Privatization of State Administrative Services

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I. INTRODUCTION

Privatization is an increasingly prevalent feature of state administrative law. It affects and overlaps with all the traditional areas of academic discussion regarding state administrative law continues to focus primarily on preemption, separation of powers, due process, and sovereign immunity. A cursory survey of recent litigation shows courts grappling with privatized state prisons,[1] healthcare facilities,[2] welfare programs,[3] motor vehicle departments,[4] workers' compensation programs,[5] schools,[6] etc. Questions of sovereign immunity/state actor dominate the litigation surrounding privatization for obvious reasons. From a policy standpoint, however, nondelegation concerns are perhaps the more serious long-term concern.[7]

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1. *See, e.g.,* Walker v. Beard, 244 Fed.Appx. 439 (3rd Cir. 2007); Laube v. Allen, 506 F.Supp.2d 969, 983 (M.D. Ala. August 31, 2007); *see also* Kathryne Tafolla Young, *The Privatization Of California Correctional Facilities: A Population-Based Approach*, 18 STAN. L. & POL'Y REV. 438 (2007).

2. *See, e.g.,* Takle v. University of Wisconsin Hospital and Clinics Authority, 402 F.3d 768 (7th Cir. 2005)(concerning privatized state hospital originally created by statute). *See also* Sarah E. Gollust and Peter D. Jacobson, *Privatization of Public Services: Organizational Reform Efforts in Public Education and Public Health*, 96 AM. J. OF PUB. HEALTH 1734, 1736 (2006).

3. *See. e.,g* In re Lauren Z., 158 Cal.App.4th 1102, 70 Cal.Rptr.3d 583 Cal.App. 2 (Cal. App. January 11, 2008) (privatization of state child welfare programs created "an upheaval in child welfare services….").

4. *See, e.g.,* State v. Perez, 883 A.2d 367 (N.J. 2005).

5. *See, e.g.,* Stewart v. West Virginia Employers' Mut. Ins. Co., Slip Copy, 2007 WL 4300595 at *1 (S.D.W.Va., Dec. 5, 2007).

6. *See also* Gollust & Jacobson, *supra* note 2, at 1735.

7. *See* Asmara Tekle Johnson, *Privatizing Eminent Domain: The Delegation of a Very Public Power to Private, Non-Profit and Charitable Corporations,* 56 AM.U.L. REV. 455 (2007); Kenneth A. Bamberger, *Regulation*

The term "privatization" has very different meanings depending on the context. Outside the United States, the term usually refers to the post-Soviet-era trend of governments selling off (or abandoning) government-owned companies and assets, like airlines, oil wells, or diamond mines.[8] In the United States, the term sometimes refers to a special form of deregulation—mostly of utility companies that historically functioned as state-subsidized monopolies.[9]

In the context of administrative agencies, however, "privatization" essentially means "outsourcing," but there is a reason for using different nomenclature for agencies. We say that a private-sector firm "outsources" when it hires another private firm to do some task that the first company could do, and perhaps was doing, "in-house." The decision to "outsource" work in the private sector is purely economic: a firm decides to hire a contractor rather than hiring its own workers to perform the tasks in order to lower the costs of production. The costs and savings vary. Sometimes it is cheaper for a firm to perform the tasks in-house because of economies of scale and the prohibitive transaction costs of hiring so many outside firms; in fact, Ronald Coase offered the latter as the *reason* firms exist in the first place, as opposed to endless webs of private contractors.[10] Other times it is cheaper to outsource a particular task, especially if the outside

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as Delegation: Private Firms, Decisionmaking, and Accountability in the Administrative State, 56 DUKE L.J. 377 (2007); Chris Reeder, *Regulation By Contractors: Delegation of Legislative Power to Private Entities in Texas*, 5 TEX. TECH J. TEX. ADMIN. L. 191 (2004); Gillian E. Metzger, *Privatization As Delegation*, 103 COLUM. L. REV. 1367 (2003); Dru Stevenson, *Privatization of Welfare Services: Delegation by Commercial Contract*, 45 ARIZ. L. REV. 83 (2003); Dru Stevenson, *Privatized Welfare and the Nondelegation Doctrine*, 35 CLEARINGHOUSE REV. 546 (2002).

8. *See, e.g.*, U.S. v. Kozeny, 493 F.Supp.2d 693 (S.D.N.Y. June 21, 2007)(privatization of Azerbaijan's oil company); Orantes-Hernandez v. Gonzales, 504 F.Supp.2d 825, 839 (C.Dist. Cal.,July 24, 2007)(discussing privatization of El Salvador's state enterprises); Jade Trading, LLC v. U.S., 80 Fed.Cl. 11, 18 n. 14 (Dec. 21, 2007) (discussing privatization of European state-owned entities); Olympia Exp., Inc. v. Linee Aeree Italiane, S.P.A., 509 F.3d 347 (7th Cir. 2007) (privatization of European airline and its affects on diversity jurisdiction).

9. *See, e.g.,* Enron Federal Solutions, Inc. v. U.S., --- Fed.Cl. ----, 2008 WL 362363 (February 07, 2008)(privatization of military base water & sewage services); Nuclear Information and Resource Service v. Nuclear Regulatory Com'n, Nuclear Reg. Rep. P 20,681, 509 F.3d 562 (D.C. Cir. 2007)(privatization of U.S. uranium enrichment operations).

10. *See* R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937)

firm already has special equipment or specialized skills to perform the task more efficiently.[11]

In other words, there is no universal answer for firms about whether "outsourcing" is good or bad. It depends on cheapest means of completing the task in question, including a consideration of the transaction costs. Outsourcing saves millions of dollars in some situations and offers no savings—or losses—in another.

Why do we use a different term—"privatization"—when a state agency "outsources" some of its tasks or functions? The two terms betray an important underlying assumption. "Outsourcing" is a semantically neutral term, connoting everyday supply lines, harkening to the "sources" of raw materials every firm must buy. "Outsourcing" is simply the purchase of outside labor or production services, and the assumption is that firms will purchase raw materials or services when it is cheaper to do so than to obtain the raw materials and services in-house. "Privatize" invokes the distinction between the state agencies—public sector—and the commercial marketplace, where the innate forces of capitalism force firms toward efficiency.[12] "Privatization" is not neutral. It connotes a comparison between free-market forces ("good" or efficient) and government bureaucracy ("bad" or inefficient). Everyone knows that "outsourcing" is sometimes good, sometimes bad. "Privatization" is supposed to sound good in every case.[13] Bureaucracy has no inherent aesthetic appeal.

