies. By mid-2000 savings were projected to be $250,000 for a total of $393,350 over two years. The telecommunication service alone has reduced collective local/long distance rates by 40%from $140,000 to $84,000 annually, and has centralized the multitude of vendor solicitations that once filtered through agency directors.”