CONTRACT THEORY AND THE FAILURES OF PUBLIC-PRIVATE CONTRACTING

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The market for public-private contracting is huge and flawed. Privatization proponents predict that privatizing will both cut costs and improve service quality. But public-private contracts for services such as prisons and welfare administration tend to result in cost savings at the sacrifice of quality service. For instance, to cut costs, private prisons skimp on security. Public law scholars have studied these problems for decades and have proposed various public law solutions. But the literature is incomplete because it does not approach the problem through a commercial lens. This Article fills that gap by applying contract-theory principles to public-private contracting.

It argues that certain categories of public-private contracts are subject to systematic biases that cause the parties to impose a cost on service recipients in the form of low-quality service. Because there is a limited competitive market for these services, the contracting parties are not forced to internalize these costs. As a result, contracts tend to be underpriced. Thus, what appears to be a cost-saving mechanism is often, in fact, a systematic market failure.

This Article proposes a counterintuitive solution grounded in contract theory and doctrine to force the parties to internalize the cost of poor service provision. It suggests reading into public-private contracts a mandatory duty to act in furtherance of the public interest. Although efficiency theory assumes that mandatory restrictions on contracting parties are inefficient, a mandatory rule is justified here because the law must protect non-parties to the contract who cannot adequately protect themselves. The Article also suggests that third-party service beneficiaries should be permitted to sue to enforce such contracts.

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INTRODUCTION

Public-private contracting is big business. Over a quarter of local government services are now provided to some degree by private entities.[1] And state governments' use of privatization is on the rise.[2] While most sectors of the economy have struggled since 2008, government contracting is seeing growth rates in the double digits.[3] Governments now contract with private companies to run public schools,[4] operate prisons,[5] place foster children,[6] administer welfare benefits,[7] and provide military services[8] and border control,[9] among myriad other examples. Public-private contracting has continued to

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1 *See* Mildred E. Warner & Amir Hefetz, *Cooperative Competition: Alternative Service Delivery*, 2002–2007, *in* MUNICIPAL YEAR BOOK 2009, at 11, 14 (2009) (reporting private entities responsible for more than twenty-five percent of local or municipal service delivery).

2 There is a dearth of empirical evidence on trends in state-level privatization, but some studies have indicated increased privatization. *See, e.g.*, John D. Donahue, *The Transformation of Government Work: Causes, Consequences, and Distortions*, *in* GOVERNMENT BY CONTRACT: OUTSOURCING AND AMERICAN DEMOCRACY 41, 47–48 (Jody Freeman & Martha Minow eds., 2009) (citing a study by the Bureau of Economic Analysis from 1950 through 2005, and noting that "[s]tate and local outsourcing starts low and grows steadily but modestly"); William M. Bulkeley, *Glitches Mar Indiana's Effort to Outsource Social Services*, WALL ST. J., Aug. 12, 2009, at A4 (citing report finding "state-government outsourcing business will amount to about $8.8 billion in revenue this year, and predict[ing] it will grow 5% annually to $11.2 billion in 2014"). There is a wealth of anecdotal evidence that state-level privatization is increasing. *See, e.g.*, Jody Freeman & Martha Minow, *Introduction* to GOVERNMENT BY CONTRACT: OUTSOURCING AND AMERICAN DEMOCRACY, *infra*, at 8 ("[T]he clear trend over the last few decades, at all levels of government, is toward outsourcing."); E.S. Savas, *Privatization in State and Local Government*, *in* RESTRUCTURING STATE AND LOCAL SERVICES: IDEAS, PROPOSALS, AND EXPERIMENTS 91 (Arnold H. Raphaelson ed., 1998) ("Privatization of state and local government services is widespread and growing."); Developments in the Law, *A Tale of Two Systems: Cost, Quality, and Accountability in Private Prisons*, 115 HARV. L. REV. 1868, 1868 (2002) ("Private prisons are on the rise.").

3 GRANT THORNTON LLP, THE STATE OF THE GOVERNMENT CONTRACTOR INDUSTRY: 2010, at 6 (2010), *available at* http://www.gt.com/staticfiles/GTCom/Government%20contractors/Government%20contractor%20files/GovConRdtble2010FINALpdf.pdf (stating that, in 2009, government contracting industry grew twelve percent over the past year); *see also* Freeman & Minow, *supra* note 2, at 6 ("During fiscal year 2006, federal agencies spent over $400 billion on procurement of goods and services from private firms, an increase of almost 90 percent since 2000.").

4 Jack M. Beermann, *Administrative-Law-Like Obligations on Private[ized] Entities*, 49 UCLA L. REV. 1717, 1726 (2002).

5 *Id.*; Jody Freeman, *The Contracting State*, 28 FLA. ST. U. L. REV. 155, 160–63 (2000); Paul Howard Morris, Note, *The Impact of Constitutional Liability on the Privatization Movement After* Richardson v. McKnight, 52 VAND. L. REV. 489, 494 (1999).

6 Daniela Caruso, *Contract Law and Distribution in the Age of Welfare Reform*, 49 ARIZ. L. REV. 665, 670 n.9 (2007).

7 Matthew Diller, *Form and Substance in the Privatization of Poverty Programs*, 49 UCLA L. REV. 1739, 1740 (2002) (discussing the privatization of Florida's public assistance program for needy families).

8 Paul R. Verkuil, *Public Law Limitations on Privatization of Government Functions*, 84 N.C. L. REV. 397, 436–37 (2006).

