

# PRIVATIZATION OF WELFARE SERVICES: DELEGATION BY COMMERCIAL CONTRACT

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## I. INTRODUCTION

On April 3, 2001, the Deputy Director of the Office of Management and Budget (OMB), Sean O’Keefe, ordered federal agencies to prepare annual inventories of their services, and to identify which ones should be considered “inherently governmental” functions.<sup>1</sup> The implication was that any position NOT identified as “inherently governmental” could be privatized (contracted out). President Bush is a major advocate of this form of privatization—hiring private firms to do the government’s work—and implemented this policy in Texas while he was governor there.<sup>2</sup> The new list of positions will be used as part of OMB’s internal review process. The expected result is an increase in privatization of government services over the next few years, as each agency bears the burden of identifying those which cannot be privatized, and the reasons why. The presumption is that most, if not all, of the agency’s tasks can be done by non-government employees.

Advocates of privatization argue that market forces automatically bring more efficiency to any government undertaking by introducing competition and

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1. Memorandum from Sean O’Keefe, Deputy Director, Office of Management and Budget, to Heads of Executive Departments and Agencies (April 3, 2001), *available at* <http://www.whitehouse.gov/omb/memoranda/m01-16.pdf> (last visited Jan. 8, 2003).

2. For a discussion, see David J. Kennedy, *Due Process in a Privatized Welfare System*, 64 BROOK. L. REV. 231, 232 (1998) (“Governor Bush’s effort to privatize most of Texas’ welfare system, in turn, seemed rooted in his attempt to make a name for himself with the kind of bold experimentation that could carry him to national office.”); Mark Carl Rom, *From Welfare State to Opportunity, Inc.: Public-Private Partnerships in Welfare Reform*, 43 AM. BEHAV. SCIENTIST 161–82 (1999), *reprinted in* PUBLIC-PRIVATE POLICY PARTNERSHIPS (Pauline Vaillancourt Rosenau ed., 2000).

profit incentives for those carrying out the tasks.<sup>3</sup> The inefficiency of government employees, the overstaffing of government agencies, and the naturally superior productivity of private-sector workers are tenets of faith for privatization advocates.<sup>4</sup>

The privatization pendulum may be swinging the other way.<sup>5</sup> In the wake of the tragic terrorist attacks in September 2001, President Bush called for the “federalization” of airport security personnel, apparently meaning a degree of de-privatization.<sup>6</sup> This year, a bill has been introduced in Congress that would restrict outsourcing of more services until the costs and benefits of the privatization in that case are first analyzed.<sup>7</sup> The Truthfulness, Responsibility, and Accountability in Contracting Act (TRAC) would temporarily suspend the process of contracting out functions that would displace federal employees. Among the “Findings” proposed in the preamble of the legislation are the following:

- (1) There has been a major increase in service contracting (relying on private contractors to provide services to the Federal Government) since 1993.
- (2) Federal agencies have been increasing reliance on service contracting even though there are no reliable and comprehensive reporting systems in place to determine whether service contracting has achieved measurable cost savings or improved Government services for taxpayers.
- (3) Federal agencies have contracted out work that either is being performed or could be performed by Federal employees without any public-private competition.
- (4) Federal employees are being replaced by contractor employees without even knowing with certainty if the result is reduced costs or improved services.

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3. See, e.g., E.S. SAVAS, *PRIVATIZATION AND PUBLIC-PRIVATE PARTNERSHIPS* 34–38, 111–25 (2000); JOHN D. DONAHUE, *THE PRIVATIZATION DECISION: PUBLIC ENDS, PRIVATE MEANS* 66–69, 90, 133–37, 217 (1989); Jody Freeman, *The Contracting State*, 28 FLA. ST. U. L. REV. 155, 162–63 (2000) (Freeman herself does not necessarily advocate this view, but provides a detailed and fair description of the different positions taken on the issue).

4. Besides arguments touting the alleged inherent superiority of the private sector over government agencies, an argument is sometimes made for privatizing simply as a way to break out of the “rut” of running welfare programs as they were first implemented in the 1950s and 1960s. This is a “new-wine-old-wineskins” argument. See Rom, *supra* note 2, at 164.

5. For a brief survey of the typical rhetoric on each side of the debate, see Lisa Vecoli, *The Politics of Privatization*, 15 HAMLINE J. PUB. L. & POL’Y 243, 246–48 (1994).

6. See Ricardo Alonso-Zaldivar, *Bush May Agree to Federalize Air Security*, LOS ANGELES TIMES, Sept. 25, 2001, at A8, <http://www.latimes.com/news/nationworld/world/la-092501airsec.story>. On October 11, 2001, one month after the terrorist attacks, the Senate passed legislation that would federalize all airport baggage screeners and allow pilots to be armed in the cockpit. Airport Security Federalization Act of 2001, S. 1447, 107th Cong. § 102 (2001) (enacted).

7. See Truthfulness, Responsibility, and Accountability in Contracting Act, H.R. 721, 107th Cong. (2001).

(5) Federal agencies do not have systems in place to provide for work currently performed by Federal contractors to be performed by Federal employees, even after a determination that in-house performance would be more efficient and more cost effective.<sup>8</sup>

“Privatization” can refer to any activity where a government cedes some task formerly performed by its employees to the private sector.<sup>9</sup> This may be a mundane task such as trash collection, or a traditional government operation such as running prisons or welfare programs. Privatization takes many forms.<sup>10</sup> A government may simply desist from an activity, leaving it up to the private sector to supply the service. In other circumstances, the government may deregulate an industry to allow private corporations to provide parallel services to the government in one area. A third model of privatization involves performance entirely by the private sector, with incorporation or official endorsement by the government of one designated entity. Finally, privatization can involve simple outsourcing, or contracting out of services that the government still takes responsibility to provide, albeit indirectly.<sup>11</sup> This Article focuses on the last type of privatization: contracting between a government agency and a private corporation or entity to assume the work involved with providing a particular government service, and in particular, the provision of government benefits or assistance for those in poverty. This Article argues that the privatization of welfare services via contract with private organizations is inherently fraught with unavoidable due process problems and overstepping of the nondelegation doctrine.<sup>12</sup>

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8. *Id.* TRAC will not impact most of the forms of privatization discussed in this Article, as they occur on the state level, where most social services are now dispensed. It may provide a helpful model, however, for states to follow.

9. *See* DONAHUE, *supra* note 3, at 5–9 (distinguishing different forms of privatization and depicting them on a helpful grid). Donahue notes that “privatization” in the sense of selling off state-owned industries (the most common use of the term overseas) is uncommon in the United States for the reason that the American government never developed the habit of owning utilities, airlines, or manufacturing. *Id.*

10. *Id.*

11. *See* Freeman, *supra* note 3, at 164–69. Freeman identifies two forms of this “outsourcing,” one being traditional government procurement of goods and services from private suppliers, and the other being contracts to have private entities exercise traditional government powers. The latter is the concern of this Article, and implicates constitutional issues. A respondent to Freeman’s approach suggests differentiating between contracts for the exercise of government’s *coercive* powers, as in private prisons (which are not addressed in this Article), and contracts for the delivery of “entitlements” or benefits (which are the focus of this Article). *See* Mark Seidenfeld, *An Apology For Administrative Law in the Contracting State*, 28 FLA. ST. U. L. REV. 215, 228–29 (2000).

12. Other commentators have noted that there is a potential issue here, but to date no one has offered a thorough analysis of privatization under the principles underlying the nondelegation doctrine. *See, e.g.,* Freeman, *supra* note 3, at 213–14 (“The judiciary will determine whether the nondelegation doctrine forbids certain contractual delegations, delineate the extent to which private contractors will be bound by constitutional constraints and statutory due process obligations, and dictate the conditions under which third-party beneficiaries will have standing to challenge the terms of public-private contracts.”). Cass Sunstein notes that private self-interest is at the heart of the nondelegation doctrine as applied in any context: “Indeed, the nondelegation doctrine might be taken as a central

Part II of this Article provides some background on the recent history of privatized welfare services. This part will also note some of the anecdotal criticisms lodged against privatized welfare. Part III surveys recent court cases applying the nondelegation doctrine to privatization, with a focus on cases that would be most applicable to privatized eligibility determinations for welfare services. Part IV analyzes the implications of the commercial contracts utilized to privatize government programs, which essentially create a special type of delegation problem: delegation by contract. The discussion focuses on delegation to private for-profit entities, but the implications for non-profit contractors are also explored. Part IV concludes that “contracting out” for the provision of welfare programs, particularly the eligibility determinations for such programs, creates an unavoidable conflict-of-interest that harms the poor people in our society. Part V discusses the special issues raised in privatization with nonprofit organizations. Part VI addresses problems with government contracting in general, and the specific problem of using commercial contract language as the mechanism for a delegation of governmental power. The conclusion constitutes Part VII.

## II. HISTORY & PREVALENCE OF PRIVATIZATION

Although “privatization” became a political mantra mostly in the 1980s and 1990s, the obsession with reducing “Big Government” has been a political agenda for a long time, at least since World War II.<sup>13</sup> Over time, the number of “official” employees of the federal government has been far surpassed by the number working for the government under federal grants and contracts.<sup>14</sup> This enormous auxiliary wing of the federal government, tacitly accepted by both parties for several decades, has been dubbed the “Shadow Government” by some commentators, and blamed for a diffusion of governmental sovereignty by others.<sup>15</sup> Regarding the privatization of welfare services in particular, the trend toward privatization has continued to accelerate since the Reagan presidency.<sup>16</sup>

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means of reducing the risk that legislation will be a product of efforts by well-organized private groups to redistribute wealth or opportunities in their favor.” Cass R Sunstein, *Nondelegation Canons*, 67 U. CHIC. L. REV. 315, 321 (2000). Sunstein’s general thesis is that while the nondelegation doctrine does not function well as a strict judicial rule, its underlying principles are quite useful and appear in many modern judicial approaches to agency actions.

13. Daniel Guttman, *Public Purpose and Private Service: The Twentieth Century Culture of Contracting Out and the Evolving Law of Diffused Sovereignty*, 52 ADMIN. L. REV. 859, 861 (2000).

14. *Id.* at 863.

15. *Id.* at 863 n.3; see also Barbara Bezdek, *Contractual Welfare: Non-Accountability and Diminished Democracy in Local Government Contracts for Welfare-To-Work Services*, 15 FORDHAM URB. L.J. 1559, 1566 (2000).

16. See Freeman, *supra* note 3, at 161. Freeman notes that the last twenty years of increased privatization have also seen a disproportionate growth in the use of for-profit contractors to perform social service operations, and that these trends have coincided with the effort by the federal government to devolve the administration of such programs to the states. *Id.*; see also DONAHUE, *supra* note 3, at 132–33 (noting that during the 1980s the number of localities privatizing various operations increased, although the share of

Often touted as a wonder-working panacea for shrinking government budgets, there is evidence that the twentieth-century practice of outsourcing is not necessary to achieve efficiency, but can be a way of hiding costs and creating illusory budget reports.<sup>17</sup> For example, it is reported that in 1966, President Johnson successfully sponsored legislation that required the Executive Branch to downsize to its 1964 level.<sup>18</sup> Personnel were terminated, pursuant to a “ceiling” imposed by the new rules, which apparently cut the personnel expenditures of the federal government. Soon thereafter, however, numerous consulting firms sprang up, manned by the former federal employees, which in turn received lucrative contracts to perform some of the very functions previously performed by the government itself. These costs exceeded the personnel costs they replaced, but did not appear as personnel costs in any department’s budget.

The privatization of welfare services, in particular, has grown much faster among the states than within the federal government.<sup>19</sup> This is partly the result of the federal government’s general trend of foisting welfare administration onto the

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individual budgets that went to outside providers actually *fell* during the same period); SUSAN ROSE-ACKERMAN, *RETHINKING THE PROGRESSIVE AGENDA* 174–76 (1992).

17. For a discussion of the problem of cloaking government spending, see DONAHUE, *supra* note 3, at 32–33. Other ignoble motivations for privatizing may be the opportunities for cronyism, nepotism and simony. Critics of delegations to administrative agencies identify nefarious motivations that would apply equally to delegations to private parties, such as shirking of responsibility or evading political accountability for the actions of the delegate. *See generally* David Schoenbrod, *Delegation and Democracy: A Reply To My Critics*, 20 *CARDOZO L. REV.* 731, 733–41 (1999). Just as troubling would be the use of privatization to “put out to pasture” programs the government would like to terminate completely, but in incremental steps. In the social services arena, the association of privatization with “welfare reform” (legislation in the late 1990s aimed at curtailing welfare programs generally) bodes of a “phase out” of the privatized programs as much as an increase in efficiency. *See* DONAHUE, *supra* note 3, at 221 (“Conservatives typically welcome private delivery of public goods and services as the next best thing to cutting them out of the government budget altogether. Most liberals lament private delivery as a retreat from the principle of collective action.”).

18. Guttman, *supra* note 13, at 878 (discussing the *Federal Political Personnel Manual*, in *PRESIDENTIAL CAMPAIGN ACTIVITIES OF 1972*, SENATE RESOLUTION 60: EXECUTIVE SESSION HEARINGS BEFORE THE SENATE SELECT COMMITTEE ON PRESIDENTIAL CAMPAIGN ACTIVITIES, 93RD CONGRESS 8903, 8976 (1974)).

19. *See, e.g.*, Paul Howard Morris, *The Impact of Constitutional Liability on the Privatization Movement After Richardson v. McKnight*, 52 *VAND. L. REV.* 489, 493 (1999) (“Despite the strong federal support, most examples of privatization in the last twenty years have occurred at the state and local level.”); *see also* Freeman, *supra* note 3, at 161–67. Another factor which should not be ignored is that the federal government can assert the sovereign immunity defense when it breaches contracts, which serves as somewhat of a deterrent to novel contractual arrangements, whereas the states can be sued in a §1983 action, making the states a more conducive environment for this growth industry. On a different note, it has been alleged that the phenomenon of privatizing welfare services is actually more prevalent in Southern states in particular than other regions. *See* Press Release, Southern Studies, Award-Winning Policy Watchdog Finds “Privatization” of Public Services Harms Communities (Feb. 9, 2000), *available at* <http://www.southernstudies.org>.

states<sup>20</sup> and the commensurate growth of state employee unions, which engage in protracted collective bargaining with the state governments. Despite a steady decline in unionization within the private sector, the last few decades have seen an explosion of growth in public-employee unions.<sup>21</sup> At the same time, since World War II, the federal sector has been shrinking as a percentage of the civilian workforce, while state and local governments (SLG) have been growing steadily.<sup>22</sup> The high rate of growth of state and municipal employees, and their unions, has been explained as follows:

The primary reason for such growth in the SLG sector has been the dramatically increased demands for services provided by this sector in areas such as income transfer payments involving social security, Medicare and Medicaid, and welfare, education, health care, law enforcement, and corrections. This demand for services is fueled by changing demographics, namely significant increases in the young (those under twenty-five) and the aged (those over sixty-five), the populations most in need of government services.<sup>23</sup>

The shifting of responsibility for government services has placed an unprecedented burden on states and municipalities, creating a financial desperation that fuels the drive for cost-cutting measures. The localized nature of these financial crises lends itself more toward contracting out to private companies than

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20. See Freeman, *supra* note 3, at 162 (“The devolution of authority from federal to state and local governments has contributed to the rise of contracting out, as lower levels of government turn to private actors in order to help execute their new responsibilities.”); Bezdek, *supra* note 14, at 1565 (“Despite recent legislation purporting to curb non-funded mandates, the federal government continues to require state programs, and the states themselves continue to require comparable county and local programs. Increasingly, public activities are carried out at the state level.”) Bezdek also discusses the oft-mentioned problem that state-level responsibility for welfare programs fosters a “race to the bottom,” where jurisdictions compete to have the fewest public charges. See *id.* at 1568.

21. Steven H. Kropp, *Reflections on Law, Economics, and Policy in Public Sector Labor Relations in Canada, the United States, and the United Kingdom*, 27 LAW & POL’Y INT’L BUS. 825, 830–31 (1996). The authors note that these parallel phenomenon—the decline of private-sector unions in popularity and the concurrent increase in government employee unions—have elicited varying explanations from commentators and analysts. Their own contribution is simply to observe that state governments often *encourage* their employees to unionize for ideological and political reasons. *Id.*

22. *Id.* at 832; see also DONAHUE, *supra* note 3, at 131 (“The federal government had roughly three million civilian workers on its payroll in the mid-1980s, while state and local governments employed nearly fourteen million. In short, there is simply more *room* to contemplate shifts toward private suppliers at lower levels of government.”). This is not to say that the growth of SLG employee unions is in any way undesirable. It does add an additional burden or inconvenience for the state in creating and administering new programs (under new federal block grants, for example), which contributes another incentive to outsource the program entirely, to have some private-sector employer deal with employees’ unions (which are less common in the private sector).

23. Kropp, *supra* note 19, at 832–33. Of course, downturns in the regional or national economy would also be likely to increase the demand for social service programs, as more people find themselves unemployed and without financial supports such as medical insurance.

would a nationwide program.<sup>24</sup> Few private companies have the infrastructure and ubiquitous facilities to administer any type of government services to the entire national citizenry. National companies like Maximus, Inc. and Lockheed Martin have operations in many states, but cannot compare to the Social Security Administration or the Veteran's Administration. In contrast, as individual states try to run welfare programs on their own, the programs are smaller and more localized, and the situation lends itself more to privatization as an alternative.