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11. Another reason an outside firm may offer savings for performing certain work is access to cheaper labor than is available to the first firm. Three scenarios where this can occur are 1) where the outside firm has non-unionized laborers while the original firm is a union shop; 2) where the outside firm has access to cheap laborers overseas; and 3) where there outside firm has access to labor at below-market wages, as where it is more willing to hire undocumented aliens than the original (usually much larger) firm. *See, e.g.,* Ysabel Bilbao, *Group of Illegal Immigrants Found Working for Federal Government,* KTVB Idaho News, May 24, 2007, available at http://www.ktvb.com/news/localnews/stories/ktvbn-may2307-illegal_immigrants.33e1b10.html.

12. Nevertheless, a study conducted comparing the two providers found that in the area of "collection of tax debt . . . the government collectors were ten times more efficient (based on dollars collected to dollars expended in collection) and that taxpayers' personal information was more secure with public collectors." Dannin, *supra* note 14, at 120.

13.*See, e.g.,* Elise Castelli, *Agencies Say They Will Open 18,000 Jobs To Contractor Competition This Year*, FEDERAL TIMES, May 3, 2007, available at http://www.federaltimes.com/index.php?S=2730289. The article quotes Paul Dennet, procurement policy manager for the Office of Management and Budget (OMB), as saying, *"Placing limits on competitive sourcing is "bad government" and prevents agencies from saving dollars that could be put toward meeting missions, such as fighting diseases and fighting wars*."

Privatization takes place through service contracts with outside firms. Rather than focusing on the classic legal doctrines infringed by privatization, this article focuses on the somewhat more mechanical problems inherent in the contracts themselves. All contracts for services—whether in the private sector or with the government—involve certain universal transaction costs, yet these transaction costs often go unnoticed in the push to privatize. In addition, there are certain costs or problems unique to government outsourcing contracts that deserve more attention.

State and local agencies frequently contract with private firms to provide government services.[14] Service contracts run along a continuum, ranging from little or no discretion invested in the hired agent to high levels of agent discretion. As with outsourcing arrangements in the private sector, some service arrangements approach the purchase of goods, such as hiring a paving company to apply asphalt to a road; the contact is as much for a finished road as it is for the labor of constructing it. At the other extreme would be contracts for making eligibility determinations for various government services, such as welfare programs and drivers' licenses. These latter types of contracts are the greater concern.

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14. *See* Ellen Dannin, *Red Tape or Accountability: Privatization, Publicization, and Public Values,* 15 CORNELL J.L. & PUB. POL'Y 111, 115 (2005), citing studies regarding municipal privation that show 18% of services are outsourced to private, for-profit contractors, and an additional 23% are public-private hybrids. On the other hand, the latest empirical research on privatization of municipal government services (particularly provision of clean water and removal of sewage of solid waste) indicates that the practice may have already peaked and is now in decline. *See* Germà Bel and Mildred Warner, *Privatization of solid waste and water services: What happened to costs savings?* WORKING PAPER - CORNELL UNIVERSITY, Ithaca NY, July 2007, at http://government.cce.cornell.edu/doc/pdf/priv%20waste%20water%20complete.pdf (last visited Feb. 28, 2008) (hereafter *What Happened to Cost Savings?*) at 2, noting that privatization of municipal solid waste removal peaked at 49% in 1997 and declined to 39% by 2002. *See also* Amir Hefetz & Mildred Warner, *Beyond the Market vs. Planning Dichotomy: Understanding Privatization and its Reverse in U.S. Cities,* 33 LOCAL GOV. STUD. 4 (2007), preprint available at http://government.cce.cornell.edu/doc/pdf/Final%20LGS%20Warner%20and%20Hefetz%20text%20ss.pdf, which finds that while privatization increased dramatically in the late 1980's and early 1990's, from 1997 to 2002 the trend reversed, so that "reinternalization" or "deprivatization" now exceeds the level of outsourcing, at least on the county and municipal level.

Private prisons and schools may initially seem to be the former type of arrangement—the provision of a big brick building with desks or cells. In actuality, they involve daily decisions by the contractor affecting the treatment of prisoners or students, respectively. Apart from immigration applications, state administrative agencies seem to make more eligibility determinations (for government services or licenses) than does the federal government.[15] In fact, eligibility determinations for some federal programs, such as Social Security Disability Insurance, occur within state administrative agencies (each state's Disability Determination Services agency, or DDS).[16] Thus, privatization by state agencies is especially likely to affect the rights and entitlements of private citizens.

At the "discretion" end of the spectrum, privatization arrangements generally take three basic forms: price-per-case contracts, flat-fee contracts (to provide service for a term of years), and incentive contracts (payment for accomplishing certain results). Each presents special problems and advantages. Some hybrid contracts attempt to combine two or more of these basic

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15. Federal privatization programs often receive more attention in the media and academic commentary, but privatization in general is more prevalent on the state and local level than on the federal level. *See* 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."). Two factors contributing to the greater prevalence of privatization among states are the federal government's ongoing trend of foisting program administration onto the states, and the disproportionate growth of state employee unions, which engage in protracted collective bargaining with the state governments. *See* Jody Freeman, *The Contracting State,* 28 FLA. ST. U. L. REV. 155, 162 (2000)("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 20, 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.").

16. For more discussion of this mandatory arrangement between states and the Social Security Administration, *see* Frank S. Bloch, , *Medical Proof, Social Policy, and Social Security's Medically Centered Definition of Disability,* 92 CORNELL L. REV. 189, 209 (2007); David A. Super, *Are Rights Efficient? Challenging The Managerial Critique Of Individual Rights,* 93 CAL. L. REV. 1051, 1002 (2005); Paul Armstrong, *Toward a Unified and Reciprocal Disability System,* 25 J. NAT'L ASS'N ADMIN. L. JUDGES 157, 181 (2005); Charles H. Koch, Jr. and David A. Koplow, *The Fourth Bite at the Apple: A Study of the Operation and Utility of the Social Security Administration's Appeals Council,* 17 FLA. ST. U. L. REV. 199, 213 n. 71 (1990).

forms to obtain the best of each, but carry the risk of producing the worst results of each. In any case, it is helpful to study the three basic forms before analyzing combinations.