9 Freeman & Minow, *supra* note 2, at 2.

gain favor during the recent recession in part as an answer to state budgetary problems.[10]

The attractiveness and success of privatization[11] derive from its presumed ability to reduce the costs of providing government services while maintaining or, ideally, improving quality. Yet time has shown that government efforts to save costs, for certain types of contracts, often come at the expense of service quality.[12] For instance, New Jersey contracted with a private company to run halfway houses for the state. The fee to house an inmate in a private halfway house is half what it costs to keep an inmate in a state prison.[13] But to cut costs and maximize profits, private companies skimp on security and inmates regularly escape and commit further violent crimes, or are raped or killed at private halfway houses.[14]

In another example, IBM entered into a $1.34 billion, ten-year deal with the state of Indiana to administer public benefits programs.[15] The deal was supposed to save Indiana $500 million,[16] but the contract collapsed in 2009.[17] Beneficiaries now allege that, because IBM wrongly denied Medicaid benefits or caused lapses in benefits, they were unable to buy crucial medications or receive life-sustaining medical procedures.[18]

Indeed, public-private contracting is a pervasive endeavor that has attracted much scholarly attention from public law scholars in recent decades.[19] For instance, Martha Minow and Jody Freeman recently suggested that:

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10 Outsourcing helps states address budgetary issues through cost-savings and sometimes in delaying payments. *See, e.g.*, Julie A. Roin, *Privatization and the Sale of Tax Revenues*, 95 MINN. L. REV. 1965 (2011) (discussing Chicago's decision to lease its parking meters).

11 The terms "public-private contracting," "government outsourcing," "privatizing," and "contracting out," mean different things in different contexts. But for purposes of this Article, they are used interchangeably to indicate a contract between a governmental entity and a private party, where the private party agrees to provide a government service for the benefit of the public in exchange for compensation by the government.

12 This Article does not suggest that these agreements always fail. Undoubtedly, there are successes. It simply suggests ways that contract law can ameliorate the most common causes of the failures.

13 Sam Dolnick, *Poorly Staffed, a Halfway House in New Jersey Is Mired in Chaos*, N.Y. TIMES, June 18, 2012, at A1.

14 *Id.*

15 *See* Bulkeley, *supra* note 2.

16 *Id.*

17 *Id.*; *see also* First Amended Complaint for Damages, Gibson v. Int'l Bus. Machs. Corp., No. 1:10-CV-00330, 2010 WL 2558577 (S.D. Ind. May 14, 2010).

18 *See* Order on Defendant's Motion to Stay Discovery, *Gibson*, No. 1:10-CV-00330, 2011 WL 4402599 (S.D. Ind. Sept. 22, 2011).

19 For a thorough account of the existing privatization literature, see Chris Sagers, *The Myth of "Privatization,"* 59 ADMIN. L. REV. 37, 42–56 (2007); *see also* Alfred C. Aman, Jr., *Privatization and Democracy: Resources in Administrative Law*, *in* GOVERNMENT BY CONTRACT: OUTSOURCING AND AMERICAN DEMOCRACY, *supra* note 2, at 261; Jody Freeman,

> Our current government contracting system does not work. It is largely invisible and unresponsive to the public in whose name it is undertaken. The existing rules and procedures fail to guard adequately against inefficiency, conflict of interest, and abuse. And much of the power being exercised through contracting is largely unaccountable to any regime of oversight—market, legal, or political.[20]

In general, public law scholars focus on problems of democratic process and accountability and propose various administrative law and Constitution-based solutions to public-private contracting problems.[21] The prevailing sentiment in the academic literature is that private, profit-maximizing firms should not be entrusted with providing government services absent safeguards because profit-maximizing goals conflict with public service values. Nonetheless, privatization continues.

Public law scholars have made important contributions to the literature, but their arguments are incomplete because they do not consider the problem through a commercial—or more specifically a contract-theory—lens.[22] Commercial law scholars, for their part, have largely ignored public-private contracting, focusing instead on commercial interactions between firms or contracts between individuals.[23] This Article bridges the gap between public and commercial law in the universe of public-private contracting by considering how economic analysis of contract law[24] bears upon the

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Extending Public Law Norms Through Privatization, 116 HARV. L. REV. 1285, 1317–20, 1342 (2003); Freeman & Minow, *supra* note 2, at 2; Michele Estrin Gilman, *Legal Accountability in an Era of Privatized Welfare*, 89 CALIF. L. REV. 569, 641–42 (2001); Gillian E. Metzger, *Private Delegations, Due Process, and the Duty to Supervise*, *in* GOVERNMENT BY CONTRACT: OUTSOURCING AND AMERICAN DEMOCRACY, *supra* note 2, at 291; Martha Minow, *Public and Private Partnerships: Accounting for the New Religion*, 116 HARV. L. REV. 1229, 1267 (2003); Sidney A. Shapiro, *Outsourcing Government Regulation*, 53 DUKE L.J. 389 (2003); Dru Stevenson, *Privatization of Welfare Services: Delegation by Commercial Contract*, 45 ARIZ. L. REV. 83, 127–28 (2003); Janna J. Hansen, Note, *Limits of Competition: Accountability in Government Contracting*, 112 YALE L.J. 2465, 2475 (2003); *supra* notes 4–8.

20 Freeman & Minow, *supra* note 2, at 20.

21 *Id.* at 14–20.

22 *Cf.* Nestor M. Davidson, *Relational Contracts in the Privatization of Social Welfare: The Case of Housing*, 24 YALE L. & POL'Y REV. 263, 303–04 (2006) (promoting the use of relational contract methods in public-private contracting); Eric A. Posner, *Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract*, 24 J. LEGAL STUD. 283, 293–95 (1995) (arguing that restrictive contract doctrines should be used to preclude enforcement of socially costly contracts).

23 *See, e.g.*, Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 619 (2003).

24 This Article views public-private contracting through the efficiency lens, as augmented by behavioral law and economics, which studies how people make boundedly rational choices. *See* Cass R. Sunstein, *Introduction* to BEHAVIORAL LAW AND ECONOMICS 1, 1 (Cass R. Sunstein ed., 2000); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CALIF. L. REV. 1051, 1054–55 (2000). For a good, high-level discussion of other approaches to contract theory, see generally Stephen A.

unique problems of public-private contracting. It argues that certain types of public-private contracts do not function like standard commercial agreements and the law (and the contracting parties) should recognize this.