The federal Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (PRWORA) provides that a state can operate its welfare programs "through contracts with charitable, religious, or private organizations."<sup>25</sup> This essentially became a federal encouragement of privatized welfare services after 1996.<sup>26</sup> Immediately, large corporations such as Lockheed Martin and Andersen Consulting began bidding on contracts to move millions from welfare rolls to the workforce in New York, and both competed with EDS to run the \$563 million welfare program in Texas.<sup>27</sup> Lockheed expressed plans at the time to "market even more comprehensive welfare contracts to states and counties in what is potentially a new multibillion dollar industry to overhaul and run welfare programs."<sup>28</sup>

The results have been controversial. The following excerpt is typical of the literature criticizing privatized welfare, and helps illustrate its pervasiveness:

Yet the view that the market inherently provides services more cost-effectively, accepted as gospel in some quarters, often proves false in this area of policy . . . . Unisys Corp.'s Statewide Automated Welfare System in California could cost twice its 1995 bid price of \$554 million. Andersen Consulting is four years behind and \$64

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24. See DONAHUE, *supra* note 3, at 131 (noting that "[w]hile federal privatization initiatives have been driven largely by ideology, at the state and local levels they have more often been spurred by expediency").

25. Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub. L. No. 104-193, §104, 110 Stat. 2161 (1996) (amending 42 U.S.C. § 604(a)).

26. See, for example, Freeman, *supra* note 3, at 162-69, for a discussion of how, despite the provision mentioned above, the entire block-grant system, whereby the federal government gives money to states to run welfare programs in its stead, fosters privatization as a quick solution to the overwhelming set of new responsibilities given to the state governments. The spending report-back features of the grants, which provide the baseline for the following year's grant to the given state, could also encourage privatization as a means of creating tidy accounting. The contract prices are easier to identify, list, and add together than actions run by the agencies themselves, which draw heavily on the infrastructure of state facilities and resources that are shared with other agencies (buildings, state vehicles, phone lines, computer networks). These shared resources make it problematic to identify how much is really spent on a program such as childcare vouchers or food stamps. The state, however, has a pecuniary interest in documenting how much is spent on the programs so that it can get the same grant amount, or more, the next time around.

27. See MICHAEL B. KATZ, *THE PRICE OF CITIZENSHIP* 152-53 (2001).

28. *Id.* at 152. It is unclear whether Lockheed's exuberant plans to "market" their services means simply offering bids in response to Requests for Proposals (RFPs) by state agencies, or if it includes lobbying efforts to convince legislators to push for privatization, thus opening up new markets.

million over budget with its computerized child support enforcement system in Texas. Ohio canceled its job-placement contract with America Works after finding it was costing the state \$24,000 per placement. Problems with an EDS auto-insurance claims system cost New Jersey \$50 million in uncollected premiums. The computerized child-support enforcement system Lockheed promised California for \$99 million in 1995 is now \$205 million over budget . . . . Tired of Andersen Consulting's cost overruns, the Nebraska Department of Social Services withheld payment in January 1996. Virginia canceled a Medicaid contract with EDS when performance ran twenty months late. EDS sold Florida a faulty social services computer system that wound up costing the state \$260 million. Florida sued for damages of \$60 million and an order keeping EDS out of Florida for the foreseeable future. Privatization also fosters its own kind of fraud. Although the question of which private corporation administers which benefit programs may seem unimportant, the process by which these bids are made and won raises serious concerns about how the programs will be administered. Corporate suitors court various state agencies in an effort to improve their chances of receiving privatization bids. Gtech Corporation, the nation's largest operator of state lotteries and the parent company of a firm under contract to administer Food Stamps in Texas, has been accused of bid-rigging and influence-peddling.<sup>29</sup>

The anecdotal criticisms above are not the only line of criticism against privatized welfare programs. Poverty advocates also contest the assumption that privatization brings greater economic efficiency to the administration of programs, through the imposition of healthy "market forces."<sup>30</sup>

Under classical economic theory, competition should lead to the lowest possible marginal costs for goods and services to consumers. True market

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29. Kennedy, *supra* note 2, at 259–61. Certainly, jeremiads such as this are not as helpful in evaluating policy as broad-based empirical research and statistical analysis. The passage above, however, is often recited by poverty advocates as effectively summarizing the experience of privatization for those attempting to assist the poor in preserving and exercising their rights. For a more empirical-statistical assessment of problems with privatized job-training programs, see DONAHUE, *supra* note 3, at 198–99.

30. DONAHUE, *supra* note 3, at 198–99; *see also* Julie A. Nice, *The New Private Law: An Introduction*, 73 DENV. U. L. REV. 993, 994 (1996) ("Opponents, including unions, counter that privatization costs more, reduces the quality of services, eliminates expertise, fosters patronage and corruption, and diminishes public accountability."); Rom, *supra* note 2, at 176 ("Some observers have been concerned that contractors, especially when motivated by profit-making goals and priorities, may not be inclined to provide equal access to services for all eligible beneficiaries or will be tempted to provide inferior services to cut costs."). The national professional journal for poverty advocates, *Clearinghouse Review*, devoted its January-February 2002 annual special issue entirely to this topic, as it has become a national consensus among legal services attorneys that privatization is one of the most pressing issues they face today in assisting poor clients. CLEARINGHOUSE REV., Jan.-Feb. 2002, available at <http://www.povertylaw.org/legalresearch/articles/showissue.cfm?id=15-Jan-02> (requires membership to view).



conditions require, among other things, enough buyers and sellers to give both groups alternative partners for transacting, relatively low entry barriers to the market, sufficient information for consumers, and elasticity of demand (similar products).<sup>31</sup> It is argued that “[i]n a typical effort to privatize human services, none of the elements which characterize a competitive market exists. The result is that privatization of human services can actually cost *more* than public administration.”<sup>32</sup> Significant information costs, for example, have led to enormous cost overruns after a private contractor began operating welfare programs in Kansas and Connecticut.<sup>33</sup> The size and complexity of the programs significantly limit the number of new entrants to the market, thus stifling the only source of competition, and creating a type of oligopoly power for companies once they have the state contract.<sup>34</sup>

Moreover, when the state contracts with outside providers to run welfare services, there is only one buyer—the state<sup>35</sup>—and usually very few bidders.

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31. See DEBORAH STEIN, NAT’L ASS’N OF CHILD ADVOCATES, DOES PRIVATIZATION OF HUMAN SERVICES PROVIDE THE BENEFITS OF MARKET COMPETITION? 1 (2000), available at <http://www.childadvocacy.org/publicat.html>.

32. *Id.*; see also DONAHUE, *supra* note 3, at 218 (“The evidence is overwhelming that where corruption, negligence, or the nature of the service itself undercuts competition [among bidders for the contracts], the benefits of privatization shrink or vanish.”); FREEMAN, *supra* note 3, at 170–74. This is not to imply that cost should be the ultimate determinant here. This Article is not focused on comparing costs or efficiencies of contracting out as opposed to using government employees to perform the tasks, but rather to look at the constitutional issues involved when governmental authority and decision-making affecting others is delegated to private parties via contractual arrangements. Efficiency inevitably arises in any discussion of privatization, though, because it is the main argument of those in favor of privatizing.

33. Stein, *supra* note 31, at 2. It is possible, of course, for the state to incur cost overruns in social service projects as well. These examples are noted only because the contracts are generally made on the promise and expectation of greater efficiency and budgetary savings.

34. *Id.* For an example of how the bidding process can evolve into a bitter battle between mega-corporations, see *Maximus, Inc. v. Lockheed Info. Mgmt. Sys. Co.*, 493 S.E.2d 375 (1997) (losing bidder accused bid winner of tortious interference with contract for circulating rumors that loser intended to obtain bid illegally through nepotism). See also *Lockheed Info. Mgmt. Sys. Co. v. Maximus, Inc.*, 524 S.E.2d 420 (2000) (dispute of remand decision from previous case).

35. Justice Scalia, in discussing government liability for mishaps in privatized prisons, made the following observation about the validity of “market pressures” on corporations performing traditional government functions: “[I]t is fanciful to speak of the consequences of ‘market pressures’ in a regime where public officials are the only purchaser, and other people’s money the medium of payment.” *Richardson v. McKnight*, 521 U.S. 399, 418 (1997) (Scalia, J., dissenting). This Article does not attempt to address the special issues raised in privatization of prisons, although the arguments presented here regarding privatized welfare services may be applicable in that arena as well. See Warren L. Ratliff, *The Due Process Failure of America’s Prison Privatization Statutes*, 21 SETON HALL LEGIS. J. 371 (1997), for one such argument, applying many of the same issues raised in this Article to the privatized prison phenomenon.

Sometimes there is only one bidder.<sup>36</sup> Thus, market forces are unable to operate effectively. This leads not only to efficiency concerns, but also undercuts the state's ability to select an option that best protects the rights of the affected citizenry. For example, when the Arizona state legislature mandated the privatization of its state welfare system, only one company offered a bid;<sup>37</sup> the state had no selection of alternatives. In Connecticut, Colonial Cooperative Care, Inc. was the only bidder for its contract to determine eligibility for disability-based cash assistance.<sup>38</sup>

In theory, privatization should not be the only solution for achieving greater efficiency in administering government programs. Civil servants can be given productivity incentives for their assigned tasks just as well as private-sector employees, and perhaps without the danger of profit-maximization tipping the scales in an unhealthy direction in this regard.<sup>39</sup> The average entry-level civil servant carrying out her duties does not function terribly differently than her private-sector replacement would when the program in question is privatized.<sup>40</sup> Thus, the relative efficiency of individual workers running a social service program, or some aspect of it, may depend more on the effectiveness of

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36. Stein, *supra* note 31, at 2. It is true that there are numerous companies around the country getting involved in these types of arrangements, but in any given Request for Proposals by a state, the parties responding tend to be few.

37. *Id.* Of course, the state always has at least *one* alternative to the private company's bid, which is to run the program itself with state employees—unless, of course, the decision to privatize has already been firmly settled for political or ideological reasons, or because of effective lobbying efforts by prospective bidders themselves. In the case mentioned above, undoubtedly the state's estimated costs in running the program were used as a benchmark for analyzing proposals. For more discussion of the problem of too few market participants in getting market efficiencies from privatization, see Johan Willner, *Ownership, Efficiency, and Political Interference*, 17 EUR. J. POL. ECON. 723 (2001).

38. For a detailed discussion of the Colonial contract, see *infra* Part IV.

39. It is easy to imagine well-balanced productivity incentives for civil servants that would boost output without necessarily creating perverse incentives to lower the work quality, which in this case would generally mean less helpful treatment toward the poor. See Patrick Francois, *Public Service Motivation as an Argument for Government Provision*, 78 J. PUB. ECON. 275, 279 (2000) (“[P]rivatization and output-related contracting with employees are not that different. . . . [T]he pursuit of market-based reforms, involving higher powered contracting in the public sector, can actually raise costs. Hence, it may not be optimal to provide such contracts even though they are feasible.”).

40. See, e.g., HERBERT A. SIMON, ADMINISTRATIVE BEHAVIOR 199 (4th ed. 1997) (“[P]ropositions about the behavior of members of an organization, in so far as that behavior is governed by the system of authority in the organization, do not ordinarily involve propositions about the psychology of the person who is behaving.”). The fact that an employee works for a non-profit or for-profit company—a question of organizational governance—is not likely to affect an individual's industriousness as much as other factors such as personality or talent. Simon's “Psychology and The Theory of Authority” (the chapter heading he gives this section) provides a theoretical analysis for the common-sense observation that most people operate day-to-day within the framework of “just doing my job.” This would seem to be just as true of most private sector employees as it is of entry-level civil servants.

management in monitoring and encouraging productivity than on the organizational unit's private-sector/public-sector status.<sup>41</sup>

Both civil servants and profit-seekers have an incentive to pursue "rents," or inefficient overpayments for their time, talents, or labor.<sup>42</sup> "Rents" here is used in the economics sense, not the sense of leasing property.<sup>43</sup> The nature of the rents is different, though, for civil servants and profit-seekers overall. Civil servants (who usually work under strict salary guidelines and no bonuses) may seek rents in the form of "fringe benefits, pleasant working conditions, congenial associates, undemanding work loads, security against dismissal," and other nonpecuniary perks.<sup>44</sup> The "rents" of private contractors, by contrast, are more likely to take the form of money.<sup>45</sup> Where the private sector employees are far removed from the company owners, however, they do not share in the rents, and are likely to behave in much the same way as civil servants. When the government contracts with a private firm to perform its functions, the rents of the private firm's owners can be more difficult to identify than those of public sector employees,<sup>46</sup> creating the illusion of savings from privatizing the service,<sup>47</sup> while the resulting effects go unnoticed. Efficiency criterion applicable in the private sector can be misapplied in the privatization context; as Herbert Simon has pointed out, "the criterion of

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41. *But see* DONAHUE, *supra* note 3, at 90 ("In private firms, a layer of managers attuned to profitability has considerable influence over the behavior of lower-level employees. . . . There is no truly equivalent function in a public bureaucracy, no link in this chain of agency relationships where incentives and authority to press for efficiency are quite so potentially concentrated.").

42. *Id.* at 92–93. Of course, individuals in any context can be motivated by altruism, ideology, or a deeply ingrained "work ethic" that mitigates the operation of normal self-interest.

43. *See id.* at 52–54 ("The excess of actual payment over the minimum needed to keep [the employee] on the job is what economists refer to as a *rent*."). Privatization could be defined as an attempt to eliminate the problem of rents in the public sector. The question remains as to whether this can be done without simply transforming the rents into their private-sector equivalent. The observable differences between the two could create the illusion of disappearance.

44. *Id.* at 92. Individual civil servants probably have little power to effect most of these rents, but individuals may seek or stay in a civil service job because of these inducements.

45. *Id.* Private sector rents tend to be highly concentrated in the owners, whereas the rents for civil servants are quite diffuse. "Ownership incentives that encourage efficiency also concentrate incentives for rent-seeking." *Id.* at 93.

46. *Id.* Note that this phenomenon of hidden "rents" by private service providers can tip the scales in their favor during deliberations about whether to privatize. The shirking or rent-seeking of the civil servants is more visible and can distort perceptions about relative efficiency.

47. *See* Francois, *supra* note 39, at 278 (noting the arguments in economic literature that private firms have an "incentive to undertake non-verifiable cost-reducing actions which compromise the quality of provision"). Civil servants, who do not pocket the savings themselves, have less incentive to compromise quality in this way.

efficiency cannot be applied to the decisions in governmental agencies without considerations of the economic effects that the activities of these agencies have.”<sup>48</sup>

### III. LEGAL ISSUES

When private parties are entrusted with the power to make welfare eligibility determinations for applicants, special legal issues arise. A certain amount of power is necessarily transferred from the government to the private party, even if this power is simply the authority to make decisions or determinations that affect others. Even with some degree of governmental oversight, the end result is a shifting downward of governmental authority to a private entity. This is the whole purpose of the privatization arrangement—to replace government employees with private sector employees.

Delegations of governmental power in general must function within certain parameters and limitations embodied in the nondelegation doctrine<sup>49</sup> and the Due Process Clause. For purposes of this Article, the “nondelegation doctrine” will be discussed *only* in regard to delegations to private parties. We are *not* concerned here with rules or traditions related to delegations to administrative agencies,<sup>50</sup> delegations from one branch of government to another, or delegations

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48. SIMON, *supra* note 40, at 254. By “economic” he appears to be referring to the effects on the overall regional or national economy, not to microeconomic considerations. Simon observes, by way of example, that when the private company employs an individual, the individual’s wage is simply an ordinary cost, offsetting the revenues. When the government employs a person, it arguably “makes use of a resource that would not otherwise be utilized and hence the wages of those employed do not constitute any real cost from the standpoint of the community.” *Id.* In the case of privatization, however, where the private company is performing the public service, one could argue that the private employee is having the same effect on the overall economy as would the public-sector equivalent.

49. The origin of this doctrine or concept is generally credited to John Locke: “The Legislature cannot transfer the Power of Making Laws to any other hands.” JOHN LOCKE, *SECOND TREATISE OF GOVERNMENT* 380–81 (Cambridge Univ. Press 1981) (1690). For discussion, see David Schoenbrod, *The Delegation Doctrine: Could the Court Give It Substance?*, 83 MICH. L. REV. 1223, 1267 (1985); Jim Rossi, *Institutional Design and the Lingering Legacy of Antifederalist Separation of Powers Ideals in the States*, 52 VAND. L. REV. 1167, 1174 (1999); Peter H. Aranson et al., *A Theory of Legislative Delegation*, 68 CORNELL L. REV. 1, 4 (1983). In *Amalgamated Meat Cutters v. Connally*, 337 F. Supp. 737, 746 (D.C. Cir. 1971), the D.C. Circuit summarized the basic idea of the nondelegation doctrine as follows:

Concepts of control and accountability define the constitutional requirement. The principle permitting a delegation of legislative power, if there has been sufficient demarcation of the field to permit a judgment whether the agency has kept within the legislative will, establishes a principle of accountability under which compatibility with the legislative design may be ascertained not only by Congress but by the courts and the public.

50. When a legislature delegates authority to an administrative agency, the separation of powers doctrine will most likely be brought to bear on the analysis of the delegation. *See, e.g.,* *Bottone v. Westport*, 553 A.2d 576, 580 (1989) (“The primary basis for the nondelegation doctrine as between coequal branches of government is the separation

from one *level* of government to another, such as federal to state, and state to municipal bodies.<sup>51</sup> While many state that the nondelegation doctrine is “dead,” or that it “only had one good year,”<sup>52</sup> such remarks are made regarding judicial review of delegations to administrative agencies. Indeed, it is difficult to find any decisions in recent decades that do not uphold such delegations. Our analysis here does not involve this type of delegation or the line of cases related to it. Rather, the discussion here focuses *exclusively* on delegations of authority from the government to private parties or entities.