When a private firm makes eligibility determinations for government services such as welfare benefits or licenses, it is very difficult to safeguard against self-interest or conflicts of interest on the part of the decision-maker.[17] These arrangements create perverse financial motivations for the private contractor in three different 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, an achievement-based contract, create a bias in the decisionmaker to skew the eligibility determinations to produce the result that yields the highest "bonus" under the contract.[18] In addition, government services involve a host of sometimes-contradictory policy values that agencies must balance—the needs of the individual wanting services, the policy goal of overall poverty reduction, the taxpayers' expectation of government frugality, competition between agencies for budgetary allocations (administrative burdens, etc.), and concerns about helping long-term residents of the state rather than recent arrivals. Incentive programs typically target just one or two of these goals and fail to balance the other important considerations that factor into any government decision.

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17. 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. Mark Carl Rom, *From Welfare State to Opportunity, Inc.: Public-Private Partnerships in Welfare Reform,* 43 AM. BEHAV. SCIENTIST 161, 178 (1999), *reprinted in* PUBLIC-PRIVATE POLICY PARTNERSHIPS (Pauline Vaillancourt Rosenau ed., 2000) (("Accordingly, contractors had no particular financial incentives to enhance client wages, benefits, or tenure.").

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

II. PRIVATIZATION BY CONTRACT: PROBLEMS WITH INCENTIVES

A. Flat-Fee Contracts

The most straightforward way to privatize state administrative services is with a flat-fee contract for fixed period (usually with a renewal option). This approach closely mirrors the traditional arrangement of using salaried civil servants to perform the same tasks. Advocates of privatization contend that civil servants lack any incentive to be efficient or productive because they collect a salary regardless of their productivity during a given month or year.[19] Unfortunately, flat-fee contracts give rise to the same incentive problems for the private firm; if the firm receives payment from the state each month regardless of its productivity or efficiency, then it has an incentive to do the minimum it must do to keep its contract. The agencies must use a byzantine process of soliciting bids before entering into a contract, which makes switching costs very high for an agency that is mildly disappointed with the performance of the privatized contractor. The small number of bidders for these contracts further diminishes the prospects for switching firms if the first has lackluster performance. These same factors also make it difficult to select a truly productive or efficient contractor ahead of time.

A flat-fee payment scheme pays the contractor a set amount for performing the overall task (or running a certain program for a given period). The payment may be in advance, to enable the contractor to cover "set up" costs, or at the end of the contract, where it could be contingent upon satisfactory fulfillment of the contract's terms. Probably more common are arrangements for periodic payments through the duration of the contract. Especially in the case of eligibility determinations for government services, these contracts present special conflicts of interest: performance of cursory reviews, dumping excessive files, etc.

The contractor's staffing and facility limitations often raise the additional marginal cost of handling new cases beyond a certain number. This potential problem can be difficult to predict during the bidding process. Before the bidding process, contractors estimate the number of applicants for the particular program, and essentially commit to a certain "size" by its choices of buildings,

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19. *See, e.g.,* E.S. SAVAS, PRIVATIZATION AND PUBLIC-PRIVATE PARTNERSHIPS 34–38, 111–25 (2000). 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).

phone system, and number of staff. If the demand for the government services significantly exceeds this estimate, many firms will engage in "dumping" of incoming files or cases, or "churning," in which the firm handles applicants selectively depending on how labor-intensive their application may be.[20] "Dumped" applications are lost, delayed indefinitely, or denied automatically. "Churning" results in the most self-sufficient applicants getting the most attention, leaving the neediest (and most resource-intensive) applicants to the side.[21]

For some administrative determinations, this thinning of the herd may be beneficial, as in the case of certain license applications where the more helpless applicants may be undesirable candidates for the licenses in the first place, from a public policy standpoint. With other state services, such as workers compensation, disabled-worker benefits, educational assistance, or public housing, the "churning" problem produces the exact opposite result from what the state intended, helping the people who need the programs the least and turning away those in most obvious need of assistance. For example, when Wisconsin used a flat-fee contract for some of its welfare programs a few years ago, one commentator noted:

For instance, [in a welfare-to-work placement program],

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20. *See* Freeman, *supra* note 15, 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."); David J. Kennedy, *Due Process in a Privatized Welfare System,* 64 BROOK. L. REV. 231, 241–47 (1998). "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; 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, 1598–1601 (2000). 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 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').").

21. *See* Kennedy, supra note 20, at 248–50; *see also* JOHN D. DONAHUE, THE PRIVATIZATION DECISION: PUBLIC ENDS, PRIVATE MEANS 198–99 (1989); Gollust & Jacobson, *supra* note 2, at 1736, describing how privatized health-care providers are often unwilling to serve underinsured patients.

> 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 . . . 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.[22]

Regarding the "dumping" phenomenon, one illustrative example is Maximus, Inc., a national firm that dominates the area of privatization by state administrative agencies.[23] Complaints, however, are ubiquitous. In Colorado, where Maximus ran a child-support program for five years from 1995–2000, there were complaints from nearly one out of seven constituents dependent on their services, that they were treated disrespectfully when trying to access services.[24] 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."[25] 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.[26] In Wisconsin, the

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22. 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).

23. As of 1999, Maximus held thirty percent of the national market in privatized health and human services. *See* BILL BERKOWITZ, APPLIED RESEARCH CENTER, PROSPECTING AMONG THE POOR: WELFARE PRIVATIZATION 4 (2001), *available at* http://www.arc.org/welfare/prospecting_nr.html. The company's website boasts operations (contracts) in thirty-four states in 2001. To view the company's website, see MAXIMUS, INC., *at* http://www.maximus.com (last visited Jan. 28, 2008).

24. BERKOWITZ*, supra* note 23, 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.

25. *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.