First, the government lacks the proper incentives to ensure high-quality service provision. This is particularly true where the service in question "benefits" the disenfranchised in society such as criminals and the poor who have no economic power (as a commercial customer would) and limited political power. Also, budget and resource pressure often account for the decision to outsource in the first place, meaning that governments are likely (and sometimes obligated) to accept the lowest bid for a project without regard to quality. These problems are likely to be worse in public-private contracting as opposed to direct service provision because by outsourcing, governments buy the right to point the finger at the private party if service provision is poor. Also, private actors may be motivated by profit maximization goals more so than government workers providing the same services.[25]

Second, even if the government were incentivized to provide high-quality service, it faces systematic difficulties in doing so. Although advocates of privatization herald the move from state-run monopoly to a competitive market, the reality is that in certain types of public-private contracting, the seller-side market is shallow. For instance, very few entities are positioned to provide such complex and sophisticated services as administering Medicaid for a state or running a prison, which has no commercial analogue. Therefore contracts do not benefit from the competitive effects of an efficient market. In addition, many government services are difficult to specify and monitor—at least quality is difficult to specify and monitor. Cost-savings are somewhat easier to detect. But despite best efforts, contracts are inherently incomplete. Even if a party can specify performance metrics, it may get just what it asked for, sacrificing compliance with higher-level goals.

These two systematic biases cause the transacting parties to impose a cost on service recipients in the form of low-quality service. As a result

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Smith, CONTRACT THEORY (2004); *see also infra* Part II. It also considers the implications of agency theory. *See, e.g.*, A.A. BERLE, JR. & G.C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). Transaction cost economics is a related concept that focuses on incentive systems and governance mechanisms in the face of competing goals amongst the parties. *See, e.g.*, Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233 (1979).

25 It is for this reason that private service provision is likely to result in lower quality than direct government provision, although this an empirical question to which there is currently no clear answer. For a further discussion of how outsourcing may differ from direct government service provision, see *infra* Part III.B.

(putting aside potential bargaining problems), contracts are underpriced. Thus, what appears to be a cost-saving mechanism is instead a systematic market failure. Absent competitive market mechanisms, the contracting parties are not forced to internalize these costs. This Article proposes a counterintuitive solution grounded in contract theory and doctrine to force the parties to internalize the cost of poor service provision: reading a mandatory duty into public-private contracts.

Economists argue that when the assumptions of the typical private business transaction are in place, contract law should have default rules that parties can contract around—not mandatory rules.[26] This Article suggests the opposite for public-private contracting. To combat the problem that the government is not incentivized to care about poor service (and nor is the private, profit-maximizing provider), the transacting parties should be subject to a mandatory duty to act in furtherance of the public interest. Essentially, the parties should be prohibited from imposing a cost on the public in the form of poor service. The rule would function like a heightened good-faith and fair-dealing requirement. Beneficiaries of the service should be permitted to sue to enforce the duty. Although conventional economic wisdom is that mandatory standards are undesirable because they hinder bargaining to efficient outcomes, that logic does not apply where there are market failures and contracts do not account for costs imposed on third parties who cannot protect themselves.[27]

This Article proceeds in four parts. Part I describes public-private contracts for the provision of traditional government services and gives examples of two high-profile failures where cost savings were achieved at the expense of quality service provision. Part II explores the economic model of contracting, and in particular efficiency theory and agency theory, in the context of the traditional firm-firm commercial transaction. Part III then considers the problems in public-private contracting through an economic lens. It emphasizes that governments privatize to take advantage of market forces and expect that their contracts will function similarly to firm-firm commercial agreements. However, the major assumptions of efficiency theory and agency theory conceived with a commercial transaction in mind do not apply to public-private contracts. Rather, poor markets, agency costs, misaligned

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[26] *See infra* Part III.B; *see also* Alan Schwartz & Robert E. Scott, *Contract Interpretation Redux*, 119 YALE L.J. 926, 930 (2010).

[27] It may be more intuitive to think about beneficiaries (e.g., prisoners in the New Jersey example or welfare beneficiaries in the Indiana example) as the principal to the government as agent. I would argue, however, that the voters or taxpayers are a better proxy for the "principal" and that the beneficiaries, who in my examples are unlikely to be paying taxes other than sales tax and probably represent a small percentage of the voting population, are more like customers who lack the conventional market power we attribute to customers.

incentives, and complicated service models that defy precise definition result in a systematic bias. Parties write contracts that reduce price but sacrifice quality. Finally, Part IV suggests a possible solution to mitigate these problems: reading into these contracts a mandatory duty to act in furtherance of the public interest. This solution, although not perfect, encourages the parties to internalize the costs of poor service delivery.

I. CONTRACTS FOR THE PROVISION OF GOVERNMENT SERVICES

Proponents of government outsourcing argue that it is more efficient and cost-effective[28] than government provision of the same services.[29] Governments function loosely as a monopoly and lack the incentive to innovate to reduce cost. By introducing competition, so the argument goes, private firms are motivated to deliver services efficiently and effectively. In addition, whereas the government must negotiate a considerable bureaucracy, private entities have more flexibility to adjust staffing and wage levels and to utilize private capital as necessary.[30] Privatization proponents conceive of public-private contracting similarly to commercial contracting and expect that governments can take advantage of market mechanisms at play in commercial transactions.

Criticism of public-private contracting, however, is widespread. Scholars condemn the efficacy of privatization, the failure of private providers to comply with democratic norms, and the lack of accountability and transparency in public-private contracting.[31]

Not all types of contracting out are subject to these criticisms. The public management literature distinguishes two types of government outsourcing contracts (focusing on state and local-level contracting)[32]:

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28 There have been many studies but no consensus on whether privatization actually cuts costs. *See* Mary Sigler, *Private Prisons, Public Functions, and the Meaning of Punishment*, 38 FLA. ST. U. L. REV. 149, 150–51 (2010) ("[S]tudies have found that private prisons may reduce the cost of housing inmates by as much as 15% . . . [but] the cost-saving claim remains controversial. Some researchers have observed that private prison contractors typically siphon off the least costly inmates—those who are healthier and less violent than the incarcerated population as a whole. More generally, simple cost comparisons that appear to favor private facilities are based on per diem rates that may not reflect the full cost of incarceration." (citations omitted)).

29 *See, e.g.*, E.S. SAVAS, PRIVATIZATION: THE KEY TO BETTER GOVERNMENT (1987); David A. Super, *Privatization, Policy Paralysis, and the Poor*, 96 CALIF. L. REV. 393, 400 (2008).