Delegations from government agencies to private parties receive special scrutiny by the courts because of the inherent risk of abuse and lack of safeguards to check the self-interest of a private party determining the rights of another.<sup>53</sup>

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of powers doctrine.”). Since the New Deal era, delegations to public agencies, commissions, and boards almost always receive the court’s endorsement, as long as the legislature provides intelligible standards to guide the agency’s actions. *See, e.g.,* Dep’t of Pub. Welfare v. Nat’l Help “U” Ass’n, 270 S.W.2d 337, 339 (Tenn. 1954). Very recently, the nondelegation doctrine has begun to resurface as a way of invalidating agency regulations which themselves are too vague or delegate too much authority to others. *See* AT&T Corp. v. Iowa Util. Bd., 525 U.S. 366 (1999); Lisa Schultz Bressman, Schechter Poultry at the Millennium: A Delegation Doctrine for the Administrative State, 109 YALE L.J. 1399 (2000); American Trucking Associations, Inc. v. United States EPA, 175 F.3d 1027 (D.C. Cir. 1999), *modified*, 195 F.3d 4 (D.C. Cir. 1999); Robert Adler, ‘American Trucking’ and the Revival (?) of the Nondelegation Doctrine, 30 ENVTL. L. REP. 10233 (2000).

51. Delegations from a state to municipalities can implicate the state constitutional scheme for municipal charters, a state constitutional “ripper clause,” which is a state-constitution clause restricting the relationship between state and municipal governments, found in Pennsylvania, California, Colorado, Montana, New Jersey, South Dakota, Utah, and Wyoming. *See* Specht v. City of Sioux Falls, 526 N.W.2d 727 (S.D. 1995) for a recent example of a court applying the nondelegation doctrine to invalidate a statute based on its ripper clause.

52. Sunstein, *supra* note 12, at 322. The reason for the statement about “one good year” is that only in 1935 did the United States Supreme Court actually invalidate statutes based on violations of the nondelegation doctrine, although it has been mentioned many other times as a concern. Sunstein argues convincingly, however, that the nondelegation doctrine is not “dead” at all: “Rather than having been abandoned, it has merely been renamed and relocated. Its current home consists of a set of nondelegation canons, which forbid executive agencies from making certain decision on their own.” *Id.* at 315. It should also be noted that while 1935 was the first time the Supreme Court used the nondelegation doctrine to *invalidate* a statute, it had acknowledged and discussed the *existence* of the nondelegation doctrine in jurisprudence as early as 1813 in *The Aurora v. United States*, 11 U.S. 382, 386 (1813) (referring to delegations from one branch of government to another). *See also* Wayman v. Southard, 23 U.S. 1 (1825) (delegation of power from Congress to the judiciary). This early history of the nondelegation doctrine is discussed at length in Thomas R. McCarthy and Richard W. Roberts, *American Trucking Ass’n. v. EPA: In Search and Support of a Strong Nondelegation Doctrine*, 23 WHITTIER L. REV. 137, 140–44 (2001).

53. *See* ALFRED C. AMAN, JR. & WILLIAM T. MAYTON, *ADMINISTRATIVE LAW* 34 (1993); *see also* Sandra B. Zellmer, *The Nondelegation Doctrine: Fledgling Phoenix or Ill-Fated Albatross?* 31 ENVTL. L. REP. 11151, n.156 (2001); *Eubank v. City of Richmond*, 226 U.S. 137 (1912) (holding unconstitutional the setting of property line by adjacent owners); *Washington ex rel. Seattle Title Trust Co. v. Roberge*, 278 U.S. 116 (1928) (zoning variance only by consent of adjacent owners unconstitutional); *Fuentes v. Shevin*, 407 U.S. 67 (1972)

During the *Lochner* Era, the Supreme Court referred to private delegation as “delegation in its most obnoxious form; for it is not even delegation to an official or official body, presumptively disinterested, but to private persons whose interests may be and often are adverse to the interests of others . . . .”<sup>54</sup>

Although delegations to private parties have been held to violate the Due Process Clause, some older cases, instead of invoking due process issues, analyzed such delegations under state constitutional “vesting” clauses, vesting law-making power solely in the legislature.<sup>55</sup> It should also be noted that a particularized body of law has developed around the practice of legislatures or agencies incorporating or enacting a code or set of rules borrowed in its entirety from some outside group, such as local fire codes or licensing requirements for practicing medicine or law.<sup>56</sup>

Perhaps the most extensive state-court consideration of private-party delegations is *Texas Boll Weevil Eradication Foundation v. Lewellyn*,<sup>57</sup> in which the Texas Supreme Court invalidated a statute that gave a private board of cotton-growers sweeping police powers to eradicate boll weevils, a crop pest.<sup>58</sup> The board members, who were area farm owners, used their power against other area growers by forcing them to raze their fields to stop dubious outbreaks of the pestilence. The Texas Supreme Court found delegation to a private group to be much more troubling than delegations to state agencies or municipalities:

[P]rivate delegations clearly raise even more troubling constitutional issues than their public counterparts. On a practical basis, the private delegate may have a personal or pecuniary interest which is inconsistent with or repugnant to the public interest to be served. More fundamentally, the basic concept of democratic rule under a republican form of government is compromised when public powers

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(decision to replevy goods made by private parties unconstitutional). “*Eubank and Roberge* remain good law today.” *Gen. Elec. Co. v. N.Y. Dep’t of Labor*, 936 F.2d 1448, 1455 (2d Cir. 1991). The *GE* court continued, “These opinions still stand for the proposition that a legislative body may not constitutionally delegate to private parties the power to determine the nature of rights to property in which other individuals have a property interest, without supplying standards to guide the private parties’ discretion.” *Id.*; see also *infra* notes 61–70 and accompanying text.

54. *Carter v. Carter Coal Co.*, 298 U.S. 238, 311 (1936). The specific concern in this Article, though, is with the modern phenomenon of privatization, whereby governmental authority is delegated through a contract between an agency and a private corporation.

55. See, e.g., *Fink v. Cole*, 97 N.E.2d 873 (N.Y. 1951).

56. See, e.g., *Stewart v. Utah Pub. Serv. Comm’n*, 885 P.2d 759 (Utah 1994) (ruling against the delegation); *Am. Home Products Corp. v. Homsey*, 361 P.2d 297 (Okla. 1961); *Davis v. B.F. Goodrich*, 826 P.2d 587 (Okla. 1992). Incorporation of “standards” from private entities and trade associations should be distinguished from incorporation of a private entity’s determination of an individual’s case, which is what occurs with privatized welfare eligibility determinations.

57. *Tex. Boll Weevil Eradication Found., Inc. v. Lewellyn*, 952 S.W.2d 454 (Tex. 1997). The decision reviews some of the leading articles and treatises on the nondelegation doctrine in recent times, and its eight-part test is essentially an amalgamation of what it found in the academic scholarship in this area.

58. *Id.* at 460–61.

are abandoned to those who are neither elected by the people, appointed by a public official or entity, nor employed by the government. Thus, we believe it axiomatic that courts should subject private delegations to a more searching scrutiny than their public counterparts.<sup>59</sup>

The *Texas Boll Weevil* case offers a particularly well-developed analysis for evaluating delegations to private parties, weaving together the concerns expressed by other courts and thoroughly surveying the academic literature. The court created its own eight-part test for evaluating the constitutionality of a private-party delegation:

1. Are the private delegate's actions subject to meaningful review by a state agency or other branch of state government?
2. Are the persons affected by the private delegate's actions adequately represented in the decision making process?
3. Is the private delegate's power limited to making rules, or does the delegate also apply the law to particular individuals?
4. Does the private delegate have a pecuniary or other personal interest that may conflict with his or her public function?
5. Is the private delegate empowered to define criminal acts or impose criminal sanctions?
6. Is the delegation narrow in duration, extent, and subject matter?
7. Does the private delegate possess special qualifications or training for the task delegated to it?
8. Has the Legislature provided sufficient standards to guide the private delegate in its work?<sup>60</sup>

Significantly, the court distinguished cases that uphold other types of delegations: "We emphasize at the outset that these standards apply only to private delegations, not to the usual delegation by the Legislature to an agency or another department of government."<sup>61</sup>

Conflicts of interest on the part of one entrusted with governmental power to victimize other individuals seems to be the inherent vice of private

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59. *Id.* at 469. This is really the thesis of this Article, that private delegations should receive higher scrutiny than other delegations, and perhaps should be approached with a presumption that the delegation is inappropriate.

60. *Id.* at 472. The Court found that the statutory scheme met muster under the second factor (representation), five of the other factors weighed against the statute, and two (the fifth and sixth) were inapplicable or inconclusive in the instant case. Thus, the statute in question was invalidated. *Id.*

61. *Id.* As stated at the outset of this Article, the focus here is *not* on delegations to administrative agencies, or any of the delegations usually considered in a law school class on Administrative Law, but rather the particular phenomenon of delegating to private parties and, for purposes of this Article, the focus is on private parties being *paid* for their performance of the delegated task.

delegations.<sup>62</sup> Other criteria, such as review by the government agency, really seem targeted at this underlying problem. Even the issue of the “judicial nature” of delegations seems to stand on the underlying concern that individuals will have their rights infringed upon by others wielding the power of the government (which is delegated by the people collectively) without the usual disinterestedness expected of government functionaries. The unfettered personal interests of the private delegate, financial or otherwise, combined with the power to directly affect the legal rights of another (the underlying feature of the “judicial character” of such delegations) constitute the real danger being averted by these conglomerations of rules. All eight of the criteria in the *Texas Boll Weevil* case aim either at curbing the delegate’s self-interest generally, or preventing the delegate’s self-interest from focusing on any one individual. Thus, the “judicial nature” of the delegation, as well as any lack of “intelligible standards” to guide the decisions or “meaningful review” afterwards, are only part of the problem.

The problem of unchecked self-interest (and conflicts of interest) on the part of the private parties presents the crux of the legal problem. The United States Supreme Court has occasionally reviewed cases where state *judges* were given a financial interest in the outcome of the cases they decided, whether directly or indirectly, and has always held that such a situation violates the Due Process Clause.<sup>63</sup> Potential conflict-of-interest, and targeted victims, becomes the essential danger with private-party delegations. It would follow, then, that if a particular type of delegation contained an *unavoidable* conflict of interest for the delegate, that such a delegation could be considered *per se* undesirable, or even unconstitutional, as an inappropriate delegation of power to private entities with

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62. “Inherent vice” is an apt phrase borrowed from the Connecticut Supreme Court, which upheld a delegation where no such evil was seen.

We perceive no inherent vice that should preclude enlistment by the legislature of private individuals or agencies to achieve a public purpose by the exercise of a governmental power so long as adequate safeguards are provided. Although elected officials and those appointed by them as public officers may be more directly answerable to the electorate for their doings, the principle of accountability remains viable in the ability of legislators to terminate or modify any delegation of legislative power that has been made and in the ultimate authority of the people to change the law by electing those amenable to the public will.

*Carofano v. City of Bridgeport*, 495 A.2d 1011, 1016 (1985) (action brought by city police officers challenging the enforcement of a binding arbitration award).

63. See *Tumey v. Ohio*, 273 U.S. 510 (1927) (criminal conviction overturned because judge had direct pecuniary interest in the fine exacted); *Ward v. Village of Monroeville*, 409 U.S. 57 (1972) (same); see also *Bennett v. Cottingham*, 290 F. Supp. 759 (N.D. Ala. 1968), *aff’d*, 393 U.S. 317 (1969) (mem.) (adjudicator’s compensation being comprised of the traffic fines imposed violated due process); *Brown v. Vance*, 637 F.2d 272 (5th Cir. 1981) (judges received flat fee per case they heard, and creditors could select the judge hearing their case, creating an incentive for a judge to give favorable rulings to creditors, so that creditors would file more frequently in courts of judges who tended to favor plaintiffs, thus increasing the judge’s “business”).



financial self-interest in the decisions being made.<sup>64</sup> This is especially true for the delegation of adjudicative-type decisions.

One of the most recent federal appellate cases to address delegations to private parties was the Seventh Circuit's *Club Misty* decision,<sup>65</sup> involving a Chicago ordinance that allowed a neighborhood referendum to control the granting or revocation of liquor licenses. The voters were actually able to bypass the usual representative political process and simply control the actions of the liquor commission via referendum fiat.<sup>66</sup> Judge Posner, writing for the court, drew a significant distinction between delegations of rule-making power, which affect a general class, and delegations of adjudicative power, which determine the rights of an individual. Mere delegation of rule-making power is more likely to survive judicial scrutiny: the legislature can empower voters to act legislatively, as in a normal public referendum, provided that the action "is on the legislative side of the legislative/judicial divide."<sup>67</sup> Transferring judicial type decision-making, on the

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64. Nothing in this Article is intended to suggest that all private service providers are corrupt or are mistreating the poor. It may even be that many are acting *against* their self-interest and out of altruistic motives. Nonetheless, the potential for abuse should not be left unchecked. The Supreme court noted in *Schechter Poultry*, that the potential for delegates acting in their own self-interest, instead of the public welfare, was at the heart of the court's concern with the delegation in that case: "But would it be seriously contended that Congress could delegate its legislative authority to trade or industrial associations or groups so as to empower them to enact the laws they deem wise and beneficent for the rehabilitation and expansion of their trades or industries?" *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495, 537 (1935). The Court answered its own rhetorical question: "The answer is obvious. Such a delegation of legislative power is unknown to our law and is utterly inconsistent with the constitutional prerogatives and duties of Congress." *Id.*

65. *Club Misty, Inc. v. Laski*, 208 F.3d 615 (7th Cir. 2000). "Club Misty" was the name of a local watering hole whose clientele was unsavory to area residents. *Id.* The area residents were organized by a competitor of Club Misty, and together they brought about the revocation of the establishment's liquor license, which the Club's owners contested in a court action. The unusual delegation mechanism here differed from the standard public hearings held by zoning and planning boards before issuing liquor licenses, in that such boards typically retain the power to make an independent decision, while in this case the neighborhood residents had the power to actually bind the board's decision. *Id.*

66. For an almost identical set of facts in a state supreme court case, see *Du Pont v. Liquor Control Commission*, 71 A.2d 84, 85 (Conn. 1949) ("since no standard whatever is prescribed to guide, limit, or control the reactions of those comprising the fifty-one percent [of the voters], a decision by them based upon whim, fancy, prejudice, caprice or other ill-founded motive would suffice under the ordinance."). *Club Misty*, 208 F.3d at 615, involved a statutory scheme enabling local residents to terminate another's liquor license through a process of circulating petitions and forcing a public referendum, while *Du Pont* involved the liquor commission acquiescing to whatever suspicious scheme a local municipality used to attack liquor proprietors.

67. *Club Misty*, 208 F.3d at 622. Judge Posner's distinction between "legislative" and "adjudicative" closely resembles the same distinction in the Administrative Procedures Act for agency actions, but here the distinction is applied to the types of activities being delegated to private parties. See 5 U.S.C. § 558 (2002).

other hand, to private parties, is “what the Due Process Clause prohibits.”<sup>68</sup> If this principle were applied to privatized welfare eligibility determinations, it would appear that these are on the judicial side, assessing the past and present individuals’ situation.<sup>69</sup>

The line between legislative and adjudicative functions is sometimes blurred. At times the adoption of standards, findings, or policies by private parties can overlap with determinations of the rights of individuals. In *General Electric Co. v. New York Department of Labor* (“GE”),<sup>70</sup> the Second Circuit reviewed

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68. *Club Misty*, 208 F.3d at 622. Judge Posner explains the conceptual difference between legislative and judicial decision making as the difference between deciding what has already happened in the past and into the present (judicial) and deciding what will be in the future commencing with the present (legislative). Justice Holmes propounded this line of thought in *Prentis v. Atlantic Coast Line, Inc.*, 211 U.S. 210, 226–27 (1908). See also Note, *The State Courts and Delegation of Public Authority to Private Groups*, 67 HARV. L. REV. 1398, 1404 (1954) (“Where a delegate is empowered only to make rules, the possibility of discrimination is more remote than in adjudication, for any rule will presumably apply uniformly.”).

69. State courts have also expressed sensitivity to the judicial or legislative character of delegations to private parties. A delegation need only be indirectly characterized as judicial in order to be unconstitutional. For example, the Kansas Supreme Court held in *Sedlack v. Dick*, 887 P.2d 1119 (Kan. 1995), that a statute allowing a labor union and a business organization to select members of the state workers’ compensation board was an unconstitutional delegation of legislative power to private organizations. The court ordered the dissolution of the existing Board, and transferred its pending cases to the nearest district court. *Id.* at 805–06; see also *Revne v. Trade Comm’n*, 192 P.2d 563 (Utah 1948). This delegation in *Sedlack* conferred only the power of appointment on private interested parties. The appointees, however, served an adjudicative function (workers’ compensation hearings), which inclined the court to treat the case as a delegation of judicial power to private individuals. The Rhode Island Supreme Court recently invalidated the state Condominium Act for just this reason: it bequeathed on condominium owners the power to exact punitive fines on other members beyond normal fees. The court found that the delegation of adjudicative powers violated the nondelegation doctrine. *Foley v. Osborne Court Condo.*, 724 A.2d 436 (R.I. 1999), remanded to 1999 WL 615736 (R.I. Super. Ct. Jul. 26, 1999), supplemental decision, 2000 WL 276817 (R.I. Super. Ct. Feb. 25, 2000); see also *Osius v. St. Clair Shores*, 75 N.W.2d 25 (Mich. 1956).

70. *Gen. Elec. Co. v. N.Y. Dep’t of Labor*, 936 F.2d 1448 (2d Cir. 1991). The statute at issue required the Department of Labor to establish fair wages for government contracts based on a review of private-sector contracts for the same type of work. The electricians’ union, however, drafted its private contracts to delineate two categories of “work,” one with wage rates double that of the other. The second, higher category was crafted in a way so that it would always serve as the reference for the Department of Labor in setting rates for government contracts, ensuring high wages (double) for those jobs. The first category would actually be the controlling feature for the private contract, enabling the contractor to be competitive in the private market while reserving future above-market prices for forthcoming government jobs. General Electric (GE), via a subsidiary, had contracted with the State of New York to service and repair railroad electrical transformers. GE paid its union workers the hourly wage normally paid in the private sector. Union workers, however, were used to receiving *double* the usual market price when working under government contracts. The New York Department of Labor then commenced proceedings to impose substantial fines on GE for failing to pay the “prevailing wage” for this type of work. *Id.* at 1450–51.