26. *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,

Legislative Audit Bureau found that Maximus had spent thousands of dollars in welfare program funds to solicit new contracts in other states.[27]

Of course, extensive oversight and constant monitoring by the administrative agency that outsourced the tasks to the private firm could help ensure that no shirking occurs, but the cost of providing such monitoring and surveillance of productivity defeats the savings that privatization promised in the first place. The more obvious solution to the lack of productivity incentives under a flat-fee contract, especially where switching and monitoring costs are prohibitive, is to pay the firm for each citizen the firm actually helps, or to set achievement goals linked to compensation. We next turn to the first of these options.

B. Per-Case Fees

Another way that state agencies privatize their functions is to pay an outside firm a fixed fee per each case or file that the firm "handles" or processes. The problem lies in the definition of "handle" or "process." If the fee depends upon the contractor rendering a "final determination," this creates an incentive to rush through the files cursorily to reach determinations (the trigger for receiving payment).[28]

Worse, there is an incentive to deny cases where the applicant is likely to re-apply (or apply for a similar program, perhaps at the recommendation of the contractor), allowing the firm to bill for

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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.

27. *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.*

28. 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.

another "case."[29] Where the contracts try to avert this latter problem by counting each individual as only "one" case for purposes of payment (regardless of the number of applications), the incentive is to recruit as many applicants as possible (even those who could not possibly be eligible), and to strongly discourage reapplications by those denied.

Privatized welfare services sometimes use this type of contract arrangement. In Connecticut, for example, Colonial Cooperative Care, Inc., which makes eligibility determinations for disability-based general assistance, receives $122 for each review it completes.[30] Significantly, this fee accrues again upon a reconsideration review of the same file. The contract stipulates a new reviewer will complete each assessment (an attempt to reduce bias by the same reviewer). When the firm receives the applicant's request for reconsideration, it collects a second fee for reviewing the file again. The relevant state agency provides fair hearings for applicants denied twice. If confronted at the hearing with medical disability evidence not previously submitted, which applicants are likely to obtain after a previous denial, the hearing officer can remand the file for yet another review; the contractor's fee accrues yet again. In this particular case, many of the individual reviewers in this private corporation are shareholders in the corporation itself, with a direct personal stake in the firm's revenues.

The private contractors in these scenarios can 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. The problem is reminiscent of the

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29. 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.

30. This is true whether the determination is favorable, unfavorable, or "undetermined." Such contracts can be obtained through a FOIA request. A copy of the Colonial contract is in the possession of the Author. 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.

situation described in *Brown v. Vance,*[31] where judges received a flat fee per case they heard, and creditors were able to select the judge hearing their case. The per-case 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; a ruling that required post-judgment hearings would directly enrich the adjudicator.[32] A nearly identical flat-fee, per-case system in Georgia was invalidated in *Doss v. Long*.[33]

In Colorado, the city of Denver recently privatized part of its traffic enforcement, hiring a contractor to install and operate a "photo radar" system for catching speeders; the private contractor's payment was based on the number of photos of speeders taken, but the firm also had control of the calibration of the sensors and the number of photos. When challenged in court, the judge agreed to suppress the evidence in part due to the inherent bias created by the per-photo payment scheme.[34] The validity of the privatization arrangement itself, however, was not the issue in the litigation.[35]

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31. *Brown v. Vance,* 637 F.2d 272 (5th Cir. 1981).

32. *Id.* at 286. This "direct potential pecuniary interest" was held to be flatly "unconstitutional" on due process grounds, because of our high commitment to independence in the judiciary. Even so, the fee system in *Brown* is particularly analogous to the compensation system with private welfare contractors, but these seldom face due process challenges because the decisionmaker is not a judge. *But 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.").

33. 629 F. Supp. 127 (N.D. GA 1985).

34. *See* City and County of Denver v. Pirosko, No. S003143859 (Denver County Ct. Jan. 28, 2002).

35. This is not to suggest that all the reviewers at every private service provider act out of egregious self-interest all the time. 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

The per-case fee arrangements can harm the neediest people in society. Even for those who receive the necessary government services on their second or third application, there are unnecessary delays, sometimes adding several months to the process. This is significant for those on the verge of homelessness or needing coverage for immediate medical treatment. Moreover, some applicants simply give up after their first denial. Discouraged and deterred, some of those most in need of public assistance, and perhaps most deserving from a policy standpoint, go without the help the state intended them to receive.

In order to combat both the "shirking" incentives created by flat-fee contracts, and the two-bites-at-the-apple incentives created by per-case contracts, state administrative agencies will sometimes use incentive contracts instead. These present a new set of problems.

C. Incentive Programs

When privatizing some state administrative agency functions, some agencies structure the contracts to reward the private firm for achieving certain targets or goals. Achievement-based contracts were very popular in the "welfare-to-work" push of the late 1990's. Wisconsin had one of the most aggressive of such programs.[36]

> 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.

36. See Diller, s*upra* note 18, at 1181:

> 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.

Similarly, the State of New York contracted in 1996 with America Works, Inc. to "place AFDC recipients in private sector unsubsidized jobs." 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. *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

One obvious pitfall for this approach is that government agencies as such are engaged in an everyday balancing act with a host of competing policy considerations. Accountability to taxpayers, the differing political interests of the state legislature and governor (both of which exert some control over the agency), the needs of individuals participating in the programs, and the overall goals of bolstering the public welfare, fitting in within the agency's established culture, and coping with fluctuating budgetary constraints are factors in every agency decision.[37] Incentive-based privatization arrangements often reflect tunnel vision on the part of certain agency officials, and designate just one or two considerations for achievement benchmarks: reducing costs or producing individual "success stories." Other considerations then elude monitoring or assessment. 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.[38] "In sum, profit-seekers cannot be expected to exceed the literal specifications of a contract."[39]

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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. New York would pay 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. *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. The employee earns minimum wage, while the employer pays America Works $6–9 per hour worked for monitoring the case. Payment is also received, however, even if the client's job ends after three months.

37. Responsibility for balancing means that government officials know they may have to answer for failures or instances when the provision of necessary services breaks down. Sometimes privatization not only creates problems with provision of services, but also creates a convenient scapegoat when things go wrong, as when two private companies were blamed for the widespread shortage of flu vaccines in 2004. *See* Gollust & Jacobson, *supra* note 2, at 1736.