30 Super, *supra* note 29, at 400; *see also* DAVID OSBORNE & TED GAEBLER, REINVENTING GOVERNMENT: HOW THE ENTREPRENEURIAL SPIRIT IS TRANSFORMING THE PUBLIC SECTOR 250–79 (1992); E.S. SAVAS, PRIVATIZATION AND PUBLIC-PRIVATE PARTNERSHIPS 111–12 (2000).

31 *See* Freeman & Minow, *supra* note 2, at 2.

32 This Article focuses on state and local level outsourcing because such contracts are, for the most part, subject to the same doctrinal contract rules as commercial contracting. *See* Caruso, *supra* note 6, at 669–70. It does not address federal government contracting or

those for "soft" government services and those for "hard" government services.[33] Hard services are those that are easy to specify, involve little discretion, and where delegation causes minimal transaction costs. Examples include garbage collection, fire protection, or road construction.[34] If a company fails to collect garbage on the designated days, the failure would be easy to detect. Almost all local governments contract with private parties to provide hard services to some degree.

Soft services are those in which *people* are the service focus.[35] Soft services tend to be more difficult to define and measure and involve discretion. Soft services have been called complex human services, and include running prisons, administering welfare benefits, and providing education. In contrast to hard services, specifying how to run a prison is much more complicated. It involves issues of security, health care, rehabilitation, etc. It is also much more difficult for the government to know when service provision falters.

Hard and soft government services also typically differ with respect to the extent of their public reach. It tends to be true that soft services are more likely to affect a narrow, disenfranchised segment of the population—for instance the poor in the case of welfare benefits or criminals in the case of prisons—whereas hard services are more likely to affect the whole population. Garbage collection and road construction benefit essentially everyone in a community.

The differences in these types or categories of services matter in meaningful ways. As Part III will explain in more detail, outsourcing of soft government services tends to be more problematic than outsourcing of hard government services.[36] With soft services, markets

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procurement, which are highly legislated by Congress and regulated by agencies. *See, e.g.*, Competition in Contracting Act (CICA) of 1984, Pub L No 98-369, § 2711, 98 Stat 1175, 1175–81 (codified at 41 U.S.C. § 3301 (2012)) (containing competition requirements for government procurement procedures). In addition, claims involving federal contracts are generally resolved in the Court of Federal Claims. Therefore, "tribunals deciding government contracts cases and those deciding common law contracts cases most frequently work without cross-pollination." Frederick W. Claybrook, Jr., *Good Faith in the Termination and Formation of Federal Contracts*, 56 MD. L. REV. 555, 557 (1997).

33 *See, e.g.*, Anna Amirkhanyan, *Collaborative Performance Measurement: Examining and Explaining the Relevance of Collaboration in State and Local Government Contracts*, 19 J. PUB. ADMIN. RES. & THEORY 523, 529 (2009); Meeyoung Lamothe & Scott Lamothe, *What Determines the Formal Versus Relational Nature of Local Government Contracting?*, 48 URB. AFF. REV. 322, 328 (2012).

34 For more examples of hard versus soft government services, see Lamothe & Lamothe, *supra* note 33, at app. A.

35 *Id.*; *see also* Ruth Hoogland DeHoog, *Competition, Negotiation, or Cooperation: Three Models for Service Contracting*, 22 ADMIN. & SOC'Y 317 (1990).

36 *See* Sergio Fernandez, Accounting for Performance in Contracting for Services: Are Successful Contractual Relationships Controlled or Managed? 11 (Sept. 2005) (unpublished manuscript) ("Previous research indicates a higher incidence of performance problems when contracting for 'soft' services, such as public safety and human services, which typically involve more complex processes and technologies and which can be more difficult to specify

tend to be shallower, tasks are harder to specify, and the ability of beneficiaries to exert pressure to force good service is more limited than with hard services.[37] Nonetheless, there has been a rise in government outsourcing of soft government services in the past decade.[38]

The two examples that follow lay the groundwork for the types of problems these public-private contracts for the provision of traditional (soft) government services often face.

A. *Prison Example: The New Jersey-Community Education Centers Contract*

In the late 1990s, New Jersey contracted with Community Education Centers (CEC), a private company, to provide halfway house services (a "soft" government service).[39] The contract requires CEC to establish facilities to house inmates released early from New Jersey prisons.[40] It also requires that CEC provide various services to assimilate inmates back into society.[41] The term halfway "houses" is somewhat misleading. The facilities can have as many as 1200 beds, making them as big as prisons. And roughly forty percent of New Jersey's state prison population passes through the system of private halfway houses.[42]

CEC is compensated by a flat fee per inmate per day that amounts to roughly half the cost of housing inmates in state prisons.[43] The contract thus reduces prison costs. In addition, by freeing beds in the state prisons, those prisons can rent beds to the federal government to house federal inmates and immigration detainees, which raises revenue. One New Jersey county receives $108 per day for each bed in its jail the federal government uses, and spends $73 per day for a bed at a CEC half-way house.[44] The state keeps the difference.[45]

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and measure."), *available at* http://localgov.fsu.edu/readings_papers/Service%20Delivery/Fernandez_Accounting_for_Performance_in_Contracting_Services.doc.

37 *See* Freeman & Minow, *supra* note 2, at 2 (arguing that contracts for run-of-the-mill supplies and commercial services "may pose few problems"). Also, John Donahue uses a different vocabulary but makes a similar point. He defines "commodity tasks" as ones that are "well defined, relatively easy to evaluate, and available from competitive private suppliers . . . ." He contrasts commodity tasks with "custom tasks." Ultimately, he argues that commodity tasks are more suitable for outsourcing than custom tasks. *See* Donohue, *supra* note 2, at 49.

38 *See* sources cited *supra* notes 1–3.

39 *See* Sam Dolnick, *As Escapees Stream Out, A Penal Business Thrives*, N.Y. TIMES, June 17, 2012, at A1.

40 *Id.*

41 *See* Dolnick, *supra* note 13.

42 *See* Dolnick, *supra* note 39.