New York's "prevailing wage" law under the nondelegation doctrine, because it allowed private parties to dictate the government's actions toward others without the usual political or judicial process. The court observed that "the Department's procedures seem not to involve the exercise of any [state agency] discretion in setting prevailing wage and supplement rates."<sup>71</sup> The "rubber-stamping" problem implicated the nondelegation doctrine for the court: "If this two wage rate system was collusively negotiated, and simply adopted *pro forma* by the state (without exercising any discretion) as the resulting wage rates, this would clearly establish an unconstitutional delegation of authority under the statute as applied."<sup>72</sup>

The plaintiffs in the *GE* case alleged that the statutory scheme was inherently flawed, in that it did not provide sufficient "intelligible standards" and safeguards against abuse.<sup>73</sup> It was argued in the alternative that the State allegedly had accepted the rates quoted in the private contracts for government jobs blindly, creating an artificial and onerous payroll burden on any electrical contractor, who faced stiff penalties for violating the statute.<sup>74</sup> The Second Circuit held that such

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71. *Id.* at 1459. It is interesting to note that the *lack* of exercising discretion by the appropriate government agency is taken to imply that someone else *is* exercising that discretion or authority—namely, the private parties. If taken as a general rule, this presents an interesting (and somewhat unexplored) concept for approaching privatization arrangements generally—that a failure of the state to review or monitor the decisions independently creates a presumption that the agency has inappropriately abdicated its authority or discretion (which it received as a delegation from the legislature) to others.

72. *Id.* The problem to which the court points is rubber-stamping of the private delegate's decisions by the state agency, meaning that while there was supposedly a structure in place for monitoring the performance or decisions of the private entity (presumably to safeguard against abuse), in practice no such monitoring was taking place. *See also* Trevino v. General Dynamics Corp., 865 F.2d 1474, 1480 (5th Cir. 1989) ("[W]hen the government merely accepts without review or evaluation the decision made by a government contractor, then the contractor not the government is exercising discretion.").

73. *Gen Elec.*, 936 F.2d at 1455, 1458. The "intelligible standards" doctrine was first articulated clearly in *Hampton v. United States*, 276 U.S. 394, 409 (1928) and *Amalgamated Meat Cutters v. Connally*, 337 F. Supp. 737, 758–59 (D.C. Cir. 1971). *See also* Osius v. St. Clair Shores, 75 N.W.2d 25 (Mich. 1956) (striking down statute that allowed public hearings on zoning applications to control outcome); *Revne v. Trade Comm'n*, 192 P.2d 563 (Utah 1948); *Union Trust Co. v. Simmons*, 211 P.2d 190 (Utah 1949). Noam Chomsky has expressed skepticism about the effectiveness of regulations or standards in reining in the self-interest of corporate contractors once privatization has taken place: "There will, of course, be regulations. . . . But there are so many ways around regulations, especially if you're rich and powerful and have a lot of lawyers. That's not a big problem. It's just like there are regulations around worker safety." NOAM CHOMSKY & DAVID BARSAMIAN, *PROPAGANDA AND THE PUBLIC MIND* 103 (2001). This pragmatic concern, however, has not received much attention from the courts. For purposes of this Article, the concern is not so much whether "intelligible standards" were supplied by the legislature to an agency (as in the cases cited above), but whether the agency has sufficient controls in place to curb the self-interest of the private contractor.

74. *Gen. Elec.*, 936 F.2d at 1458. It does not appear that proof of actual collusion was necessary to find a violation of the nondelegation doctrine, but rather a true lack of safeguards or critical oversight to prevent it.

an arrangement would be unconstitutional if “neither side was forced to curb its self-interest.”<sup>75</sup>

Due process concerns in the privatization arena are muddled by the availability of fair hearings or other recourses even in a system rife with abuse and conflicts of interest. Applicants for welfare services usually have a right to an agency fair hearing.<sup>76</sup> In the *GE* case, the Department of Labor asserted that its internal fair hearing process should be an adequate review system as a rebuttal to GE’s due process complaints.<sup>77</sup> The availability of both departmental fair hearings and federal court review did not deter the court from holding that the practice of “rubber-stamping” (“adoption *pro forma*”) made the statute unconstitutional as applied.<sup>78</sup>

Lack of governmental review of each decision is a concern because of the potential for abuse when no adequate review occurs. The private party lacks political accountability to the voting populace, it can easily elude the searching eye of the media, and it is unlikely to encounter the checks and balances of often competing branches of government. Thus, it becomes particularly important to have the private delegate’s decisions reviewed and scrutinized by those who do face such forces of accountability.

It remains unclear how much review is enough.<sup>79</sup> Consistent, thorough review would seem to undermine the usefulness of the delegation in the first place—much of the work must be done twice, instead of simply having the government agent responsible in that situation do the job herself in the first place. This is, in fact, a criticism of privatization that has been raised by others: the monitoring costs of the government are often forgotten or ignored in assessing the

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75. The case was remanded for further discovery on whether the statute, on its face, delegated legislative power to private parties without sufficient standards to guide them.

76. The widespread practice of fair hearings before denying or terminating welfare benefits is the result of *Goldberg v. Kelly*, 397 U.S. 254 (1970).

77. Another example of this theory may be found in *State v. Stoddard*, 13 A.2d 586, 590 (Conn. 1940), where the Connecticut Supreme Court hinted in dicta that the availability of appeal into superior court may satisfy due process requirements. The case, however, involved a delegation to an administrative agency, and was decided on separation of powers grounds instead of due process.

78. The Second Circuit noted that there were not adequate “procedural safeguards” in situations where the adjudicator had some financial or partisan self-interest in the case. See *Gen. Elec.*, 936 F.2d at 1459. In *Ward v. Village of Monroeville*, 409 U.S. 57, 61–62 (1972), the Supreme Court noted that claimants are “entitled to a neutral and detached judge in the first instance.”

79. In *State ex rel. Haylett v. Ohio Bureau of Workers' Compensation*, 720 N.E.2d 901, 905–06 (Ohio 1999), the Ohio Supreme Court rejected a nondelegation-doctrine challenge to the use of managed-care organizations (MCOs) by the state workers’ compensation bureau, in part because the state agency “continually monitors and evaluates” the MCO, “supervises” them, and “makes the final decision about compensation and payment.”

purported savings when privatization is first being contemplated.<sup>80</sup> One recent study concluded:

[T]he public sector is likely to respond to a mix of political pressures and may in addition undertake a benefit-cost analysis that weighs all relevant social costs and benefits associated with the project. Private sector proposals will be influenced only by the expected private rate of return on the project, which will disregard political pressures one way or the other, and are likely to also disregard external costs and benefits of the project that would be captured in a comprehensive social benefit-cost analysis.<sup>81</sup>

Individuals have certain due process rights, and protection of these rights is costly, involving fair hearings, court proceedings, and administrative “reconsiderations.” The hidden costs of monitoring are really the crux of David Kennedy’s concerns with due process in the midst of privatized welfare: “To the extent that privatizing state functions is intended to save money and improve service delivery, imposing potentially costly and complicated due process requirements will undermine these goals.”<sup>82</sup>

#### IV. DELEGATION BY COMMERCIAL CONTRACT

Private corporations have a fiduciary duty to their shareholders to try to maximize profits;<sup>83</sup> this duty is in conflict with the duty to honor the rights of the

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80. See, e.g., Darrell A. Fruth, *Economic and Institutional Constraints on the Privatization of Government Information Technology Services*, 13 HARV. J.L. & TECH. 521, 535 (2000). The costs of monitoring the contract must be factored into the analysis. The different motivations of the government agent and the private agent—one a public servant, the other an entrepreneur—necessarily requires monitoring to regulate the conflicting interests. This also adds a cost to privatization. According to Fruth, recent studies of privatization on the state and local level showed that performance monitoring was much more cumbersome than simple auditing of the contracts.

81. Ronald J. Daniels and Michael J. Trebilcock, *Private Provision of Public Infrastructure: An Organizational Analysis of the Next Privatization Frontier*, 46 U. TORONTO L.J. 375, 393 (1996).

82. Kennedy, *supra* note 2, at 231, 285.

83. See, e.g., *Stallworth v. AmSouth Bank of Alabama*, 709 So.2d 458, 461 (Ala. 1997); *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919) (“[a] business corporation is organized and carried on primarily for the profit of the stockholders”); WILLIAM KLEIN AND JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 27 (1996); ROBERT CHARLES CLARK, *CORPORATE LAW* 141 (1986); J. Gregory Sidak, *Acquisitions by Partially Privatized Firms: The Case of Deutsche Telekom and Voicestream*, 54 FED. COMM. L.J. 1 (2001); John D. Colombo, *The Marketing of Philanthropy and The Charitable Contributions Deduction: Integrating Theories for the Deduction and Tax Exemption*, 36 WAKE FOREST L. REV. 657, 672 (2001); Nancy J. Knauer, *The Paradox of Corporate Giving: Tax Expenditures, the Nature of the Corporation, and the Social Construction of Charity*, 44 DEPAUL L. REV. 1, 22–23 (1994); David Chang, *Selling the Market-Driven Message: Commercial Television, Consumer Sovereignty, and the First Amendment*, 85 MINN. L. REV. 451, 488 (2000); D. Gordon Smith, *A Proposal to Eliminate Director Standards from the Model Business Corporation Act*, 67 U. CIN. L. REV. 1201, 1204 n.16 (1999); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary*

poor<sup>84</sup> whose social service programs are dispensed by the private corporation in a privatized scenario. “One fundamental and constant tenet of corporate law is that the corporation’s primary *raison d’etre* is shareholder wealth maximization. . . . [T]he corporation exists to maximize shareholder profits and not to serve an eleemosynary function for the benefit of non-shareholder corporate constituencies such as employees and consumers.”<sup>85</sup>

When a private entity makes eligibility determinations for welfare services, it is very difficult to safeguard against self-interest or conflicts of interest on the part of the decision-maker.<sup>86</sup> These arrangements create perverse financial motivations for the private contractor in at least three ways, depending on the general type of contract being used. With contracts paying a fee per case handled, there is a motivation to deny an application the first time with the prospect of receiving a second fee for reviewing the individual’s reconsideration application. With flat-fee contracts, there is an incentive to spend as little time as possible reviewing each application file, in order to collect higher profits for fewer labor-hours, to “dump” files, or to “churn,” servicing only the easiest cases, explained more below. A third alternative, achievement-based contracts, create the incentive to deny claims to receive a contract “bonus” for moving individuals off welfare programs and supposedly into the workforce.<sup>87</sup>

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*Duties*, 21 STETSON L. REV. 23, 36–99 (1991). Even where there is not a strict legal boundary to transgress, private firms arguably have a moral obligation to investors, and these may take priority over customers. See Pauline Vaillancourt Rosenau, *Strengths and Weaknesses of Public-Private Policy Partnerships*, in PUBLIC-PRIVATE POLICY PARTNERSHIPS 223 (Pauline Vaillancourt Rosenau ed., 2000).

84. See, e.g., *Goldberg v. Kelly*, 397 U.S. 254 (1970).

85. Cheryl L. Wade, *For-Profit Corporations that Perform Public Functions: Politics, Profit, and Poverty*, 51 RUTGERS L. REV. 323, 329 (1999). Wade argues that the only way to resolve the conflict of interest between the fiduciary duty to shareholders and the indigent recipients of the services is to create a legal fiduciary duty between such corporations and the indigents they are hired to serve. “If, however, the shareholder-primacy paradigm remains inviolable, perhaps the . . . provision of financial assistance to the indigent should be left to the federal and local governments, even though they have proven, in some instances, to be woefully inadequate. Maybe our focus should be on helping governments do a better job.” *Id.* at 368; see also Rosenau, *supra* note 83, at 224 (“Businesses in the private sector are not altruistic organizations, nor should they be expected to fulfill a welfare function. The abuse potential is evident when . . . private partners . . . provide services for pay to populations that are at a great power disadvantage. . .”).

86. In Wisconsin, where private firms were used extensively in its “W-2” welfare reform program to help place former recipients in jobs, the contracts were unable to incorporate standards regarding their wages, benefits, or job retention. Rom, *supra* note 2, at 178 (“Accordingly, contractors had no particular financial incentives to enhance client wages, benefits, or tenure.”).

87. See Matthew Diller, *The Revolution in Welfare Administration: Rules, Discretion, and Entrepreneurial Government*, 75 N.Y.U. L. REV. 1121, 1181 (2000).

*A. Per Case Fees: The Case of Colonial Cooperative Care in Connecticut*

Privatized welfare contracts often pay a per-case fee to the private entity for each case review. In Connecticut, for example, Colonial Cooperative Care, Inc., which makes eligibility determinations for disability-based general assistance, receives \$122 for each review it completes.<sup>88</sup> This is true whether the determination is favorable, unfavorable, or “undetermined.” Significantly, this fee accrues again upon a reconsideration review of the same file. The contract stipulates a new reviewer will complete each assessment. Thus, when Colonial receives the file a second time upon the applicant’s request for reconsideration, Colonial collects a second fee. If a fair hearing officer within the administrative agency remands the file for yet another review, as when new medical evidence is submitted at the hearing, the fee accrues again. It also appears that many or all of the individual reviewers in this private corporation are shareholders in the corporation itself. This gives the reviewer a personal stake in any profits the company generates.

The private contractor in this case could easily increase revenues by denying a certain number of cases, or finding them “undetermined,” if it seemed likely that the case would be re-submitted for another review.<sup>89</sup> As a practitioner in

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88. Such contracts can be obtained through a FOIA request. A copy of the Colonial contract is in the possession of the Author and Greater Hartford Legal Assistance. Connecticut also privatized its childcare-voucher program for a period, contracting with Maximus, Inc. The scandal surrounding this contract received national media attention, and a non-profit contractor recently replaced Maximus. See Liz Halloran *Welfare Contract Raises Doubts: State Privatized Program Without Analyzing the Cost*, HARTFORD COURANT, Mar. 6, 1998, at A1; Adam Cohen, *When Wall Street Runs Welfare*, TIME, Mar. 23, 1998, at 64. Connecticut has also privatized its Medicaid program for most recipients, delegating it to several private managed care organizations. There are two class actions pending against the state and private contractors for alleged abuses, although the constitutionality of the delegations themselves have not been challenged.

89. In *Brown v. Vance*, 637 F.2d 272 (5th Cir. 1981), judges received a flat fee per case they heard, and creditors were able to select the judge hearing their case. Thus, the fee system created an incentive for a judge to give favorable rulings to creditors, so that creditors would file more frequently in courts of judges who tended to favor plaintiffs. Judges could increase their business by building their reputation accordingly. Moreover, the judge (a justice of the peace) received a fee (\$8) of “prepaid court costs” for the filing of each suit, regardless of the outcome of the case. Rulings resulting in post-judgment proceedings, however, such as execution of fines and garnishments, generated the same small filing fee *again* for each of those proceedings. Thus a ruling that required post-judgment hearings would directly enrich the adjudicator. This “direct potential pecuniary interest” was held to be flatly “unconstitutional” on due process grounds. *Id.* at 286. The fee system in *Brown* is particularly analogous to the compensation system with private welfare contractors.

A nearly identical flat-fee, per-case system in Georgia, was invalidated in *Doss v. Long*, 629 F. Supp. 127 (N.D. GA 1985). Some cases have treated financial self-interest as part of private-delegation analysis, as in *Texas Boll Weevil* and *Club Misty*, but others consider this a completely separate legal theory that must be pleaded and briefed separately. See *Wilson v. Andrews*, 10 S.W.3d 663, 671 (Tex. 1999) (“But the two arguments are distinct. The inherent bias argument raises an equal protection issue, not an unconstitutional delegation challenge.”).

this area, I have observed some state agency case workers in Connecticut who automatically re-submit a claim in an attempt to help the applicant.

A review of this particular contract, as well as corporate information submitted to the state during the bidding process, revealed that Colonial was a small, tightly knit firm of local doctors, apparently augmenting their incomes through the venture. It appears that the individuals designated to complete the review of applications, and make eligibility determinations, were stockholders (owners) of the firm. The examiner thus had a direct financial interest in the outcome of the case, in the sense of whether it would be reviewed only once or several times.<sup>90</sup>

This boomerang-denial method of increasing revenue harms the poor in two ways. First, it creates unnecessary delays for receiving benefits, sometimes adding several months to the process. This is significant for those on the verge of homelessness or needing coverage for immediate medical treatment. Secondly, a certain percentage of the applicants simply fall through the cracks, just giving up after their first denial. Some of those most in need of public assistance, and perhaps most “deserving,”<sup>91</sup> go without the help the state intended them to receive, discouraged and deterred by an initial denial.

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A Colorado trial court recently suppressed evidence from a “photo radar” system for catching speeders, where the photo system was installed and operated by a private contractor, whose payment was based on the number of photos of speeders taken. While the parties in the case did not raise a constitutional delegation argument, the judge did agree to suppress the evidence in part due to the inherent bias created by the per-photo payment scheme. *See City and County of Denver v. Pirosko*, No. S003143859 (Denver County Ct. Jan. 28, 2002).

90. This is not to suggest that all the reviewers at Colonial acted out of their self-interest all the time or even part of the time. Any number of individual reviewers could have been controlled by an altruistic desire to help poor disabled people, or prevented by conscience from harming another for his or her own benefit. The problem is the unchecked potential for abuse. In *Brown v. Vance* the court observed:

[T]here must be many, many judges in Mississippi, as in any other state, pure in heart and resistant to the effect their actions may have on arresting officers and litigating creditors. Nonetheless, the temptation exists to take a biased view that will find favor in the minds of arresting officers and litigating creditors. This vice inheres in the fee system. It is a fatal constitutional flaw. Every accused person and every civil litigant is entitled to a trial in a system that is not only fair on its face but in practical operation is free of temptation to the trial judge to enhance his income by leaning in the direction of conviction in criminal cases and judgment for the plaintiff in civil cases.