38. *See* ELLIOT D. SCLAR, YOU DON'T ALWAYS GET WHAT YOU PAY FOR: THE ECONOMICS OF PRIVATIZATION 115 (2000).. 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

A second and more concrete problem with incentive-based contracts is the phenomenon of "churning" described above: the private contractors can easily screen individual applicants or participants for those most likely to "succeed" or reach the benchmark that triggers the bonus (incentive payment), or to screen out those who will fail or require disproportionate resources. With any type of achievement benchmark that triggers a financial bonus for the contractor, there will be an unintended consequence. Certain individuals will be "easy cases," and therefore more profitable for the firm, and thus will receive preferential treatment, regardless of how this serves the policy goals of the agency or the legislature. "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."[40]

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 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.[41]

III. GENERAL CONTRACT/DELEGATION PROBLEMS WITH PRIVATIZING STATE ADMINISTRATIVE PROGRAMS

A. General Problems with Government Contracts for Services

Privatization usually comes premised on the idea that harnessing free-market forces will enhance the efficiency and productivity of government agencies, by replacing the bureaucracy

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correspond to a dramatic drop in the number of people using the transit system in that period. *Id*.

39. DONAHUE, *supra* note 21, at 89.

40. *Id.* at 93.

41. 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). For a detailed discussion of the problems with privatization of government services besides welfare, see SCLAR, *supra* note 38, at 90–129.

with profit-motivated workers.[42] It is debatable whether contracts with the government can *ever* function with free market ideals, and the problem starts with the bidding process. Government agencies and programs can be massive compared to the average firm, and there are few companies large enough to take on the work of an agency when it wants to privatize some of its functions. The scale of operations precludes market entry for smaller start-ups.[43] This means there are very few bidders for the contracts.[44] Having a limited number of bidders undermines the competitive forces necessary for market-driven efficiency to occur.[45] Instead, the very small number of bidders for most privatization contracts results in oligopoly or monopoly "rents" or premiums on the price of the contract. A disturbing number of government outsourcing contracts involve *only one bidder* for the contract.[46] Those with multiple bidders often have only two or three. The bidding is rarely as competitive as the regular marketplace.[47]

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42. *See, e.g.,* SAVAS, *supra* note 19, at 34-38; Gollust & Jacobson, *supra* note 2, at 1734; Bel and Warner, *What Happened to Cost Savings?, supra* note 14, at 3.

43. In many cases, the profit margin – as a percentage – can be disappointingly low for the contractor, which makes the government contracts less appealing for new, entrepreneurial start-up firms. *See* Elise Castelli, *Working for the Government is Risky Business, Contractors Say,* Federal Times Feb. 20, 2008, available at http://www.federaltimes.com/index.php?S=3380834 (last visited Feb. 29, 2008), describing a recent empirical survey that found 69% of government contractors claimed profit margins of less than 10%, and 7% of contractors found that they had no profit margin at all. A very large, established firm may still find that such a percentage worthwhile if its overhead costs are predictable or are already on the diminishing side of the curve.

44. *See* Gollust & Jacobson, *supra* note 2, at 1734.

45. *See* Dannin, *supra* note 14, at 113 (noting that when federal employees have the opportunity to bid against private contractors for the same work, they win 90% of the time); *id.* at 114, noting that local government employees get to bid on the work being outsourced about one-fourth of the time.

46. *See, e.g.,* Chris Strom, *FEMA Gives Lawmakers List of Nearly 4,000 Sole-Source Contracts,* CONGRESSDAILY, May 25, 2007, *available at* http://www.govexec.com/story_page.cfm?articleid=37023&dcn=todaysnews (discussing the rampant problem with single-bid outsourcing by a federal agency); Elise Castelli, *OMB Plans New Guidance To Increase Competition For Government Contracts,* FEDERAL TIMES, May 15, 2007, available at http://www.federaltimes.com/index.php?S=2760996).

47. *See* Bel & Warner, *What Happened to Cost Savings? supra* note 14, at 8, explaining, "The benefits of competitive contracting (increased efficiency) would come primarily with competition *for* the market as monopoly provision would continue to be necessary due to economies of scale. Thus benefits from privatization would be expected to erode over time." They note that only one-third of empirical studies of municipal privatization found any cost savings, and

Competitive bidding also founders on the problem of estimating the costs of the firm's overhead compared to the agency's costs. State governments possess an overwhelming infrastructure of support services: state buildings, fleets of state cars (sometimes with their own subsidized fueling stations), centralized payroll and personnel offices, centralized computer networks and tech support, telecommunications services, and various personnel with experience in tangentially-related state agencies who retain a connection with the workers there. These are part of the economies of scale for the state government [48]performing tasks in-house, and the savings are difficult to tabulate. Those wanting to privatize have a temptation to view the "cost" of the agency performing the work merely as payroll numbers for the civil servants devoted to that task. A private firm may well be able to underbid this price because it plans to pay its workers lower wages or demand higher productivity,[49] but the government has many hidden savings from doing the work itself within its own infrastructure. The reduced transaction costs that Coase viewed as the impetus for having large firms in the private sector (instead of businesses outsourcing everything) seem even more visible in the largess of a sprawling state government.[50] The complexity of the services provided by the government, and the cost analysis and comparison for not only personnel but also

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those that did were from the 1970's. They offer this advice to agency administrators:

> [B]e wary of over reliance on the importance of competition in markets for waste collection where the only potential competition is *for* the market – for the initial contract. Empirical results suggest that competition *for* the market is not sufficient to ensure cost savings sustain over time. We see economies of scale tend toward monopoly production, at least at the neighborhood or municipal scale, and most municipalities do not face a competitive market of alternative suppliers.

Id. at 13.

48. *See* DONAHUE, *supra* note 21 at 141-43, discussing economies of scale and privatization.

49. At the same time, lower wages for the workers often correlate with a high turnover rate for workers, resulting in unforeseen increases in administrative and training costs. SCLAR, *supra* note 38, at 111.