43 *See id.*

44 *See* Sam Dolnick, *At Penal Unit, A Volatile Mix Fuels a Murder*, N.Y. TIMES, June 18, 2012, at A1 (noting that about forty percent of that county's jail space, or roughly 2400 beds, are now reserved for federal use).

The *New York Times* recently published a series of articles following a ten-month investigation of these private halfway houses. They labeled the halfway houses as "at the vanguard of a national movement to privatize correctional facilities."[46] But they reported that the halfway houses "seem[] to embody the worst in the prisons [they were] intended to supplant."[47]

First, there are not enough guards or sufficient security. Although inmates have more freedom in halfway houses than prisons, state law still emphasizes that these facilities must be secure.[48] Because of lax security, gang activity is high and escapes occur too frequently.[49] The *New York Times* reports that "[s]ince 2005, roughly 5,100 inmates have escaped from the state's privately run halfway houses."[50] Some escapees have gone on to commit gruesome crimes. One halfway house escapee who was jailed for assaulting a former girlfriend escaped and immediately killed another young woman.[51] Another inmate imprisoned for drugs and weapons charges escaped and went on to kill a man just three miles from the halfway house.[52]

Second, the counseling services that New Jersey pays for are not being provided.[53] Workers falsify inmate records and management does nothing despite seeing case file after case file with identical records.[54]

Third, the halfway houses were originally designed to house and rehabilitate only nonviolent offenders.[55] But low-level offenders are now thrown in with violent offenders. One nonviolent offender was recently murdered by a convict with a violent history in a CEC halfway house.[56]

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45 *Id.*

46 *See* Dolnick, *supra* note 13.

47 *Id.*

48 Press Release, State of New Jersey, Office of the State Comptroller, *State Comptroller Audit Exposes Crucial Weaknesses in State Oversight of Inmate Halfway Houses* (June 15, 2011), *available at* http://www.nj.gov/comptroller/news/docs/doc_pr.pdf ("Despite emphasis in state law on ensuring the security of these facilities, DOC officials were unable to provide a precise total of escapes over that time period for all halfway house facilities.").

49 *See* Dolnick, *supra* note 39.

50 The *New York Times* compares this number to escapees from state prisons. The author states that the "the state's prisons had three escapes in 2010 and none in the first nine months of 2011, the last period for which the state gave figures." *Id.* A more apt comparison would be between privately run halfway houses and state-run halfway houses, but such data is not readily available. It is therefore difficult to assess what this number means in the abstract, other than to say that the number sounds high for what is supposed to be a secure facility.

51 *See* Dolnick, *supra* note 39.

52 *Id.*

53 *See* Dolnick, *supra* note 13 ("The government requires that Bo Robinson provide therapy, job training and other services, but current and former workers said they had neither the skills nor the time to do so.").

54 *Id.*

55 *See* Dolnick, *supra* note 44.

56 *Id.*

The reasons for these breakdowns are undoubtedly complicated, but one issue is clear. Contracting out for this service has not solved the problems that plague government-run prisons as privatization theory predicts.[57] To maximize profit, CEC is incentivized to house as many inmates as possible in its facility at any given point in time. It also has the incentive to keep its costs as low as possible.[58] Therefore, it operates without enough staff or adequate security.

Additionally, as the state comptroller determined in an audit last year, state oversight and monitoring of the program have been lacking[59]:

> [A]s a state we have done a poor job of monitoring the program and have made no real attempt to find out what taxpayers are getting for their money. It is critical that the state takes a more active role in ensuring the success of these programs. It cannot simply cut these halfway houses a check and hope for the best.[60]

Poor monitoring likely means that the government did not know the extent of the problems prior to the *New York Times* exposé, which reports that when CEC "gave tours of Bo Robinson to officials or potential investors, everything was staged. Hallways were scrubbed and painted. Visitors were kept far from the men's units, the rowdiest areas."[61]

If New Jersey entered into the contract believing it would save money *and* CEC would provide high-quality service, this has not occurred. Rather, the government seems to have succeeded in cost cutting, but at the expense of quality.[62]

B. *Welfare Example: The Indiana-IBM Contract*

State and local governments have long relied on private actors to provide welfare services,[63] but there has been a dramatic increase in the last two decades.[64] Notably, in 1996, Congress enacted the Personal

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57 For further comparison of direct service provision with private contractor provision, see *infra* Part III.A.3.

58 *See* Dolnick, *supra* note 13 ("Community Education made money not on how many people they rehabilitated. 'How many bodies can we get in here and keep here for a certain amount of time?'—that's what they were interested in.").

59 *See* Press Release, Office of the State Comptroller, *supra* note 48.

60 *Id.*

61 *See* Dolnick, *supra* note 13.

62 Some may argue that by privatizing, the government knows it will receive lower quality in return for reduced cost, but that view is at odds with privatization theory. This issue is addressed further *infra* at Part III.A.

63 *See* Catherine Donnelly, *Privatization and Welfare: A Comparative Perspective*, 5 LAW & ETHICS HUM. RTS. 336, 339 (2011) (using a comparative approach to discuss challenges to accountability and human rights that arise from using privatization in the welfare context).

64 *See* Wendy A. Bach, *Welfare Reform, Privatization, and Power: Reconfiguring*

Responsibility and Work Opportunity Reconciliation Act of 1996 (PRWORA).[65] The Act, part of the "reinvent government" movement, explicitly provided that a state can administer its welfare programs "through contracts with charitable, religious, or private organizations."[66] Accordingly, state and local governments turned to the private sector to provide a range of (soft) government services.