*Brown*, 637 F.2d at 276.

Similarly, in *Ward v. Village of Monroeville*, the fact that the mayor did not share directly in the fees and costs did not justify the situation. The “possible temptation” (quoting *Tumey*) existed because the mayor’s “executive responsibilities for village finances may make him partisan to maintain the high level of contribution from the mayor’s court.” *Ward*, 409 U.S. 57, 60 (1972).

91. The idea of some individuals being more “deserving” than others of public assistance is controversial and philosophically problematic, but represents an unfortunate political reality.



Privatization arrangements also twist corporate incentives due to the higher profit margin realized by a cursory review of files if the contractor receives a fee for each case reviewed. The less time spent reviewing each case, the more profit is realized per labor-hour. The incentive, therefore, is to expend as little effort and time on each determination as possible, because the fee is the same no matter how much time the review takes.<sup>92</sup>

### ***B. Flat-Fee Contracts***

Another way to structure a contract for privatizing government services is to use a flat-fee payment scheme, where the contractor is paid a set amount for performing the overall task (or running a certain program for a given period of time). The payment could be made in advance, to enable the contractor to cover “set up” costs, or at the end of the contract, where it can be made contingent upon satisfactory fulfillment of the contract’s terms. Alternatively, some contracts provide for periodic payments through the duration of the contract, to facilitate covering the contractor’s payroll obligations and other overhead expenses. While flat-fee contracts would appear to avoid the perverse incentives inherent in per-case payment arrangements, special conflicts of interest arise under this scenario as well: performing cursory reviews, dumping excessive files, etc.

Under a flat-fee contract or a per-case contract, the contractor’s staffing and facility limitations can actually raise the additional marginal cost of handling new cases beyond a certain number, which may be difficult to predict during the bidding process. During the bidding process for these contracts, the contractor must estimate the number of applicants for the particular program, and essentially has already committed itself to a certain “size” by its choices of buildings, phone system, and number of staff. Once the contractor reaches the maximum number of applicants it can process within these limitations, it will likely engage in “dumping” of incoming files or cases, or “churning,” in which applicants are handled selectively depending on their resource requirements and expected payoffs.<sup>93</sup> The “dumped” applications are lost, delayed indefinitely, or denied

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92. Of course, a cursory review, with a terse explanation, may be more likely to come back as a reconsideration application, thus doubling the profit, as discussed above. “Notice of Decision” letters from the private entity making determinations may contain vague, conclusory, and circular rationales for denials. Such notices take less time and give rise to more appeals and reconsideration reviews.

93. See Freeman, *supra* note 3, at 170 (“For example, one might oppose privatizing welfare benefits on the theory that it will not cut costs and might result in the ‘creaming’ or ‘churning’ of welfare recipients to limit the numbers of claimants.”); Kennedy, *supra* note 2, at 241–47. “Churning” is the term used for the use of burdensome application and maintenance procedures that provide obstacles or disincentives to poor applicants, such as extensive paperwork and documentation requirements, and waiting periods. “Creaming” or “cream skimming” is the term used for focusing resources on the best-qualified or easiest-to-accommodate applicants, allowing or causing the most difficult or disabled applicants to fall by the wayside. See *id.* at 263; Bezdek, *supra* note 14, at 1598–1601. The concept is not restricted to social service applications, but rather the term is borrowed from economic literature on price discrimination and market behavior. See, e.g., Jean-Jaques Laffont & Jean Tirole, *Optimal Bypass and Cream Skimming*, 80 AM. ECON. REV. 1042 (Dec. 1990) (“What distinguishes these examples from other situations in which

automatically; “churning” results in the most self-sufficient applicants getting the most attention, leaving the neediest (and most resource-intensive) applicants to the side.<sup>94</sup> The problem is inherent in privatized human services, which delegate governmental authority via commercial contracts.<sup>95</sup> Analyzing Wisconsin’s privatized Welfare-to-Work program, one commentator explained the conflict of interest as follows:

This model merges public purpose with private profit, two goals which tend to be incompatible. For instance, [in a welfare-to-work placement program], if a vendor makes the highest profit by placing people in private sector jobs, there is a built in incentive to avoid having people in the caseload who are hard to place. It will be more profitable to exclude hard-to-place people by determining that they are ineligible for the program or sanctioning them for not abiding by all of the program’s rules. These profit motives do not promote the public interest in improving the lives of the most marginalized people in our society. Hence, when joining private profit with public purpose, it is essential to create a system that either prohibits or makes unprofitable activities that are contrary to the public interest. . . . Even if a vendor is obligated to take hard-to-place participants, there is still an obvious incentive to sanction more costly participants by claiming they violated some rule, such as refusing to accept a job or missing a job interview.<sup>96</sup>

One apparent example of the “dumping” phenomenon is Maximus, Inc., a major national player in the arena of privatization. As of 1999, Maximus held thirty percent of the national market in privatized health and human services.<sup>97</sup> The company’s website boasts operations (contracts) in thirty-four states in 2001.<sup>98</sup> Complaints, however, are ubiquitous. In Colorado, where Maximus ran a child-support program for five years from 1995–2000, there were complaints from

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a regulated firm faces competition is that the competitive pressure focuses on the high-demand customers (‘the cream’) and not on the low-demand ones (the ‘skimmed milk’).”).

94. See Kennedy, *supra* note 2, at 248–50; see also DONAHUE, *supra* note 3, at 198–99.

95. Noam Chomsky maintains that the national media, under the control of large corporations, has attempted to generate public resentment against welfare programs for the express purpose of setting the stage for privatization, which will in turn benefit the large corporations. See CHOMSKY & BARSAMIAN, *supra* note 73, at 103. He goes further and asserts that privatization of social services and health care will be characterized by a focus on minimizing costs: “And that means you go after the patients who are least risky and are not going to cost you too much . . . [eighty] percent of customers aren’t worth the bother, so get rid of them, and provide services for the 20 percent who are rich enough to yield profits.” *Id.*

96. Melissa Kwaterski Scanlon, *The End of Welfare and Constitutional Protections for the Poor: A Case Study of the Wisconsin Works Program and Due Process Rights*, 13 BERKELEY WOMEN’S L.J. 153, 163 (1998).

97. BILL BERKOWITZ, APPLIED RESEARCH CENTER, PROSPECTING AMONG THE POOR: WELFARE PRIVATIZATION 4 (2001), available at [http://www.arc.org/welfare/prospecting\\_nr.html](http://www.arc.org/welfare/prospecting_nr.html).

98. To view the company’s website, see MAXIMUS, INC., at <http://www.maximus.com> (last visited Jan. 5, 2003).

nearly one out of seven constituents dependent on their services, that they were treated disrespectfully when trying to access services.<sup>99</sup> A caseworker from the District Attorney's office explained the non-renewal of the contract, noting, "many clients just do not have their cases worked."<sup>100</sup> In Connecticut, where Maximus ran a childcare-voucher welfare program, the program was in disarray within months, leaving half of the 17,000 bills to daycare centers over thirty days overdue.<sup>101</sup> In Wisconsin, the Legislative Audit Bureau found that Maximus had spent thousands of dollars in welfare program funds to solicit new contracts in other states.<sup>102</sup>

### *C. Incentive Programs*

Some states have structured their contracts with private welfare administrators without a flat fee for the program, or a per-case-reviewed reimbursement.<sup>103</sup> Instead, the contracts are structured to reward the contractor for meeting the state's overall policy goals, which include reducing the welfare rolls themselves. This provides an incentive for companies to engage in various techniques to either drive welfare recipients away from state programs completely, or, in the case of job-placement programs, to place people quickly in jobs where they may not last long. Wisconsin had one of the most aggressive of such programs:

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99. *Id.* at 6. While such anecdotal complaints may seem rather trite compared to large, mismanaged budgets, this concern is actually closer to the core of the problem addressed by this Article: that privatization ends up infringing on the rights and dignity of the people whom the privatized program was intended to help.

100. *Id.* An applicant in need of some sort of social services, such as Medicare/Medicaid, cash assistance, or emergency housing, can suffer greatly from prolonged delays in processing of the application. When such delays become widespread, local social problems begin to mount, and tension builds within the local service office over the backlog. Government agencies themselves are not immune to this shortcoming, of course, but the privatized providers generally promise greater efficiency as part of their contract.

101. *Id.* at 7. The 1996 welfare reform laws required many poor single mothers to enter the workforce (instead of remaining on the AFDC rolls), which created a sudden acute need for childcare that is accessible to these individuals, both in terms of cost and location. Many states created childcare-voucher programs to facilitate moving single mothers off the welfare rolls and into full-time jobs. The day care centers depended on prompt payment from the social service agency to cover the operating costs and staffing to watch the children of these individuals. When the payments would be unduly delayed, as in the example provided, hundreds of day care centers are left unpaid for their services, and face difficulties in meeting their own payrolls. When the day care centers are harmed by the privatized service provider, they often have no recourse (being so many steps removed from the policy makers), and generally must retaliate against the parents by refusing to take the children.

102. *Id.* at 8. Maximus agreed thereafter to pay back \$500,000 in taxpayer money for social services, and to spend another \$500,000 on "extra services for the poor in Milwaukee County to try to make amends." *Id.*

103. Examples from New York and Wisconsin are discussed in the following paragraphs.

Private contractors typically are reimbursed and evaluated pursuant to performance measures that emphasize outcomes. Welfare reform in Wisconsin illustrates the potential culmination of this trend. After the legislature adopted the welfare reform package known as "W-2," all counties were permitted to implement W-2 for a specified period. Those who met certain program standards, including a projected decline in caseloads, were permitted to operate the program for an additional time period. In Milwaukee, where more than sixty percent of the state's recipients live, the county did not meet these standards, and its administration was handed over to six nonprofit and for-profit operators. Both private and public W-2 agencies are subject to performance standards. Moreover, the profit or loss of W-2 agencies is determined by the amounts that they expend for benefits, services, and administration.<sup>104</sup>

Similarly, the State of New York contracted in 1996 with America Works, Inc. to "place AFDC recipients in private sector unsubsidized jobs."<sup>105</sup> This contract paid the corporation when a welfare recipient: 1) enrolled in the program; 2) was placed in a job by the program; and 3) retained the job for at least 90 calendar days.<sup>106</sup> According to Mark Dunlea of the Hunger Action Network, the state pays America Works about \$5,000 for each person in the program, and it also gets to keep a percentage of their salary earned in the first few months.<sup>107</sup> The employee earns minimum wage, while the employer pays America Works \$6–9 per hour worked for monitoring the case.<sup>108</sup> Payment is also received, however, even if the client's job ends after three months.

The National Association of Child Advocates has published a series of studies on the privatization of child-related welfare services, especially child support collection, concluding:

[B]ecause private vendors are profit driven, vendors pick and choose among [child support] cases based on their estimate of

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104. Diller, *supra* note 87, at 1181. The author discusses similar programs in California, Florida, and New Jersey.

105. BERKOWITZ, *supra* note 97, at 12 (quoting New York Comptroller Carl H. McCall). The goal of this ubiquitous feature of welfare reform was to foster self-sufficiency and break down patterns of dependence. *Id.*

106. *Id.* at 12–13. To their credit, in this case the agency was trying to include *something* in the contract to address the problem of job retention for those moving off the welfare rolls, and to protect against the private service provider collecting fees for sticking clients in jobs that would last only a few days. Ninety days, however, is not really long enough to ensure that an individual in poverty is safely on the way to self-sufficiency; at the same time, it is hard to set a precise length of time that *is* adequate. This illustrates the problem with trying to draft the contracts in such a way as to eliminate the dangers of privatization.

107. *Id.* at 13. Presumably, the employer *also* pays several dollars per hour in FICA, Social Security withholdings, workers' compensation insurance, and any benefits that apply to the employee. The problem then presented is that the individuals being moved off the welfare rolls into these jobs can be more expensive for employers than other employees would be, creating disincentives in the private sector for hiring these individuals and providing an opportunity for them to achieve self-sufficiency.

108. *Id.*

likelihood of success. While an appropriate strategy for profit maximization, this does not meet the program goals. Public child support services are supposed to be available to serve all families—not just those with the richest absent parents or greatest likelihood of success.<sup>109</sup>

#### *D. Summary of Contract Incentives*

In summary, the profit-seeking nature of private corporations may be inherently irreconcilable with the goals and implementation requirements of social service programs. “In the case-by-case choice between forms of organization, in short, the material interests of agents run counter to those of the public at large.”<sup>110</sup> The very traits that motivate or produce market-based efficiencies run counter to the task being delegated by the state agencies to the contractors.

### V. PRIVATIZATION THROUGH NONPROFITS

If for-profit entities have an irreconcilable conflict of interest in running programs for public welfare, one possible solution would be to use exclusively nonprofit corporations as contractors. The elimination of explicit profit-seeking motivations would seem to circumvent the perverse incentives being discussed in this Article.<sup>111</sup> In fact, some proponents of privatization would probably fear that the use of nonprofits would forfeit the very market-driven efficiencies that make privatization appealing in the first place.

Experience has shown, however, that use of nonprofits for such purposes can suffer the same infirmities as profit-maximizing corporations. When competing with for-profit companies in the same arena, nonprofits have been observed to behave more like their profit-driven counterparts.<sup>112</sup> In addition, a rule

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109. DEBORAH STEIN, NAT'L ASS'N OF CHILD ADVOCATES, HOW WILL THE CONTRACT SHAPE PERFORMANCE? 2 (2000), available at <http://www.childadvocacy.org/publicat.html> (last visited Jan. 6, 2003).

110. DONAHUE, *supra* note 3, at 93.

111. The ideological commitments of nonprofits may also provide an extra incentive to provide social services in a manner more consistent with the government's public policy. They also may be more effective at experimenting with and developing new approaches to providing these services. See ROSE-ACKERMAN, *supra* note 16, at 180. An additional advantage may be that many nonprofit contractors would receive income from private contributions besides the fee charged under the government contract. This type of private charitable subsidy to the public expenditure (an idea not without some irony) could enable the nonprofit to charge below-cost fees under its government contract, thus outdoing the “efficiency” savings of for-profits. Susan Rose-Ackerman notes elsewhere, however, that when nonprofits and for-profits compete in the same market, the nonprofits actually tend to charge *higher* fees (at least in the cases of hospitals and day care centers), perhaps as a premium for the ideologically-reified product/service offered. See Susan Rose-Ackerman, *Altruism, Nonprofits, and Economic Theory*, 34 J. ECON. LITERATURE 701, 722–23 (1996) [hereinafter Rose-Ackerman, *Altruism*].

112. See BERKOWITZ, *supra* note 97, at 15; see also SAVAS, *supra* note 3, at 280 (“Contracting with nonprofits has long been practiced, although it has been attacked for altering—if not deforming—the basic nature of those organizations.”). Savas believes strongly that delegating social services from the government to for-profit contractors is the

that requires use of nonprofits exclusively, in an arena where for-profits also operate, could result in entrepreneurs simply organizing with a nonprofit form for bidding purposes and then enjoying the profits in hidden ways.<sup>113</sup> William Ryan, a nonprofit consultant based in Cambridge, Massachusetts, writes that “[b]y playing in the new marketplace, nonprofits will be forced to reconfigure their operations and organizations in ways that could compromise their missions.”<sup>114</sup> In Wisconsin, the YWCA actually created a for-profit subsidiary to partake in a \$40 million welfare-to-work contract.<sup>115</sup>

The National Association of Child Advocates acknowledges the difference in the underlying nature of nonprofits and regular corporations, but maintains, “nonprofits also function under economic constraints, and will be hard-pressed to expend extra funds to provide good services, particularly if the contract doesn’t adequately compensate them for those services.”<sup>116</sup>

Hospitals and similar health-care facilities have functioned for several decades with nonprofit and for-profit institutions operating parallel to one another, even competing with each other. This parallel existence of otherwise identical institutions has provided the opportunity for extensive studies, comparisons, and commentary on the interplay between the two.<sup>117</sup> Marked similarities have arisen

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best, if not the only, solution. *Id.* For a discussion of the coexistence of nonprofits and for-profits in the same market, see Rose-Ackerman, *Altruism*, *supra* note 111, at 718–21.

113. See Rose-Ackerman, *Altruism*, *supra* note 111, at 721 (noting that profits could be hidden through real estate arrangements and other means).

114. BERKOWITZ, *supra* note 97, at 16. Berkowitz continues, “[T]he danger is that in their struggle to become more viable competitors in the short term, nonprofit organizations will be forced to compromise the very assets that made them so vital to society in the first place.” *Id.* This is not to say that it is wrong for nonprofits to compete, or to strive for greater efficiency, but that they could fall prey to the same perverse incentives under the privatization contracts described in this Article with regards to for-profit companies.

115. *Id.* It is not necessarily always a bad thing for a nonprofit to own a for-profit subsidiary. The point is that when nonprofits enter the same marketplace as for-profits, and bid against them for the same government contracts, they begin to take on more and more characteristics of a for-profit entity.

116. STEIN, *supra* note 109, at 2. This does highlight a particular aspect of the dangers with privatization: underestimation of the costs of running the program by the contractor. When a state agency experiences a budget shortfall, it is likely to simply overspend or obtain additional funds through bureaucratic means, without significantly curtailing its services to the public (although such agencies are often understaffed anyway). A private contractor, however, can find itself in a real bind if its costs began to outstrip its revenues—there may be no continuing source of financial input. The perilous need to reduce costs in such a situation—whether for a nonprofit or a for-profit—would present a serious temptation to curb services, allow for more delays in processing applications, etc.