50. Ronald Coase, The Nature of the Firm, 4 ECONOMICA 386 (1937).

facilities and support services, makes information costs for government agencies formidable in any contract.[51]

Where multiple bidders do exist for privatization contracts, less-qualified contractors often offer the lowest prices, which is the purported goal of privatizing in the first place.[52] In many cases, there are statutory or regulatory requirements that government agencies select the lowest bidder.[53]

Ongoing provision of government services usually requires long-term contracts when states privatize the functions.[54] Long-term contracts contain inherent hazards for principal-agent problems.[55] Switching costs are high for the state agency, both financially and politically, enabling the contractor to engage in hold-up games and unrealistic underbidding.[56] High switching

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51. *See* HERBERT A. SIMON, ADMINISTRATIVE BEHAVIOR 270 (4th ed. 1997)("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. . . ."). *See also* Gollust & Jacobson, *supra* note 2, at 1734; SCLAR, *supra* note 38, at 91 ("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."). 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.

52. *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.

53. *See* DONAHUE, *supra* note 21, 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.").

54. These long-term contracts are especially unfortunate in light of recent widespread empirical evidence that the cost savings of outsourcing steadily erodesover time. *See* Bel & Warner, *What Happened to Cost Savings? supra* note 14 at 7-8.

55. *Id.* at 103–05. At the same time, for purposes of the government programs short-term contracts would probably make the set-up costs outweigh the possible profits for contractors.

56. *See* Gollust & Jacobson, *supra* note 2, at 1734. "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

costs and long-term contracts also foster political cronyism and simony,[57] and monitoring the bidding and contract processes to eliminate these problems adds additional costs.[58] 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.[59]

The state bureaucracies are not perfect, and may not be terribly efficient. Yet the benefit of bureaucracy is that usually no individual civil servant can cheat all that much from the state agency (or taxpayers) by being unproductive.[60] The owner of a

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privatization did not work out as planned. Elliot Sclar cites the following example: "New York City pays the highest price in 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 38, at 160–61.

57. *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 though nepotism). *See also* Lockheed Info. Mgmt. Sys. Co. v. Maximus, Inc., 524 S.E.2d 420 (2000) (dispute of remand decision from previous case).

58. The Department of Defense, recognizing its lack of expertise in bidding out and monitoring contracts, hires private contractors to handle its contracting with others. *See* Dannin, *supra* note 14, at 114.

59. DONAHUE, *supra* note 21, 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.*

60. Frank Knight observed this is his seminal economic text, RISK, UNCERTAINTY, AND PROFIT (1927):

> Another interesting misconception in regard to the public official should be pointed out before we leave this topic. It is common and natural to assume that a hired manager, dealing

private firm getting a large contract, however, can make a fortune.[61]

An additional cost for the agency that is notoriously difficult to quantify – and therefore unlikely to factor into the discussions about whether to privatize a particular program – is the loss of agency expertise as new private-sector hires replace lifelong civil servants.[62] The ability of agency personnel to develop expertise in technical areas has always been one of the best justifications for today's ubiquitous delegations from the legislatures to the administrative agencies.[63] To the extent that privatization undermines the stock of expertise within an agency, it undermines the justification for having the agencies in the first place.

Apart from whether privatization brings efficiency, it also features prominently - and somewhat deceptively - in movements

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> with resources which belong to others, will be less careful in their use than an owner. This view shows little insight into human nature and does not square with observed facts. The real trouble with bureaucracies is not that they are rash, but the opposite. When not actually rotten with dishonesty and corruption, they universally show a tendency to "play safe" and become hopelessly conservative. The great danger to be feared from political control of economic life under ordinary conditions is not a reckless dissipation of the social resources so much as the arrest of progress and the vegetation of life.

Id. at 361. Advocates of privatization tend to be shrill alarmist about government waste or overspending, but the greater tendency of bureaucracy is simple inertia.

61. Indeed, some firms like Maximus boast of endless success stories for their shareholders; *but see* Castelli, *supra* note 43, citing a recent survey: "Contrary to recent public and political perception, government contracting is not a business where companies generate abnormally high profits . . . Only 12 percent of responding companies said they generated profits of more than 15 percent from their government contracts in fiscal 2006."

62. *See* Peter Hettich, *Governance By Mutual Benchmarking in Postal Markets: How State-Owned Enterprises May Induce Private Competitors to Observe Policy Goals*, 32 U. DAYTON L. REV. 199, 210 (2007) ("There is also the argument that privatization saves costs mainly at the expense of the workforce's wages, leading to a frequent turnover and to a loss in expertise.").

63. *See, e.g.,* James J. Park, *The Competing Paradigms of Securities Regulation,* 57 DUKE L.J. 625, 664 (2007)("The first assumption of the administrative paradigm is that regulatory norms should be developed by experts."); see also Mark Seidenfeld, *A Civic Republican Justification for the Bureaucratic State*, 105 HARV. L. REV. 1511, 1518-19 (1992); Jerry L. Mashaw & David L. Harfst, *Regulation and Legal Culture: The Case of Motor Vehicle Safety,* 4 YALE J. REG. 257, 305 (1987).

to "downsize" state government generally.[64] Privatization allows the politicians proposing a budget to shift or hide payroll costs, because outsourced services fall under procurements instead of state personnel.[65] The costs to the taxpayers remain, but there appears to be a decrease in the "size" of the government because there are fewer workers employed by the state. Similarly, state agency heads or governors can use privatization as a union-busting tool, undermining the power of the state employees' union by outsourcing programs and supposedly eliminating state jobs.[66]

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64. At risk of overgeneralization, the motivations for privatization differ somewhat on the federal, state, and local level. Ideology plays a role most often with federal privatization; simple pragmatism or necessity factors into decisions most often at the local level; and it seems that political expediency is most often afoot in the state-level political push to privatize. Economist John Donahue observed 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." DONAHUE, *supra* note 21, at 131. Similarly, privatization expert Mildred Warner noted recently, "Local privatization is not ideological; it has been shown to be primarily pragmatic, as local governments must manage political interests in both the market and policy arenas." Mildred Warner & Germà Bel, *Challenging Issues in Local Privatization,* ENVIRONMENT AND PLANNING C: GOVERNMENT AND POLICY 1 (2008) (FORTHCOMING), available at http://government.cce.cornell.edu/doc/pdf/Gand%20P%20overview%20final.pdf. (last visited Feb. 28, 2008).