Indiana had an antiquated and highly inefficient welfare system, thought to be one of the worst in the nation, with high error rates, long customer wait times, onerous in-person appearance requirements, and high rates of fraud.[67] In 2006, Indiana's Family and Social Services Administration (FSSA) signed a $1.37 billion, ten-year contract with IBM to revamp, modernize, and take over the application process and general administration of the system.[68] Under the terms of the agreement, IBM was to automate components of a system that were previously caseworker-based. It also had "the day-to-day responsibilities of working with beneficiaries to determine their eligibility and process their appeals."[69] The contract required IBM's subcontractor to hire the former state caseworkers to handle these tasks. Although the state "retained final authority to approve or disapprove eligibility[,] it was dependent upon the fact-gathering, computer entries, and recommendations of the IBM Coalition staff when making correct determinations on whether to start, stop, or change Medicaid coverage for an individual."[70]

IBM implemented the modernized system in over fifty Indiana counties, but it was not a success.[71] Significant problems were reported, from lost applications to delays in approving benefits, failure to process appeals, and errors in decision-making regarding eligibility.[72] Individual beneficiaries claim that these problems led to a host of serious consequences. For instance, plaintiffs have alleged that inability to

Administrative Law Structures from the Ground Up, 74 BROOK. L. REV. 275, 278–81 (2009) ("The most recent national survey, released in 2002 by the United States General Accounting Office, reported that in 2001, forty-nine states and the District of Columbia used contracts with private entities to provide some welfare services.").

65 Pub. L. No. 104-193, 110 Stat. 2105 (codified as amended in scattered sections of 8 and 42 U.S.C.).

66 42 U.S.C. § 604a(a)(1)(A) (2012).

67 Press Release, IBM, IBM Seeks Enforcement of Indiana Welfare Contract (May 13, 2010), *available at* http://www-03.ibm.com/press/us/en/pressrelease/31641.wss.

68 *Id.*

69 Bowman v. Int'l Bus. Machs. Corp., No. 1:11-CV-00593, 2012 WL 566258, at *2 (S.D. Ind. Feb. 21, 2012) (citations omitted).

70 *Id.*

71 Press Release, IBM, *supra* note 67.

72 *Indiana, IBM Sue Each Other over Welfare Contract*, INDIANAPOLIS BUS. J. (May 13, 2010), http://www.ibj.com/indiana-ibm-sue-each-other-over-welfare-contract/PARAMS/article/19928.

obtain benefits resulted in consequences from serious medical ailments to lost educational opportunities.[73]

Ultimately, in 2009, Indiana cancelled the contract and instead contracted directly with IBM's subcontractors.[74] Indiana kept some of IBM's design and its hardware, but implemented a "hybrid" system that returned caseworkers to the process. Both parties sued. Indiana sought the return of $437 million in fees it had paid to IBM, and treble damages—amounting to more than $1.3 billion.[75] IBM claimed the state still owed $100 million under the contract.

The legal dispute centered on whether IBM had breached the contract by failing to satisfy certain performance metrics. The parties also disputed whether Indiana cancelled the contract "for cause" or "for convenience," a distinction that affects damages.[76]

Medicaid applicants also sued IBM under a variety of theories. Notably, they tried to establish standing to sue for breach of contract as third-party beneficiaries. But in general, members of the public cannot sue to enforce public-private contracts such as this one.[77] It is particularly true that members of the public cannot sue where the contract contains an explicit "no third-party beneficiaries" clause, as the Indiana-IBM contract does, and as is common in such agreements. On that basis, the Indiana court dismissed the putative class's claim for breach of contract.[78]

The Marion County, Indiana court also recently issued its decision in the main case.[79] It denied Indiana's claims and granted IBM $52 million in damages to cover the cost of equipment Indiana kept and subcontractor assignment fees. The court stated:

> Neither party deserves to win this case. This story represents a "perfect storm" of misguided government policy and overzealous corporate ambition. Overall, both parties are to blame and Indiana's taxpayers are left as apparent losers.[80]

Indiana vows to appeal, but regardless of the ultimate outcome, both spent resources implementing a system that they ultimately abandoned (at least in part). And allegedly, Medicaid beneficiaries received poor service that resulted in serious ramifications for their

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73 *See* Gibson v. Int'l Bus. Machs. Corp., No. 1:10-CV-00330-LJM, 2011 WL 4402599, at *1 (S.D. Ind. Sept. 22, 2011); *Bowman*, 2012 WL 566258, at *2.

74 *Bowman*, 2012 WL 566258, at *2.

75 *Id.*; *see also Indiana, IBM Sue Each Other over Welfare Contract*, *supra* note 72.

76 *See* State *ex rel.* Ind. Family & Soc. Servs. Admin. v. Int'l Bus. Machs. Corp., No. 49D10-1005-PL-021451, slip op. at 18 (Ind. Super. Ct. July 18, 2012).

77 *See infra* Part IV.C.

78 *See Bowman*, 2012 WL 566258, at *2.

79 *Int'l Bus. Machs. Corp.*, No. 49D10-1005-PL-021451.

80 *Id.*

health and well-being. Both parties also spent significant resources on litigation. The result could have been better.

C. *Other Examples*

Certainly not every public-private contract for the provision of soft government services results in poor service provision to the public. No empirical study has attempted to measure the success of these public-private agreements in any systematic way over any significant sample size.[81] That being said, the New Jersey and Indiana experiences are far from isolated.

Texas had an agreement with Accenture LLP and Maximus, Inc., similar to the Indiana-IBM contract. The agreement encountered similar difficulties and was cancelled as a part of a December 2008 settlement of claims.[82] New York City's first large-scale privatization effort also failed. Following PRWORA, the City of New York contracted with private vendors to provide welfare-to-work services.[83] A research study conducted by Community Voices Heard states: "Our findings point to a failure of this work-first model in achieving its main goal—moving people from welfare to work, into jobs and toward economic independence."[84] Instead of focusing on long-term employment success through education and training, the private entities worked with the easiest candidates to place, ignoring the more difficult cases, and targeted short-term job placement, even if it was unlikely to stick.[85]

In another example, Nebraska contracted with KVC Behavioral Health Services, a private firm, to manage and coordinate child welfare services across the state.[86] The arrangement was highly criticized and

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81 Indeed, it is often lamented that there are myriad case studies on privatization failures and privatization successes, but little to no systematic empirical data on the privatization experience more broadly. *See, e.g.*, Donahue, *supra* note 2, at 47.

82 Settlement Agreement Between the Tex. Health & Human Servs. Comm'n, Accenture LLP, and Maximus Inc. (Dec. 21, 2008), *available at* http://alt.coxnewsweb.com/statesman/pdf/12/121208_accenture.pdf (last visited Feb. 17, 2012).