117. See, e.g., Rose-Ackerman, *Altruism*, *supra* note 111, at 721–22; Eleanor Kinney, *Legal and Ethical Issues in Mental Health Care Delivery: Does Corporate Form Make a Difference?* 28 HOUSTON L. REV. 175 (1991); Robert Charles Clark, *Does the Nonprofit Form Fit the Hospital Industry?* 93 HARV. L. REV. 1416 (1980) (analyzing the problems created by nonprofit health care); Regina E. Herzlinger & William S. Krasker, *Who Profits from Nonprofits?* HARV. BUS. REV., Jan.-Feb. 1987, at 93 (questioning the propriety of nonprofit health care).

in the behavior of for-profits and nonprofits in the health care field, such as a focus on the bottom line and subordination of the stated corporate "mission."<sup>118</sup> Nonprofits start to seek patients that can pay and avoid those that cannot pay.<sup>119</sup>

The Supreme Court of Utah addressed this convergence between for-profit and nonprofit hospitals in *Utah County v. Intermountain Health Care, Inc.*<sup>120</sup> The Court held that Utah Valley Hospital, part of a nonprofit hospital group, was not entitled to a property tax exemption. Noting the "increasing irrelevance of the distinction between nonprofit and for-profit hospitals for purposes of discovering the element of charity in their operations,"<sup>121</sup> the court created two conceptual classifications or categories of nonprofits based on their mode of operation: the "physicians' cooperative" and the "polycorporate enterprise."<sup>122</sup> In the former, physicians exercise direct and indirect control over the hospitals, directing their patients there, and thereby realize increased incomes. The "polycorporate enterprise," on the other hand, consolidates the power in the hands of administrators in large organizations with multiple facilities. The latter behave much more like for-profit firms.<sup>123</sup>

It is true that nonprofits function differently than for-profits in many respects.<sup>124</sup> In comparisons of nonprofit with for-profit hospitals, for example, job duties and characteristics tend to be the same in each,<sup>125</sup> but the respective salaries are consistently lower for the top executives in nonprofits.<sup>126</sup> The compensation for top managers at for-profits involves a much higher proportion of performance-based bonuses than their nonprofit counterparts, indicating that the directors of

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118. See Kinney, *supra* note 117, at 186. It appears that one factor in changing the behavior of nonprofit hospitals is that their income source became essentially the same as the for-profits after the advent of widespread health insurance and the creation of Medicare and Medicaid.

119. *Id.* at 193. The provision of welfare service, of course, does not involve "paying" clients. The concern in this context would be that nonprofits favor "low-maintenance" applicants, those involving the least costly accommodations, special exceptions, fair hearings, etc. The problem is that often the most "costly" (difficult) applicants to help are those most in need of government intervention and services.

120. 709 P.2d 265 (1985).

121. *Id.* at 271.

122. *Id.* at 272.

123. *Id.* at 271-72. The point is that privatizing by means of contracting with nonprofits will not necessarily solve the issues being raised in this Article. In certain situations, including those where a non-profit is competing against a large for-profit company for the opportunity to run a social service program, the non-profit may succumb to the same pitfalls and perverse incentives as the for-profit.

124. For a detailed analysis of empirical differences in wage scales for different levels of employees, see Myron J. Roomkin and Burton A. Weisbrod, *Managerial Compensation and Incentives in For-Profit and Nonprofit Hospitals*, 15 J.L. ECON. & ORG. 750 (1999).

125. *Id.* at 757-59. Actually, the authors found that the top executive and managerial positions at nonprofits were just as complex as comparable jobs at for-profits, and sometimes more complex.

126. *Id.* at 778-79.

nonprofits have motivations that include factors besides financial success.<sup>127</sup> On the other hand, lower level managers at nonprofits tend to have compensation that is less performance-based, and generally *higher*, than low-level for-profit managers.<sup>128</sup> While the top managers influence many of the overall policies in a nonprofit organization, it is these lower-level employees who are actually dealing with the poor people who apply for benefits in privatized welfare programs.

Clearly, nonprofits do not share the exact same conflict of interest as for-profits, in that for-profits actually have a legal fiduciary duty to try to maximize shareholder profits.<sup>129</sup> This duty, as discussed above, is at odds with proper treatment of those in poverty, when the contract is for service of these individuals. Nonprofits can, however, succumb to analogous pressures if a shortage of funds produces a similar drive to lower costs. The drive to lower costs comes from different roots, but produces the same fruit.

The lack of private investors and capitalization leaves the nonprofit with less of a buffer to cover its overhead. The employees of nonprofits are dependent on the continued existence of their employer for their jobs just as for-profit corporate employees are. The culture within nonprofits can become obsessively focused on cost-control, and there is no reason that this would not lead to the same problems with “dumping” and “churning” described above.

Moreover, nonprofits may come to depend on contract revenue for their ongoing existence instead of contributions.<sup>130</sup> The need to increase revenue for survival can create similar perverse incentives for getting “two bites at the apple” in the case of per-case contracts, as discussed above. The only difference between the incentive structures for for-profits and nonprofits is that one is driven by the desire to become wealthy, and the latter by the fight for survival. It is not clear

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127. *Id.* at 779 (“[O]ur analysis disclosed that top executives, whose actions are most influential on organizational behavior, face quite different incentives across sectors.”).

128. *Id.* at 778. It should be noted that this also applies to comparisons between the public and private sectors: “Lower level civil servants sometimes earn more than their private sector counterparts, while senior officials generally make less.” DONAHUE, *supra* note 3 at 91.

129. *See* Wade, *supra* note 85, at 329.

130. *See, e.g.,* SAVAS, *supra* note 3, at 275 (“The private, nonprofit, charitable organizations that historically had been dealing with troubled people were transformed into auxiliaries of the state.”). On this point, Savas reveals his true attitude about privatization, about which he is not always forthright: he believes that *every* function of government should be privatized, and that it *must* be contracted out to a for-profit corporation in order to capture market efficiencies. In other places, however, he uses anecdotes of private nonprofits successfully providing social services as proof that the private sector can always do things better than the government. *See id.* at 276 (describing Catholic homeless shelters in New York that lamentably went out of business when government-operated shelters opened nearby); *id.* at 277 (praising the Black Muslim sect for doing “more to discourage drug abuse than government programs have.”). Savas’ tendency to make sweeping generalizations based on pithy anecdotes—*anecdotes that seem contradicted by his own statements elsewhere*—is one of the major weaknesses of his work. For a discussion on some of the academic literature criticizing nonprofits that owe their existence to public funds, see Rose-Ackerman, *Altruism*, *supra* note 111, at 717.



under any theory of economics that profit-maximization takes priority over an organizational instinct to survive.<sup>131</sup>

## VI. THE CONTRACT/DELEGATION PROBLEM IN SOCIAL WELFARE PROGRAMS

Government contracts with private entities are subject to special problems, even when they do not delegate power over other individuals. It is debatable whether contracts with the government can *ever* function with free market ideals.<sup>132</sup>

### A. General Problems with Government Contracts for Services

The complexity of the services provided by the government, and the cost analysis and comparison for not only personnel but also facilities and support services, makes information costs for government agencies formidable in any contract.<sup>133</sup> “Absent strong information, the time, money, and experiential costs of using the market option to discipline outside providers become too expensive and risky to use in all but the most extreme case of malfeasance.”<sup>134</sup> Long-term contracts, which are more suited for the provision of ongoing government services or activities, contain inherent hazards for principal-agent problems.<sup>135</sup> The switching costs are high for the government, both financially and politically, enabling the contractor to engage in hold-up games and unrealistic underbidding.<sup>136</sup> High switching costs and long-term contracts also foster political

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131. Herbert Simon has pointed out that the decisions of individual employees are partly affected by what he calls “organizational loyalty,” whether in the private sector, non-profit, or even public agencies. See SIMON, *supra* note 40, at 144.

132. For a detailed discussion of the problems with privatization of government services besides welfare, see ELLIOT D. SCLAR, *YOU DON’T ALWAYS GET WHAT YOU PAY FOR: THE ECONOMICS OF PRIVATIZATION* 90–129 (2000).

133. See SIMON, *supra* note 40, at 270 (“Little progress has as yet been made toward a program that will tell the legislator and the citizen what this program means to him in terms of public services . . . little progress has as yet been made toward estimating the cost of maintaining government services at a particular level of adequacy. . .”).

134. SCLAR, *supra* note 132, at 91. Waiting for the contract term to expire in order to replace a problematic private delegate can mean homelessness and lack of basic life needs for those in poverty excluded from social service programs through the contractor’s malfeasance.

135. *Id.* at 103–05. At the same time, for purposes of the government programs discussed in this Article, which are quite complex and involve processing thousands of applications for assistance, short-term contracts would probably make the set-up costs outweigh the possible profits for contractors, and inconvenience the state as it was forced to put out more frequent Requests for Proposals, negotiate contracts, and endure the “learning curve” of the new contractor’s employees in performing the tasks.

136. “Switching costs” are the transaction costs incurred in changing from one contractor to another. Several elements go into such switching costs: the time and money it takes to search for an appropriate alternative contractor, the costs of terminating the contract with the original vendor (which can include liability for breach), and the political fallout that results from acknowledging that the first attempt at privatization did not work out as planned. Elliot Sclar cites the following example: “New York City pays the highest price in

cronyism and simony,<sup>137</sup> and monitoring the bidding and contract processes to eliminate these problems adds additional costs. John Donahue describes how contracts with a promise of greater “rents” can increase the risk of bribery and corruption:

Civil servants and profit-seekers will differ in their propensity to bribe officials in the same way as they differ in their propensity to donate money to campaigns. If a profit-seeker has large rents at stake, and if he is undeterred by moral scruples or the threat of discovery, he may be inclined to devote significant sums to induce officials to boost spending, to increase available rents through looser management, or to steer a contract away from more efficient or more qualified competitors. Individual civil servants, with smaller rents at stake, should be willing to spend correspondingly less to defend or to expand them—probably too little to corrupt a politician.<sup>138</sup>

A special form of adverse selection can infect the process of government contracting, where the least competent bidder wins the contract by simply underbidding the more qualified contestants.<sup>139</sup> Asymmetries in information between the state and the contractor about the latter’s competence for the task can skew the process of efficient service procurement.<sup>140</sup> This is a prevalent problem with many types of privatization, where the public buyer must select from an array of inexperienced or unknown sellers. Less-qualified contractors often offer the

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the country for contracted municipal school-bus service and has no cost-effective way to obtain access to alternative bus service. The assets, drivers, and vehicles are controlled by the contractors.” SCLAR, *supra* note 132, at 160–61.

137. *Id.* at 106. For a bitter battle over a contract to run a state’s child support enforcement office, involving malicious accusations of nepotism and cronyism, see *Maximus, Inc. v. Lockheed Info. Mgmt. Sys. Co.*, 493 S.E.2d 375 (1997) (losing bidder accused bid winner of tortious interference with contract for circulating rumors that loser intended to obtain bid illegally through nepotism). See also *Lockheed Info. Mgmt. Sys. Co. v. Maximus, Inc.*, 524 S.E.2d 420 (2000) (dispute of remand decision from previous case).

138. DONAHUE, *supra* note 3, at 97. Donahue concludes, therefore, that “task by task . . . the privatization decision should be biased against contracting when campaign contributions are important factors . . . or where corruption is difficult to detect or deter.” *Id.*

139. This applies to the contractor’s competence in terms of staffing, resources, and skill (Sclar’s concern), as well as motivation to achieve the public-good goals of the agency. John Donahue describes another type of adverse selection that affects contracts for government services, regarding the motivations of competing bidders: “But if profit-seekers *differ* [from one another] in their devotion to the common good, the more public-spirited of them tend, by the logic of cost-based bidding, to lose contract competitions.” DONAHUE *supra* note 3, at 88.

140. SCLAR, *supra* note 132, at 107. That is, when an agency requests bids for running a social service program, the bidders often are able to obtain a great deal of information about the government’s costs in running the program, and are fully aware of the government’s ability to make good on its end of the contract (i.e., to pay). The agency, however, has less information about the private contractor’s true ability to perform and complete the contract, whether in terms of competency or solvency.

lowest prices, which is the purported goal of privatizing in the first place.<sup>141</sup> In many cases, there are statutory or regulatory requirements that government agencies select the lowest bidder.<sup>142</sup> The rationale for such a rule would not only be proper stewardship of taxpayer resources, but to avoid the problems of nepotism and simony mentioned above. The solution, however, presents its own problem by forcing the agency to enlist the cheapest bidder and giving bidders an incentive to understate the true long-term costs. Moreover, cheap bids usually generate lower wages for the workers, which correlates with “an inordinately high rate of labor turnover,”<sup>143</sup> raising administrative and training costs. A high turnover rate among the efficient private contractor’s staff can lower the quality of service and increase mishaps.

Even where adverse selection is avoidable, as with larger, more experienced, or more reputable contractors, moral hazards can infect the process of contracting.<sup>144</sup> The contractor’s incentive is to tailor its activities to the actual stated performance measures in the contract itself, often at the expense of other overarching goals of the government agency.<sup>145</sup> “In sum, profit-seekers cannot be expected to exceed the literal specifications of a contract.”<sup>146</sup>

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141. *See id.* at 108. As stated elsewhere, the goal of this Article is not to challenge the real savings of privatization—although that is Sclar’s main point—but to show that delegation of governmental decision-making to private entities is fraught with problems of constitutional dimensions. The point made here, that privatization contracts can result in the least-qualified party actually winning the contract, is significant for our purposes from the standpoint that the poor will be the ones suffering from any ineptitude on the part of the private contractor or its employees.

142. *See* DONAHUE, *supra* note 3, at 88 (“When regulations require public officials to accept the lowest qualified bid . . . as is generally the case, and for good reasons—reputation [for honoring the public interest] cannot be taken so fully into account.”).

143. SCLAR, *supra* note 132, at 111. In social service programs, this issue is particularly problematic, much more so than with non-interpersonal tasks such as trash removal or carpentry. Those running the programs often need special training in dealing with the special needs and problems of the poor, with accommodating mentally ill applicants, etc. The quality of service and accommodation of special needs can be significantly decreased by frequent turnover in the employees. The flip-side of a promise for “free market efficiency” would presumably be that unproductive workers will be quickly replaced by more efficient ones. It may, in fact, be easier to terminate and replace private sector employees than civil servants. The costs of doing this, however, are partly externalized onto the individuals applying for the social services in question.

144. *Id.* at 115. By “moral hazards” we do not mean in the usual economic sense of insurance coverage providing perverse incentives toward carelessness, but rather that the contractor does not have an incentive to achieve the true goals of the legislature, or even the agency, but only the benchmarks for performance evaluation under the contract. *See also supra* notes 76–81 and accompanying text.

145. *Id.* The example provided by Sclar is the attempt at privatizing the Metro-Dade Transit Agency during the 1980s, in which Greyhound (who won the private contract with the lowest bid) showed spectacular reductions in program costs, which later turned out to correspond to a dramatic drop in the number of people using the transit system in that period. *Id.*

146. DONAHUE, *supra* note 3, at 89.

This is particularly true, of course, with privatization of human services, which focus on the well-being of individuals. “The concept of well-being, although understandable in the abstract, becomes quite squishy when we try to pin it down.”<sup>147</sup> The provision of such services involve issues of intake levels, diversity of claimants, differing needs for levels of service, and ultimate public policy goals, such as preventing malnourishment in children or vocational rehabilitation for disabled adults. “The danger. . . is that given the lack of consensus about well being, agencies should be extremely careful about what they seek from their contractors in the way of performance measures.”<sup>148</sup>

Government contracts are inherently at risk for skewed market effects and diminished efficiency. Usually, those harmed by these bad deals are the taxpayers, and the harm is thus distributed widely and thereby diffused. In the case of welfare services, however, a bad government contract afflicts the most vulnerable segment of society, those who are not self-sufficient and who depend on public benevolence. In a sense, the poor are like third-party beneficiaries to these contracts, but would be likely to gain standing only as a class in any type of contract action. The full brunt of the harm, however, is experienced by each individual welfare recipient—unlike many class-actionable harms, the harm itself is not necessarily diffused, but rather individualized. This is the value of analyzing these situations under the nondelegation doctrine, as it may afford a more practical remedy than would an action based on third-party beneficiaries to a contract.

If government contracts are problematic by nature, then using them as a vehicle for delegating governmental power and decision-making is inherently dangerous. Moreover, contracting out may be unnecessary for achieving the goal of greater efficiency in the administration of social service programs.

### ***B. Delegation and Contract Language***

It would be simplistic to propose a complete solution to the problems of private actors’ conflicts of interest based only on drafting the “perfect contract.” Obviously, the contracts should receive close attention and be drafted as carefully as possible to avoid pitfalls. As Jody Freeman points out, however, “No matter how careful the drafter, some tasks are difficult to specify in contractual terms (for example, delivering quality health care or providing a safe environment for

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147. SCLAR, *supra* note 132, at 127. Of course, the agencies themselves have usually been entrusted with a more specific task than the general “well-being of the public,” and certainly the individual programs being privatized are more focused than that. The point here is that private-sector corporations are used to assessing their success in terms of goals that are much more conducive to empirical analysis, such as costs and revenues, while the goals of the state in helping the poor are less tangible, yet no less important.