65. For discussion of the problem of cloaking government spending, see DONAHUE, *supra* note 21, at 32–33. *See also* Ronald L. Wisor, Jr., *Community Care, Competition and Coercion: A Legal Perspective on Privatized Mental Health Care,* 19 AM. J.L. & MED. 145, 158 n. 103 (1993)("In the first year of privatization, Massachusetts reduced state hospital 'full-time equivalent' positions by 1,706. . . Many of the employees laid off by the state were rehired by the now-private clinics at lower salaries.").

66. *See, e.g.,* Jeffrey Rugg, *An Old Solution to a New Problem: Physician Unions Take The Edge Off Managed Care*, 34 COLUM. J.L. & SOC. PROBS. 1, 26 (2000) (". . . [S]ome public-sector hospitals sought to privatize, in part to rid themselves of their legal obligation to recognize a housestaff union under state law."); Donald G. Featherstun, D. Whitney Thornton II, & J. Gregory Correnti, *State And Local Privatization: An Evolving Process,* 30 PUB. CONT. L.J. 643, 660-61 (2001) (". . . [O]ccasionally employee unions attempt to use collective bargaining agreements to block privatization projects, with mixed success."). "[P]ublic employees may find themselves overtaken by the growing adoption of statutory schemes that authorize privatization." *Id.* at 662. *See also* Mark S. Kaduboski, Note, *A Skirmish in the Battle for the Soul of Massachusetts State Government: Privatization of Government Services and the Constitutionality of Appropriation Restriction Measures*, 38 B.C. L. REV. 541, 542 (1997)("State employees, for example, charged the Administration with union busting, and claimed that privatization was costing the taxpayers money and disproportionately affecting minority workers. These concerns ultimately led the Legislature to take a position in the debate over privatization with the

Courts have already confronted such claims by government employees' unions, and appear to be sympathetic to the unions on this point.[67]

B. Delegation and Contract Language

There is no simple contractual solution to the problems of private actors' conflicts of interest or to the paucity of competitors for bids.[68] No contract could ever be specific enough *and* detailed enough to anticipate every temptation awaiting a private provider.[69]

A further complication with privatization of state administrative services is the interpretive aspect of delegations. We have a vast body of law about statutory construction as it pertains to the laws that authorize state agencies to act. These include the "intelligible standards" benchmark for nondelegation analysis, the *Chevron* two-part test for evaluating agency interpretations of vague terms in their own governing statute, and *ultra vires* doctrine for determining whether an agency's actions

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passage, in 1993, of the Pacheco Act."); John Kincaid, *Foreword: The New Federalism Context of the New Judicial Federalism,* 26 RUTGERS L.J. 913, 931 (1995)("Although there are legitimate concerns about public-service efficiency and public-school effectiveness, privatization and school choice partly reflect efforts to topple labor union pillars of state resurgence."); Wisor, *supra* note 65, at 103 ("Privatization also allows the government to circumvent higher union wages in the state system.").

67. *See, e.g.,* Johanson v. Department of Social and Health Services, 959 P.2d 1166 (Wash. Ct. App. 1998)(holding that state health agency's privatization scheme initiative would impaired the state's obligations under its collective bargaining agreement with the state employee union); National Air Traffic Controllers Ass'n v. Pena, 944 F. Supp. 1337, 1347 (N.D. Ohio 1996) (allowing standing for federal employees' union to challenge Federal Aviation Administration's privatization plan); *but see* Jones v. United States, No. 02-10775-NG (D. Mass. Mar. 11, 2003), available at http://www.pubklaw.com/rd/courts/02-10775.pdf (last visited Feb. 28, 2008)..

68. 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 prisoners)." Freeman, *supra* note 15, 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.

69. *See 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.").

(whether regulatory or adjudicative) exceed its statutory authority. Vague or ambiguous terms in the authorizing statutes are often the vehicle by which the legislature delegates discretion to agency officials.[70] Terms that are more general confer more discretion on the agency; precise terms limit the ambit of the agency's decision-making.

Privatization, however, further delegates power from the agencies to private firms, through commercial contracts. We have a separate—and very different—body of law about the interpretation of contracts. This creates a conundrum for courts about which to use when evaluating the private firm's actions.[71] The state agency delegates decision-making power and discretion;

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70. 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. 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. 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. *See* 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).

71. *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).

the vehicle for this delegation, however, is not a statute, but a contract.[72]

Contract interpretation focuses on the intent of the parties; courts normally read each word as the parties would presumably have understood it,[73] and parties work with this assumption in mind as they make the contract and throughout its performances. In contrast, statutory interpretation (the usual domain of delegations) uses "intent" (the legislature's) as just one of many factors for consideration.[74] A statute and a contract are different genres of legal text and imprecision functions differently in each.[75] It is difficult to predict ahead of time whether courts will interpret the private firm's duties under contract principles or delegation/statutory interpretation principles.[76] This uncertainty encumbers the privatization decision.

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72. 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 21, at 86 ("The relative risks of inefficiency due to *vaguely* defined mandates versus inefficiency due to *badly* defined mandates depends on what happens at lower levels when goals or procedures are left imprecise.").

73. *See* Mark L. Movsesian, *Are Statutes Really "Legislative Bargains"?: The Failure of the Contract Analogy in Statutory Interpretation,* 76 N.C. L. REV. 1145, 1149 (1998)*; 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.

74. *See id.*. at 64–70, 93–108.

75. 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).

76. *See* Freeman, *supra* note 15, 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 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

C. Lessons Learned? Empirical Evidence of Decline in Municipal Privatization

The latest empirical studies of privatization show a surprising reversal of the trend on the local or municipal level. This article, in keeping with the subject of the Symposium, focuses primarily on state agencies and privatization at the state level, but new empirical evidence about trends in municipal privatization (or de-privatization, as the case may be) might reflect a broader trend affecting state governments as well. It is easier to find empirical data about local privatization because the professional association of city managers (the International City/County Management Association, or ICCMA) has conducted its comprehensive Survey of Alternative Service Delivery every five years since 1982, monitoring the levels of privatization by municipalities.[77]

The data shows that privatization was increasingly popular from the late 1980's through the mid-1990's.[78] It seems, however, to have peaked around 1997 and is now declining on the local level.[79] The trend now is back toward provision of public services by the local government itself, although some privatized services remain. For example, privatization of municipal solid waste removal peaked at 49% in 1997 and declined to 39% by 2002.[80]

The reasons for the abandonment of privatization by local governments are partly political (citizens were dissatisfied with the

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codifying contractual terms in state law or promulgating them as regulations." *Id.; see also id*. at 207–08.