83 *See* Bach, *supra* note 64, at 281–82.

84 *Id.*; *see also* SONDRA YOUDELMAN & PAUL GETSOS, THE REVOLVING DOOR RESEARCH FINDINGS ON NYC'S EMPLOYMENT SERVICES AND PLACEMENT SYSTEM AND ITS EFFECTIVENESS IN MOVING PEOPLE FROM WELFARE TO WORK 1–11 (2005), *available at* http://www.cvhaction.org/sites/default/files/The%20Revolving%20Door-Executive%20Summary.pdf.

85 YOUDELMAN & GETSOS, *supra* note 84.

86 Grant Schulte, *Neb. Contractor to Stop Managing Child Cases*, NECN.COM (Feb. 21, 2012), http://www.necn.com/02/21/12/Neb-contractor-to-stop-managing-child-ca/landing.html?&apID=9348128d09cf49cfb1b1838e90edc7d4; JoAnne Young, *Child Welfare Reorganizes After Loss of KVC*, LINCOLN J. STAR (Feb. 21, 2012), http://journalstar.com/news/state-and-regional/nebraska/child-welfare-reorganizes-after-loss-of-kvc/article_23f2bb24-0cde-5c37-979c-b20155533f73.html.

encountered problems from the outset.[87] A performance audit was undertaken at the request of the Health and Human Services Committee.[88] The Committee "found that the reform effort lacked specific goals, had no clear timetable and failed to consider the true cost of a reform that has cost $30 million more than original projections."[89] The relationship was mutually terminated on February 21, 2012, when KVC sought additional funds to complete its contractual duties.[90] Several bills seeking to bring the system back into state control have been introduced in the state legislature.[91] Maryland and Connecticut, among other states and localities, have had similar experiences.[92]

In the prison context, media reports and case studies similar to the New Jersey example are pervasive.[93] Accounts have documented numerous incidents of "abuse, neglect, violence, escapes, poor conditions, and other alarming events in private facilities."[94] Studies are

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87 Schulte, *supra* note 86.

88 *Agency Supported Foster Care Contract Between the Nebraska Department of Health and Human Services Division of Children and Family Services and KVC Behavioral Healthcare Nebraska, Inc*. (July 12, 2011), *available at* http://dhhs.ne.gov/children_family_services/Contracts/48872O4KVCAgencySupportedFC.pdf.

89 Schulte, *supra* note 86; *see also* PERFORMANCE AUDIT COMM. NEB. LEG., DHHS PRIVATIZATION OF CHILD WELFARE AND JUVENILE SERVICES, 17 COMM. REP., No. 1, 102nd Leg. 1st Sess., at 33–34, 51 (2011), *available at* http://nebraskalegislature.gov/pdf/reports/audit/privatization2011.pdf.

90 *See* Schulte, *supra* note 86.

91 Martha Stoddard, *Lawmakers Debate Ending Child Welfare Privatization*, OMAHA.COM (Feb. 29, 2012, 3:22 AM), http://www.omaha.com/article/20120228/NEWS01/702299953.

92 *See, e.g.*, Greg Garland, *Lockheed Called Failure on Child Support Goals: State Announces Collection Contract Will Not Be Extended*, BALT. SUN, Mar. 4, 1999, at 1B ; Jonathan Rabinovitz, *In Connecticut, a Privately Run Welfare Program Sinks into Chaos*, N.Y. TIMES, Nov. 24, 1997, at B1. For additional examples, *see* Diller, *supra* note 7, at 1740 (discussing the privatization of Florida's public assistance program for needy families); Gilman, *supra* note 19; and Verkuil, *supra* note 8, at 436–37 (several examples).

93 For examples of private prisons around the country and associated media attention, see GRASSROOTS LEADERSHIP, CONSIDERING A PRIVATE JAIL, PRISON, OR DETENTION CENTER?: A RESOURCE PACKET FOR COMMUNITY MEMBERS AND PUBLIC OFFICIALS (2d ed. 2009), and the online resources of The Private Corrections Working Group, PRIVATE CORR. WORKING GRP., http://www.privateci.org (last visited Mar. 18, 2013). *See also* AM. CIVIL LIBERTIES UNION OF OHIO, PRISONS FOR PROFIT: A LOOK AT PRISON PRIVATIZATION (2011); Sharon Dolovich, *State Punishment and Private Prisons*, 55 DUKE L.J. 437, 461 (2005) (detailing quality failures at Corrections Corporation of America's Youngstown, Ohio, facility); Freeman, *supra* note 5, at 186 (describing issues with private prison contracts); Jeff Amy, *Feds Say Prison Operator in Mississippi Fined*, HUNTSVILLE TIMES, June 13, 2012, at 6A (reporting on citations issued by OSHA against a private prison for knowingly failing to provide adequate staffing, fix malfunctioning cell door locks, or provide training to protect employees from inmate violence); Fred Grimm, *Horrors Continue in Privatized Lockups*, MIAMI HERALD (June 25, 2012), http://www.miamiherald.com/2012/06/25/2867737/horrors-continue-in-privatized.html (reporting on lawsuit allegations of staffers using violent "take-down" tactics, orchestrating inmate-on-inmate fights and doing little to protect vulnerable kids from violent attacks from other inmates in private juvenile prison).

94 CHRISTOPHER HARTNEY & CAROLINE GLESMANN, NAT'L COUNCIL ON CRIME & DELINQUENCY, PRISON BED PROFITEERS: HOW CORPORATIONS ARE RESHAPING CRIMINAL

inconclusive or mixed on the quality of care differential between public and private prisons, but there is at least some indication that "private prisons experience a higher proportion of inmate-on-inmate assaults; greater likelihood of inmate misconduct, drug abuse, and escapes; lower or unmet standards of care; and systemic problems in maintaining secure facilities."[95]

Before addressing the question of why these public-private agreements for government services (in particular soft government services) tend to result in low-quality service provision,[96] it is necessary to lay some groundwork. The next Part turns to contract theory and its traditional application to firm-firm commercial agreements.