148. *Id.* at 128. It may be that welfare services should simply *never* be contracted out, due to the nature of the governmental task.

prisoners).<sup>149</sup> No contract could ever be specific enough *and* detailed enough to anticipate every temptation awaiting a private provider.<sup>150</sup>

William Eskridge and Judith Levi have posited that governmental discretion or decision-making is delegated through what they call “regulatory variables,” linguistic devices in the statute that leave the delegated interpreter a range of meanings and applications.<sup>151</sup> As stated at the outset of this Article, delegations from the legislature to administrative agencies are now a commonplace and a widely accepted part of our system of governance. Some parts of the statute entrusting particular tasks to a given agency are clear and directive. Other provisions contain some ambiguity—sometimes not evident until a difficult case arises—requiring the authorized official or administrator to exercise some discretion about the proper policy or action in that situation. It is in this sense that authority is really being delegated.<sup>152</sup> Regulatory variables relate less to the delegation of “pure” power in the sense of “police powers” or exertion of force, and more to the delegation of decision-making and discretion. As Levi and Eskridge observe, “The level of linguistic generality permits an inference about the speaker’s willingness to delegate gap-filling discretion to another person (i.e., police officers and judges). The more general the statutory term, the more discretion is implicitly vesting in the implementing official.”<sup>153</sup> Classic examples of regulatory variables are such words as “reasonable,” “substantial,” “goodfaith,” and the phrase “all deliberate speed.”<sup>154</sup>

This approach to vagueness in statutory text is different from those that either try to prescribe rules for how to derive a “right” answer whenever statutory imprecision is encountered, and is also different from those who see a

149. Freeman, *supra* note 3, at 171. Even tasks that seem relatively discreet, such as determining the severity of a disability applicant’s impairments, are then subject to the types of abuses described in previous sections.

150. *Id.* (“For many important services and functions contractual incompleteness is inevitable. No contract can be specific enough to anticipate any and all situations that a private provider might encounter. Instead, the contract becomes a framework and a set of default rules that will help direct future gap filling.”).

151. William N. Eskridge, Jr. & Judith N. Levi, *Regulatory Variables and Statutory Interpretation*, 73 WASH. U. L.Q. 1103 (1995). In the course of the article, the authors shift to using the term “regulatory variability” out of fear that readers will imagine a list of magic words that delegate discretion, while others do not. *See id.* at 1107–08. This approach was harshly criticized by Harold Krent in *The Failed Promise of Regulatory Variables*, 73 WASH. U. L.Q. 1117 (1995). Krent’s critique seems misguided, based on part on a misunderstanding of Levi & Eskridge’s conceptual framework (Krent thought that every word would be a regulatory variable, making the idea rather meaningless) and an inability to distinguish between the type of interpretive enterprise engaged in by administrative agencies as opposed to that of the courts. Another writer, Jim Chen, attempted to metamorphosize the “regulatory variable” notion into the building blocks for a purported Chomskian Theory of Legal Syntax, but seems to have lost the significant feature of delegation in the original model. *See* Jim Chen, *Law as a Species of Language Acquisition*, 73 WASH. U. L.Q. 1263 (1995).

152. *See* Sunstein, *supra* note 12, at 330 (“[W]hen statutory terms are ambiguous, there is no escaping delegation.”).

153. Eskridge & Levi, *supra* note 151, at 1111.

154. *Id.* at 1113.

philosophical advantage in verbal imprecision in legal texts.<sup>155</sup> This is not to say that the language reveals the legislature's intention to delegate, which is clear enough already. Rather, this analysis is observing that the mechanism for delegation is, in many cases, the use of general or vague terms in the statute.<sup>156</sup> Without regulatory variables, the civil servant is an *agent* of the state, but not a *delegate*.

A problem arises with the application of the "regulatory variable" concept to the commercial contracts involved in privatization of welfare services. Power is being delegated in the form of decision-making and discretion. The vehicle for this delegation, however, is not a statute, but a *contract*.<sup>157</sup> Not only has the private entity been entrusted with a governmental task to perform, its performance is delineated in the contract under which it operates. Every vague term in the contract, then, becomes an interpretive variable, a delegation or discretionary power.<sup>158</sup>

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155. See Timothy A.O. Endicott, *Vagueness and Legal Theory*, 3 LEGAL THEORY 37 (1997). Endicott discusses Dworkin's and Kelsen's schemes for resolving cases of vagueness and ambiguity, which he finds logically problematic. His own view is that vagueness serves the purpose of avoiding an infinite succession of "borderline cases" that would result from an attempt at perfect precision of every term. *Id.* at 60–63.

156. It may be going too far to say that the legislature intended each vague word to be vague, as it could not possibly anticipate the borderline cases that would arise, making application/interpretation of some specific provision difficult. Rather, the legislature intends generally to leave it to the agency to fill in the gaps, to figure out whatever situations arise within the general confines of the clear provisions. Interestingly, Cass Sunstein notes that "nothing appears to link agency performance with statutory clarity." Sunstein, *supra* note 12, at 324.

This point is in response to a common argument by nondelegation advocates that statutory vagueness "reflects irreconcilable policy differences among legislators. Congress does not resolve issues, but merely ignores them by legislating at a meaningless level of generality." Bernard Bell, *Dead Again: The Nondelegation Doctrine, The Rules/Standards Dilemma and the Line Item Veto*, 44 VILL. L. REV. 189, 205 (1999). Bell himself is not advocating using the nondelegation doctrine, but rather summarizing the views of others. *Id.* John Donahue argues that statutory vagueness may actually be a good reason to *privatize*, as a means of obtaining more specificity through the process of drafting the contract. See DONAHUE, *supra* note 3, at 85 ("When vagueness results solely from political officials' negligence or failure of nerve, shifting from civil servants to profit-seekers may offer a partial remedy. Writing contracts with profit-seeking agents requires devising specifications by which performance will be evaluated."). This assumes, however, that the contracts can effectively eliminate vagueness or problematic language, which is debatable. Reduction of vagueness in the contracts would, however, reduce the degree of delegation to the private contractor.

157. Jody Freeman notes that in contracts, vagueness is sometimes desirable, "as . . . when the parties are familiar with each other, have been repeat players, and have established trust." Freeman, *supra* note 3, at 171.

158. Government contracts have been shown to be replete with vague and ambiguous terms that often result in the government failing to receive the services it intended to obtain by the contract. See Christopher J. Aluotto, *Privatizing and Combining Electricity and Energy Conservation Requirements on Military Installations*, 30 PUB. CONT. L.J. 723, 747 (2001); see also DONAHUE, *supra* note 3, at 86 ("The relative risks of inefficiency due to *vaguely* defined mandates versus inefficiency due to *badly* defined

One problem with this situation is that interpretive mechanisms employed in interpreting a statute allow a party to arrive at whatever one of the possible meanings appears to best suit the present situation, and *different* mechanisms normally are employed in interpreting ambiguities in contracts.<sup>159</sup> Interpreting the terms of a contract is almost completely “intentionalist”-driven; the parties, or the courts, are expected to read each word as the parties would presumably have understood it.<sup>160</sup> In the context of statutory interpretation and construction, legislative intent is only one of a large array of interpretive tools employed.<sup>161</sup> Of course, these canons of interpretation are the tools of the trade for *judges*, not necessarily agency officials fulfilling their duties. They serve to illustrate, however, that a statute and a contract are different genres of legal text and the imprecision may function differently in each.<sup>162</sup> At the present time, the contracts being used to delegate power to private entities follow the traditional government-procurement model, and are not formed in the context of regulatory notice-and-comment rulemaking.<sup>163</sup> The courts are likely to interpret privatization arrangements according to contract principles.<sup>164</sup>

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mandates depends on what happens at lower levels when goals or procedures are left imprecise.”).

159. See, e.g., *City of S. El Monte v. S. Cal. Joint Powers Ins. Auth.*, 33 Cal. Rptr. 2d 714, (Cal. Ct. App. 1994), *vacated*, 45 Cal. Rptr. 2d 729 (Cal. Ct. App. 1995) (modified on denial of rehearing) (terms not subject to rules governing interpretation of contracts, which require strict construction against insurer, but, as statute, are subject to rules of statutory construction, including rule that statute must be construed to effect its purpose); Mark L. Movsesian, *Are Statutes Really “Legislative Bargains”?: The Failure of the Contract Analogy in Statutory Interpretation*, 76 N.C. L. REV. 1145 (1998).

160. See Movsesian, *supra* note 159, at 1149; see also LAWRENCE SOLAN, *THE LANGUAGE OF JUDGES* 89–92 (1993). Solan notes the rule in jurisprudence that ambiguous terms in a contract should always be construed *against* the party that prepared the contract. *Id.* at 87–88. Even before litigation, the parties can anticipate the implications of such an interpretive rule and act accordingly. The rule would seem to be nearly impossible to apply to a statute, however.

161. See Solan, *supra* note 160, at 64–70, 93–108.

162. All communication involves some degree of ambiguity and requires interpretation by the audience. See H.P. Grice, *Logic and Conversation*, reprinted in *PHILOSOPHY OF LANGUAGE* 165–75 (A.P. Martintech ed., 2001); Allan Bell, *Language Style as Audience Design*, 13 LANG. SOC. 145 (1984); Herbert H. Clark & Thomas B. Carlson, *Hearers and Speech Acts*, 58 LANGUAGE 332 (1982). For an analysis of how varying audiences can affect interpretation of criminal statutes, see Meir Dan-Cohen, *Decision Rules and Conduct Rules: On Acoustic Separation in Criminal Law*, 97 HARV. L. REV. 625 (1984).

163. See Freeman, *supra* note 3, at 176. The idea that these contracts involve a conferring of certain governmental powers, without involving the usual procedures followed under the Administrative Procedure Act, brings up a host of other issues about general accountability in the bidding process and contract negotiation. Normally, an agency would not engage in anything close to notice-and-comment procedures for creating procurement contracts. Normally, however, procurement contracts for services do not entrust private actors with powers to make eligibility determinations for welfare applicants.

164. *Id.* at 183. Another significant difference between the operation of contracts and regulations is that agencies are generally free to change or amend problematic regulations (as long as proper procedures are followed), while contracts cannot be freely revoked by states (although the federal government can claim sovereign immunity when it

This is not to say that the solution to self-interested actors is to eliminate all vagueness or “variables” from either the relevant statutes or the contracts. Cass Sunstein notes that “congressional specificity often seems to produce outcomes that reflect the power of self-interested private groups, as, for example, where legislation reflects a capitulation of organizations using public-spirit rhetoric for their own parochial ends.”<sup>165</sup>

It may be that this linguistic distinction—between delegatory<sup>166</sup> variables in regulations and contracts—could serve as a useful tool in formulating the elusive definition of “inherently government functions” that should not be delegated.<sup>167</sup> All government procurement contracts will have some terms that encompass some range of meanings. When the terms in a service procurement contract begin to function more like the “regulatory variables,” conferring discretion instead of inviting inquiry into the intent of the parties, the courts could draw a helpful line and distinguish the permissible from the excessive on these terms.

### C. Problems with Agency in Welfare Eligibility Determinations

Apart from oversimplified ideologies about “efficiency” in private corporations versus civil servants, there are legitimate problems with the efficient administration of welfare programs that pose puzzling choices for policy makers in the coming years. If “efficiency” is defined in terms of maximized accuracy in the eligibility determinations instead of simple cost-savings, the incentives and gaming involved take on a different shape.<sup>168</sup> The representative political process sets a policy for which individuals should receive public assistance (such as the disabled), and how much these individuals should receive (the spending on the

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breaches a contract). Freeman notes that “an agency may find itself, even if only temporarily, bound to a bad bargain and unable to alter it through a simple interpretive decision or rulemaking process. States may choose to avoid these complications by codifying contractual terms in state law or promulgating them as regulations.” *Id.*; see also *id.* at 207–08.

165. Sunstein, *supra* note 12, at 323. He raises this as a problem with the traditional nondelegation doctrine as applied to administrative agencies, which took a dim view of statutory language allowing any leeway or discretion on the part of the unelected officials. Strict application of this view, however, can lead to rent-seeking, and disproportionate interest-group influence, “Statutory clarity, especially on details, is often a product not of some deliberative judgment by Congress, but of the influence of well organized private groups.” *Id.* at 324.

166. I have changed the term here from “regulatory” to “delegatory” because it more precisely captures what is being described, and because the point of this Article is that these delegation-effecting linguistic phenomena are occurring in contracts instead of regulations. “Regulatory variable” seems to connote that the discussion is focused on a creature of promulgated rules, which may be its only rightful domain, but does not describe the looseness of the present situation.

167. See *supra* note 1 and corresponding text. Thus far, there has been no consensus on a model for defining the activities that are so inherently governmental that the government should always do them through civil servants.

168. See Robin Broadway et al., *Agency and the Design of Welfare Systems*, 73 J. PUB. ECON. 1 (1999).

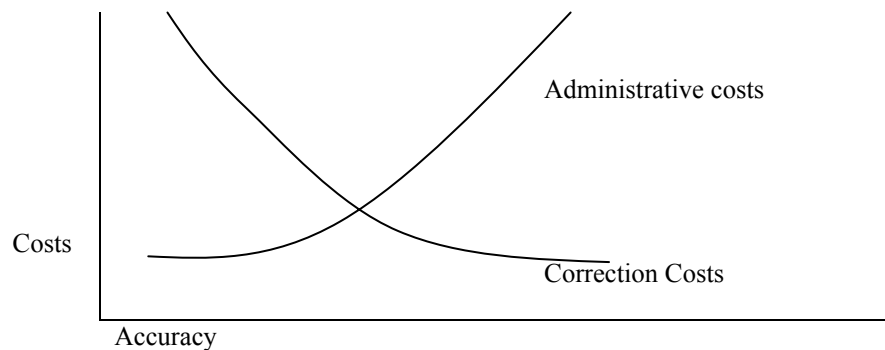


program besides administrative costs). Minimizing administrative costs for the program is certainly a desirable goal. The administrative cost, though, is in tension with the cost of having inaccurate eligibility determinations made. It is a cost, or at least an undesirable outcome, to have the wrong people receive the money allotted for the class of intended recipients.<sup>169</sup>

Administrative costs might be lowered to a level where so much inaccuracy or randomness corrupts the determination process that the low costs pose a new type of inefficiency. People who were intended to receive assistance for some reason are denied access to the program, and others who should not qualify for the program in question receive the benefits instead.<sup>170</sup>

If marginal administrative costs could be graphed as a curve on the same table as the marginal accuracy of eligibility determinations, the best policy, as Table 1 illustrates, would be the point where the two curves intersect, where the greatest accuracy could be achieved for the lowest cost. This would foster the optimal benefit from the program for the best value. Unfortunately, much of the privatization impetus has been focused only on forcing administrative costs as low as possible, ignoring the corresponding increasing cost (after a certain point) of lost accuracy in the decisions.

**Table 1: Marginal Costs of Accuracy**



***D. A Possible Solution: Independent Contractors***

The area fraught with the greatest problems or potential breakdowns in this situation lies with the individual decision-makers processing the applications, who have an incentive to shirk, whether they are paid per case processed, by hours worked, or on a fixed salary.<sup>171</sup> Ensuring accuracy requires some effort on the part of the worker, whether a civil servant or private-sector employee. The worker may be inclined either to grant cases too easily, or deny cases too summarily, in either

169. *Id.* at 12–13.

170. Studies have shown that the margin of error tends to be about the same in both directions when the decisions are made by civil servants, with balance tipping slightly in favor of excessive generosity. *Id.* at 3.

171. *Id.* at 9–12 (finding social worker utility is declining in effort).

case finishing an application assessment without expending the effort required to yield the correct result.<sup>172</sup>

One solution may be to pay the worker on the basis of cases processed, as with the Colonial Cooperative Care contract above, but with a penalty for cases decided inaccurately. This could take the form of having the government recoup the payment disbursed for processing that individual case (presumably the inaccuracy would not be found out until some later point, after the decision-maker had been paid for that case's work). Perhaps a greater penalty, reflecting a punitive element, would be even more effective. In either case, a penalty for wrongly-decided cases removes any advantage to the worker to shirk, and theoretically removes the incentive to spend inadequate effort to obtain the result desired by the government.

There are problems with this simple solution. The first is the cost of monitoring, or "quality control," required for detection of the cases decided wrongly.<sup>173</sup> Some of these cases will become evident through appeals by rejected applicants, or the fraud-detection units that track down people receiving benefits who are really not eligible. A significant number must fall through the cracks. It increases the administrative costs of a welfare program to review every case for worker accuracy; a complete review would essentially be a reduplication of effort.

This problem of monitoring costs may be a justification for high punitive penalties against the decision-maker when bad decisions or shirking are detected. From the worker's standpoint, the penalty is discounted by the likelihood of getting caught. A remote chance of getting a "chargeback" for payment on any given case leaves the worker, most of the time, still better off by shirking effort.<sup>174</sup> The penalty could be set high enough to correspond to the detection rate. A remote chance of being caught and having a huge chargeback may indeed provide a sufficient deterrent to shirking.

The second problem with this scheme is that civil servants are generally salaried, not paid by the cases processed.<sup>175</sup> It would be difficult to marry this type of carrot-stick system with the rigid salary scales of civil servants or with collective bargaining with the state employee union. Privatization may seem like a

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172. By "correct result" I mean making sure that the eligible individuals obtain benefits and that ineligible applicants do not.

173. Welfare programs such as AFDC and SSI have always had quality control monitoring in place to some extent. *See Rom, supra* note 2, at 164. The quality control, however, focused more on checking to see if individuals were receiving the correct amount of benefits, not necessarily whether an individual worker had shirked in a particular case to the recipient's detriment. *Id.*

174. I borrow the term "chargeback" from the sales and marketing field. Insurance salespersons receive their commission almost immediately after signing up a new client for the company. Many of these "sales" cancel their policy after their first or second payment (often because the insured has switched to a competing carrier), and the sales representative receives a "chargeback" for the previously-paid commission in the subsequent paycheck.

175. *See Francois, supra* note 39 (suggesting such a model for civil servants as the most efficient form of provision under certain circumstances).

better fit for this type of incentive system,<sup>176</sup> although there is some evidence in the economic literature that the optimal situation would still be non-privatized civil servants who have compensation incentives to produce good results.<sup>177</sup>

Privatized welfare programs, however, have generally turned over all the application processing for a given program to a single company with a body of employees. The employees for companies like Maximus, Lockheed-Martin, and Colonial Cooperative are salaried, and present the same situation as the civil servants.