77. Mildred Warner**,** *Reversing Privatization, Rebalancing Government Reform: Markets, Deliberation and Planning***,** page 12, Presented at Conference on Reasserting the Public in Delivery of Public Services, National University of Singapore (Sept 27, 2007), available online at the following URL: http://government.cce.cornell.edu/doc/pdf/Singapore%20warner%20paper.pdf (last visited Feb. 28, 2008).

78. *Id.*

79. *See* Hafetz & Warner, *Beyond the Market vs. Planning Dichotomy, supra* note 14, at 4.

80. *See* Bel & Warner, *What Happened to Cost Savings?, supra* note 14, at 2.

services provided and demanded a change) and partly economic.[81] From the standpoint of economics, Mildred Warner and her fellow researchers have conducted extensive surveys of the econometric studies on municipal privatization, most often showing that privatization resulted in no cost savings at all.[82] Local governments experimented widely with privatization throughout the 1980's and 1990's, and learned the hard lessons that it does not yield cost savings, for many of the reasons discussed in this article, which generally fit into the broad categories of transaction costs and agency costs.[83]

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81. *See* Hafetz & Warner, *Beyond the Market vs. Planning Dichotomy, supra* note 14, at 6, noting that the problems with transaction costs and other economic considerations were not the only reason for the failure of privatization in many area.

82. *See id.*; Bel & Warner, *Challenging Issues in Local Privatization, supra* note 64 at 2-3; Bel & Warner, *What Happened to Cost Savings?, supra* note 14. at 1-4; Warner, *Reversing Privatization, supra* note 77, at 7, 12.

83. There may be an additional, more theoretical problem with the economics of privatization, not yet discussed in the academic literature, and which is offered here merely as a footnote or postscript; but it relates to the de-privatization trend on the local level. Maverick economist Frank Knight famously distinguished between "risk" and "uncertainty" in his classic text, *Risk, Uncertainty, and Profit. See generally* KNIGHT, *supra* note 60. "Risk" more properly refers to situation with relatively predictable outcomes and odds – like rolling dice – while "uncertainty" refers to situations where the range of possible outcomes, or their relative likelihood, is impossible to ascertain or even estimate. *See, e.g., id.* at 309-312. The well-known thesis of Knight's book is that true profits for entrepreneurs exist only where there is uncertainty instead of risk; the net revenues accrued in the face of business risks (often misnamed "profits") are merely compensation for opportunity costs or offsets for future discounting on the money and time invested in the venture.

Less familiar is the fact that Knight admits, in the last pages of his text, that uncertainty causes entrepreneurial ventures to fail most of the time, and that the aggregate losses of those who fail probably far exceed the collective "profits" of those who succeed. *See id.* at 363-68. Objectively speaking, the free market is a bad deal for entrepreneurs, in the grand scheme., even if a minority of them strike it rich with windfall profits as a result of good luck and fortuitous judgment. *See id.* at 325. Why, then, do we permit this system as a society? Knight's counter-intuitive answer: entrepreneurs are extremely efficient at bringing suppliers of raw goods together with manufacturers and consumers, creating the optimal allocation of resources and stream of commerce for society as a whole, due to the entrepreneur's combination of private information with the willingness to assume enormous possible losses, and uncertainty. *See, e.g., id.* at 278, 370-71. In other words, society externalizes and concentrates the costs of innovation and development of production facilities onto these private individuals (who take this role voluntarily for the chance of great wealth or the thrill of facing uncertainty). The benefits of the aggregate efforts of entrepreneurs (that is, the economic development all around us) are diffuse,

It is difficult to say whether this trend among municipalities is a grassroots harbinger of what we will soon see at other levels of government. On the one hand, the empirical and econometric data on local privatization is more extensive and more readily available, so it may be the first glimpse of what is happening elsewhere. On the other hand, as noted above, local governments generally privatize for different reasons than state or federal agencies.[84] Municipalities privatize out of financial necessity and pragmatism, while higher levels of government more often feel the pull of market-centered ideology or political expediency (union-busting, etc.). The fact that municipalities then change tactics when they see no cost savings may therefore have less relevance for levels of government where privatization's greatest allure is more ideological or opportunitistic.

IV. CONCLUSION

Privatization of state administrative services may appear at first to be a panacea for the universally-acknowledged problems of bureaucracies. Eliminating the downsides of bureaucracy through outsourcing, however, is more difficult than it may seem. The three basic types of contractual arrangements governing each instance of privatization contain perverse incentives for the private

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benefiting everyone with the supply of convenient goods and services, the creation of jobs, and the purchase of raw materials. The greatest costs or losses do not spread across the population, however, but fall disproportionately on the entrepreneurs. Instead of pooling the risk losses, as we do with insurance, we concentrate the losses, leaving the majority to enjoy the benefits freely.

Ironically, this creates a problem when we come to privatization of government services, because now the public (taxpayers) *are* assuming the potential losses of failed ventures (the contractors' firms). The net advantage for everyone besides the contractor is necessarily lower than where the contractor assumes all potential losses, as is the case with the traditional separation between public and private sectors. Again, this is only a theoretical problem, and is less likely to have a direct effect on the actual decisions of agency policymakers than the financial bottom line. On the other hand, if the implications of Knightian uncertainty *do* make privatization of government services a bad deal for the community at large, as would seem to be the case, the municipalities would be the first to feel this, and would face local political pressure to revert to the previous model.

84. *See supra* note 64, and sources cited therein.

firms that frustrate the policy goals of the administrative agency. The frequent lack of competition for the contracts, combined with transaction costs of monitoring and switching, undermine the free-market forces that were supposed to bring efficiency to the programs. The duties of the agency and the private firm are difficult to ascertain amidst the confusing doctrinal overlap of statutory construction and contract interpretation that inhere in these arrangements. In the end, it is not clear that we were any worse off having civil servants within the traditional bureaucracy perform the government's tasks.