If, instead, privatization took the form of a *network of independent contractors*, that is, individual decision-makers, it may solve some of these conflicts. Instead of contracting with one large firm to administer a program, the state could solicit a reasonable number of individuals who work under a per-case contract. They would receive hefty chargebacks when one of their cases is reversed by a hearing officer (wrongly denied), or detected by the fraud unit (wrongly granted) and shown to be an easy faker to spot. This would also solve the problem, discussed above, with too few market participants (bidders). Yet, it would sacrifice some of the economies of scale inherent in larger corporations.

The Social Security Administration already uses a network of independent-contractor physicians as “consultative examiners” in making disability determinations for SSI/SSDI. The doctors who examine applicants for disability benefits receive a fixed fee per examination, with the length of the examination set by regulation. The examination reports function as a second opinion for Social Security to be compared with the applicant’s own treating physicians. There is no penalty for misdiagnoses in this system. It is presented to illustrate how privatization can be implemented nationwide with a vast network of individual contractors, instead of corporations, and it works relatively well. It does not appear that this has been tried by the states in processing applications for their welfare programs, but the system could hold promise if the incentives could be balanced properly. This goal may prove elusive. It may be that the possibility of chargebacks severe enough to deter shirking would deter contractors altogether.<sup>178</sup>

An additional problem with the use of independent contractors is that many may prove judgment-proof to significant damages. If the sanctions or chargebacks are made steep enough to deter shirking, they may also create a marginal deterrence effect once the contractor knows he or she is liable for more

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176. Wisconsin included performance measures and penalties in its contracts with W-2 welfare service providers. Private contractors (firms) would be subject to \$5,000 in fines for failing to provide required services. *See Rom, supra* note 2, at 178. Such penalties, however, were levied against the firm as a whole, not against individual assessors, so the incentive effect against improper shirking would have been diluted significantly. *Id.*

177. *See Francois, supra* note 39. Francois argues that public-service motivation can be tapped as a cost-free incentive more easily in the public sector than with private contractors. Even with private contractors, writing penalty clauses into contracts has proven difficult in both contract formation and enforcement. *See also Rom, supra* note 2, at 177.

178. *See Rom, supra* note 2, at 177 (“The solution . . . [is] to punish financially those firms that withhold services from potential clients. These measures are difficult to implement and, perhaps, will make private firms less interested in developing partnerships with governmental agencies.”).

than the state could extract from the contractor in judgment. At that point, the contractor may feel the incentive to shirk even more, as there is nothing left to lose once caught, and enjoy the payments that come in the meantime. This is especially true given the lag time that would necessarily occur between the issuing of wrongly-decided determinations and the appeal and reversal that would result in a chargeback. One possible solution to this problem is to require contractors to be bonded as a condition of the contract.

A final problem with this model is that it does not account for measuring both shirking in the direction of generosity and the direction of summary denials. The denials would be found out when the claimants appealed their cases, which they have their own incentive for doing. Claimants awarded benefits they did not deserve may be unlikely to report the error so that the case assessor can be caught. There would be additional administrative costs to monitor for shirking in this direction.

Establishing such a network of independent contractors may prove to be the best option among alternatives for privatization. The administrative costs in establishing and monitoring such a system, as well as the problems with providing an optimal balance for deterrence of shirking, serve as yet another illustration of the inherent problems with privatizing welfare services in general. If the model that best addresses the problems and concerns of privatization is itself unworkable, this may testify to the futility of the privatization attempts in less ideal arrangements as well.

## VII. CONCLUSION

In the privatized welfare arena, it is difficult to create a contract that could effectively protect the poor from abuse by the contractors. Per-case contracts, as they currently function, create an incentive to increase the number of cases by making the applicants return a second or third time to get their benefits. Flat-fee contracts will always create an incentive to do as little work as possible for the flat fee, driving both for-profit and nonprofit contractors to favor the “easy to serve” applicants, and to provide the minimum for those in need. Achievement-based or goal-oriented contracts will always tempt the contractor to focus on the applicants most likely to be “success stories,” while neglecting those most in need, and to work exclusively for effects being measured, ignoring side effects and resultant human costs that lie outside the purview of the contract terms.

This is not to say that there are no intermediate measures that would help the situation where privatization has already occurred. Certainly, one helpful step would be for all such contracts to incorporate by reference the existing relevant statutes, regulations, and internal policies of the social service agencies. This means more than just a clause stating that the contractor “shall engage in no activity that violates the laws of this state.” Rather, contractual clauses should reference specific statutory sections addressing the welfare program in view, and require conformity to the details *and* purpose of the statute. Beneficiaries should have a right, specified in the contract, to bring actions against the agency *and* the contractor for failures to comply with the stated purpose and intent of the statutes

and regulations.<sup>179</sup> Mandatory self-disclosure, self-monitoring, and reporting on the part of the private entity could also be included, as well as possible “accreditation” by some nationally-recognized, independent board.<sup>180</sup> The private contractor should be subject to FOIA requests in the same way that the contracting agency would be.<sup>181</sup> It may be that there should be a judicial or statutory rule creating a fiduciary duty between the private contractors and the poor they serve, which would supervene the duties to maximize shareholder profits.<sup>182</sup>

The decision to privatize additional programs should be subject to notice-and-comment rulemaking,<sup>183</sup> and should involve the promulgation of regulations authorizing the contract, delineating its intended operation and purpose, and prescribing monitoring and enforcement mechanisms to prevent abuses and failure to achieve the agency’s goals.<sup>184</sup> This would provide the benefits that usually attend notice-and-comment rulemaking, such as the opportunity for involvement by affected parties and their attorneys,<sup>185</sup> information about issues or problems that the agency had previously overlooked, and accountability to the public for the whole venture.<sup>186</sup> Importantly, in areas where privatization is already underway, it

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179. See David M. Lawrence, *Private Exercise of Governmental Power*, 61 IND. L.J. 647, 691–92 (1986) (an Article generally favorable of privatization, but noting that certain protections should be in place first: “[o]ccasionally, a damages remedy might be a safeguard.”).

180. See Freeman, *supra* note 3, at 205 (describing such provisions in the state of Texas’ contracts with private prison companies). In the welfare-eligibility determination context, accreditation could come from the National Association of Disability Examiners or the National Association of Administrative Law Judges. See NATIONAL ASSOCIATION OF DISABILITY EXAMINERS, at <http://www.nade.org> (last visited Jan. 5, 2003); NATIONAL ASSOCIATION OF ADMINISTRATIVE LAW JUDGES, at <http://www.naalj.com> (last visited Jan. 5, 2003).

181. The need for more publicly-available information about the private contractors’ decisions is discussed in Rosenau, *supra* note 83, at 230, although she does not mention the legal issues surrounding FOIA specifically.

182. See Wade, *supra* note 85, at 368; Andrea K. Marsh, *Sacrificing Patients For Profits: Physician Incentives to Limit Care and ERISA Fiduciary Duty*, 77 WASH. U. L.Q. 1323, 1326 (1999); *but see* Pegram v. Herdrich, 530 U.S. 211 (2000) (reversing circuit court holding that HMO physicians have a fiduciary duty to patients under ERISA).

183. See Bezdek, *supra* note 15, at 1569 (noting that notice-and-comment requirements currently do not apply to private contracting arrangements, and discussing the pitfalls of the present arrangement).

184. This is not to suggest, as Freeman does, that the agencies promulgate the contracts themselves as regulations. Rather, the privatization phenomenon should be subject to formal rulemaking procedures under the APA, and that agency create a detailed “policy” (regulations) for how and when the contracts will operate, how monitoring will occur, and how grievances will be redressed. See Freeman, *supra* note 3, at 208. The TRAC act, discussed *supra* note 7, is a step in this direction on the federal level. Privatization of welfare services, however, is mostly a state-level phenomenon, and state legislatures should pursue a similar course to that of TRAC, but even more extensive, including regulations tailored to setting parameters for private welfare-service providers.

185. See Lawrence, *supra* note 179, at 688–89.

186. See SAVAS, *supra* note 3, at 250–52 (discussing the need for adequate regulation to facilitate the privatization of the entire nation’s infrastructure, to prevent abuses and mishaps).

can help guard against the types of abuses designed to capture more contracts from the government. There should be clear statutory authorization from the legislature prescribing which agency or agency official has the power to enter into these agreements.<sup>187</sup>

An important part of the promulgated rules should be a minimum number of competing bids before one can be accepted.<sup>188</sup> This would significantly change the landscape of privatization as it now stands, where very often there is only one bidder for the state's contract, and a firm already holding the contract for a program in the state is likely to have an advantageous position to bid for and capture other programs as well. Savas, in advocating for wholesale privatization, proposes that the relevant state agency or department itself be required to bid (seriously, not as a pretense) on every outsourcing contract.<sup>189</sup> The state agency

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187. See *State Dept. of Pub. Welfare v. Harambee, Inc.*, 346 A.2d 594 (Pa. 1975), where a court held that the contract under which the firm was to operate two child welfare service facilities was both illegal and unenforceable, as the agency was not authorized to enter into such contracts, and the means for the disbursement of funds did not track existing state statutes.

188. See, e.g., SAVAS, *supra* note 3, at 186, 196–99. Savas sees multiple bidders as necessary to obtain maximum market efficiencies through adequate competition. See also ROSE-ACKERMAN, *supra* note 16, at 177 (“When private production is feasible, the government will obtain none of the benefits of competition if only a single provider is available.”)

189. SAVAS, *supra* note 3, at 186. If nothing else, this idea provides another means of obtaining a realistic picture of the true costs of the proposed venture. The department about to be outsourced would have some incentive to put together a competitive bid.

This does raise a conceptual problem, however, with privatization in general, but one related to the financial merits of the phenomenon as opposed to the constitutional and contractual problems. It would seem, in theory, that an agency unit of civil servants *should* be able to have the same productivity as their private-sector counterparts, assuming that both are staffed by humans. If the government were to run the program at the same cost-level as the private contractor, the savings would all accrue to the state, and ultimately to the taxpayers. With a privatized program, part of the lower costs or savings converts into profits accruing to the owners. It could fairly be said, therefore, that any savings obtained by outsourcing could be greater if the job were performed in-house but done at the same level of efficiency. This is especially true where the state already owns a vast array of facilities, peripheral resources, and support services, making it unlikely that a private company could obtain greater economies of scale than the state.

We are left, then, with the only advantage of privatizing being the profit-possibility motivation for the private entity's managers driving the costs lower. There is an assumption, then, underlying any justification for privatization, that profit motivation alone can reduce costs lower for the same unit of productivity than any motivation or resource the state (or a nonprofit, for that matter) could employ. Theoretically, the civil servants should be able to produce just as efficiently as the private sector, but they simply are not being forced to (according to privatization advocates)—but they *could* be forced to. The host of laws and regulations governing private employment relationships in this country limit the practical differences in what a manager can do to reduce costs or increase productivity of the unit workers. It would seem that a state agency unit manager with a strong ideological commitment to minimizing costs, or operating under a strong enough legislative or executive mandate, could achieve the same results as an owner pursuing his own financial prosperity. The taxpayers would be better off in this situation, because every cent that would have gone to the private contractor as profit would then remain in the public coffers,

should be forced to continue operating the program until there is a sufficient number of bidders to ensure both market efficiency and alternatives to companies that have earned a bad reputation elsewhere.

Similarly, the contracts should be kept small and short.<sup>190</sup> Where privatization has already taken place, the state should consider a bias *against* using the same contractor for the next contract term, tending toward an “automatic renewal” scenario. This prevents one giant corporation, like Lockheed or Maximus, from taking over all of the welfare programs of the state at once, subjecting all the poverty-ridden citizens there to whatever internal problems or shortcomings that corporation may have. It also would make monitoring of individual outsourced programs much more feasible, and encourage more market entrants. Shorter contracts create higher transaction costs, but foster healthy competition and accountability, as private contractors know their contract is up for renewal before long.<sup>191</sup>

Clearly the contracts should avoid provisions that create a financial interest on the part of the contractor in the outcome of the case (as where they will be paid again when the applicant reapplies or requests a second look).<sup>192</sup> Instead,

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at the taxpayers’ disposal. The underlying question here is whether market competition and private ownership are the only mechanisms for controlling “rent-seeking” in the provision of these services. This is yet unproven. *But see* DONAHUE, *supra* note 3, at 90 (“In private firms, a layer of managers attuned to profitability has considerable influence over the behavior of lower-level employees. . . . There is no truly equivalent function in a public bureaucracy, no link in the chain of agency relationships where incentives and authority to press for efficiency are quite so potently concentrated.”). Donahue admits, however, that the “exercise of ownership rights will tend to transform any contractual slack into extra profits and channel it to the owners, rather than leaving it as benefits to the employees.” *Id.* at 92.

190. *See* SAVAS, *supra* note 3, at 186. Savas, an unabashed zealot for privatization of nearly every government function, encourages this as a means of obtaining more bids from competitors, resulting in more healthy competition. “One way to attract many bidders, in the case of a service that is geographically dispersed, is to divide the contract area into small zones, leaving each zone large enough to allow economies of scale. If the service does not permit geographic subdivision, it may be divisible into small functional units . . .” *Id.* While this is a solution to the problems presented by a paucity of bidders (which could, in turn, reduce the agency’s ability to select the bidder most likely to act fairly), it does not solve the inherent vice of the contractor’s self-interest infringing on the rights of other individuals. Colonial Cooperative Care in Connecticut is a small operation in a small state, hired to make disability determinations for one state program (General Assistance). Yet its contract creates an incentive for it to deny meritorious claims as a way of doubling its income when the claims are re-submitted.

191. In reality, every remedy to problems with government procurement comes at a cost. *See* DONAHUE, *supra* note 3, at 111 (“While most individual breakdowns of the procurement system seem remediable, every remedy, each incremental safeguard, refinement, or level of oversight in the contracting process comes at a cost, and fixing one problem is apt to exacerbate others.”).

192. Lawrence, *supra* note 179, at 687 (“The risk of a conflict between public and private interest would also be minimal when the delegate’s motivations parallel those of the alternative public actor.”); *see also* Rom, *supra* note 2, at 178 (“An additional challenge is to develop contracts that specify program results in sufficient detail to hold contractors accountable; this challenge might be especially difficult for relatively inexperienced state and local governments.”).

the contracts should be structured in the opposite direction, with a bias in favor of the intended beneficiaries of the program. For example, if Colonial Cooperative Care would only receive payment *once* for reviewing any applications from the same individual, this would eliminate the inappropriate incentive to deny the case. Instead, it may even create some incentive to *grant* cases likely to come back again and again (which may be the people who are really the most disabled and desperate anyway).

State and federal antitrust/unfair trade practice enforcement officials should closely monitor the private contractors.<sup>193</sup> This practice would discourage companies from pursuing monopoly positions, from using social service program funds for rainmaking efforts in other jurisdictions, and for “holdup games” with the agencies after obtaining the contract.

On the other hand, in the debate about which government services are best-suited for private enterprise, the provision of welfare services should be among the last in line. The policy goals are simply too complex and, in a democratic society, conflicted. Policy judgments about who “deserves” welfare are only part of the problem; the answers to this first question must then be balanced by the policies about the long-term goals for the individuals being “helped,” and finally with the government’s duty to handle taxpayer funds responsibly. Private entities are ill-suited for the balancing act. Private contractors are, at worst, either focused entirely on profit maximization or bare survival.<sup>194</sup> At best, they must balance these private interests with the already challenging array of interests and policy goals bearing on welfare agencies. Of course, the fault here is not solely with the private contractors, but with the agency officials who create these arrangements.<sup>195</sup> For this reason, this type of privatization must be reassessed from a policy standpoint, instead of simply embarking on a monitoring and enforcement crusade against the private contractors themselves.

Unfortunately, the privatization trend will probably continue for several more years, given the popularity it can bequeath on politicians and the profits to be had by corporations.<sup>196</sup> At some point, however, society will realize that the poor were left out in the cold while all the benefits accrued to the contractors and the government itself. The people delegate the government’s power to it; there must be limits on the government delegating the power away to self-interested

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193. See SAVAS, *supra* note 3, at 207–09.

194. “[P]rofit-seekers may perceive as slack *any* use of resources that does not boost net revenue, whether it is simple waste or attention to some precious public goal that has not been made contractually explicit.” DONAHUE, *supra* note 3, at 90.

195. See SIMON, *supra* note 40, at 269 (“Too often, under current practice, the basic decisions of policy are reached by technicians in the agency entrusted with budget review, without any opportunity for review by the legislature.”).

196. See Freeman, *supra* note 3, at 174 (“In any event, there appears in the United States (and indeed worldwide) to be little public appetite for relying directly on government itself to deliver most social services. In an era marked by antipathy toward government bureaucracy, neither technocratic nor ethical objections are likely to deter the trend toward contracting out.”).



individuals.<sup>197</sup> “The worst case scenario, and it is to be avoided, is one in which vulnerable populations (children, the elderly, the disabled, and the cognitively impaired) are dependent on providers whose main motive is to make a profit or reduce costs in a context of low regulation and little attention to monitoring quality.”<sup>198</sup> Delegation of power by commercial contract should be subject to heightened constitutional scrutiny under a revived nondelegation doctrine. To the extent that policy makers succumb to the pressures to take privatization too far, it may be up to the courts to protect against the abuses of governmental power being placed in the hands of private parties with vested financial interests.

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197. The courts should be involved instead of leaving these issues up to the legislature to analyze. “Sadly, there is no reason to expect the political process to lead to the right pattern of privatization. Unless we are luckier than we are and more careful than we are likely to be, political pressures will tend to retain for the public sector functions where privatization would make sense, and to privatize tasks that would be better left to the government.” DONAHUE, *supra* note 3, at 13.

198. Rosenau, *supra* note 83, at 234–35.