II. THE ECONOMIC APPROACH TO CONTRACT LAW

Scholarly criticism of the problems discussed in the prior Part is not novel. Public law scholars have analyzed problems with poor service provision and lack of accountability in depth. But commercial law scholars have not approached these problems from a private law—and in particular an efficiency theory—perspective. Doing so yields a new way to frame these problems, and a new set of potential solutions.

There are many theories of contract law. Efficiency theory and autonomy theory are the most prominent. Efficiency theorists tend to study commercial contracts between sophisticated firms. They apply the principles of law and economics and argue that the law should encourage rational actors to enter into economically efficient contracts that maximize the joint surplus.[97] Autonomy theorists focus mostly on individual-individual contracting, arguing that contract obligations are deserving of respect based on the rights of the contracting parties regardless of whether they tend to produce other benefits.[98] Efficiency

JUSTICE IN THE U.S. 8 (2012), *available at* http://nccdglobal.org/sites/default/files/publication_pdf/prison-bed-profiteers.pdf.

95 *Id.*

96 This Article concedes that these examples of problematic service provision more closely bear upon the contract between the public and private entity if private provision of these services is somehow worse than public provision. See *infra* Part III.A.3 for a discussion of why it is likely, in theory, that private firms are less intrinsically motivated to provide quality services than the government and why outsourcing provides an excuse for the government to permit reduced quality of services.

97 Schwartz & Scott, *supra* note 23, at 619.

98 More broadly speaking, it is non-economic theorists who tend to focus on individual-individual contracting. This includes so-called transfer theories of contract. *See, e.g.*, Daniel Markovits, *Contract and Collaboration*, 113 YALE L.J. 1417 (2004); *cf.* Nathan Oman, *Corporations and Autonomy Theories of Contract: A Critique of the New Lex Mercatoria*, 83 DENV. U. L. REV. 101, 103, 107–08 (2005) (arguing against then-typical claims that "autonomy theories are not useful in understanding contracts by corporations because such theories assume that contracting parties are human beings"). Because non-economic theories of

gains are the major reason that governments enter into privatization agreements, therefore, it makes the most sense to explore these contracts through an efficiency lens. Put another way, public-private contracts are modeled on the firm-firm commercial contracting platform. The idea is that public-private contracts will function like traditional commercial agreements and indeed the law treats these agreements essentially the same as traditional commercial agreements.[99] Therefore, this Article applies efficiency theory principles to better understand why public-private contracts tend to result in poor service provision. But before that, this Part briefly covers how efficiency theory approaches firm-firm commercial agreements.

A. *Efficiency Theory*

The economic analysis of law proposes that the purpose of the law should be to promote economic efficiency.[100] Building upon the work of Ronald Coase and Guido Calabresi, Richard Posner first laid the groundwork for efficiency theory in the 1970s. He argued for the "allocation of resources in which value is maximized."[101] It followed that the goal of contract doctrine should be "to minimize [contractual] transaction costs, broadly understood as obstacles to efforts voluntarily to shift resources to their most valuable use."[102]

Put simply, parties trade efficiently when, and only when, the value of the exchanged performance to the buyer exceeds the cost of performance to the seller. These types of deals are "efficient." The focus

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contract mostly focus on individual-individual contracting, they seem to have more limited application to public-private contracting.

99 *See* Caruso, *supra* note 6, at 669–70; *see also* Frederick W. Claybrook, Jr., *Good Faith in the Termination and Formation of Federal Contracts*, 56 MD. L. REV. 555, 555 (1997) ("It remains a touchstone in federal contracting law that when the government enters the marketplace, it 'contracts as does a private person, under the broad dictates of the common law.'" (quoting Torncello v. United States, 681 F.2d 756, 762 (Ct. Cl. 1982) (en banc))). There are some limited exceptions to the rule that the law treats private-private and public-private contracts the same. For instance, section 313 of the *Restatement (Second) of Contracts* contains a higher bar for achieving third-party beneficiary status to a government contract than it does for other contracts. *Compare* RESTATEMENT (SECOND) OF CONTRACTS § 313 (1981) (government contracts), *with id.* § 302 (other contracts).

100 For a more thorough discussion of efficiency-based analysis, see Richard A. Posner, ECONOMIC ANALYSIS OF LAW 98 (6th ed. 2003) (defining and differentiating between two models of efficiency, one based on a concept of Pareto-superiority and the other on the Kaldor-Hicks construction of efficiency as wealth maximization).

101 *Id.*

102 Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581, 1583 (2005); *see also* Schwartz & Scott, *supra* note 23, at 544 ("[C]ontract law should facilitate the efforts of contracting parties to maximize the joint gains (the 'contractual surplus')").").

of efficiency theory is on ex ante efficient contracting;[103] i.e., which rules will encourage parties to *enter into* deals that are efficient and wealth maximizing?

Efficiency theory is predicated on a number of assumptions rooted in firm-firm commercial contracts.[104] In a world of low transaction costs and a competitive market, efficiency theory assumes that rational market participants will bargain efficiently to maximize the joint surplus.[105] Efficiency theory further assumes that contracts do not impose negative externalities.[106] The following Sections discuss these assumptions, which pervade efficiency theory analysis, but tend not to be present in public-private contracting.

1. Rational Actors Incentivized by Maximizing Profit Obtain Gains from Trade and Efficiently Split Surplus

A central tenet of efficiency theory is that parties will make rational, wealth-maximizing choices. Efficiency theory assumes that parties value assets more or less correctly and that their transacting choices are motivated solely by wealth maximization goals.[107] Relatedly, efficiency theory assumes that parties *can* make rational, wealth-maximizing choices because they have good information and "can take clues from the market."[108]

The existence of a competitive market is said to reinforce rationality. Where rational actors have choices and contracting parties do a poor job, they will lose renewal opportunities and future work from other contracting partners.[109] Similarly, individual manager failures will come to the attention of owners through well-functioning feedback mechanisms. For this reason, efficiency theory assumes that managers rationally pursue profit-maximizing strategies.[110] Indeed, contracting agents are often financially incentivized by the overall profit goal of the company, for instance, by having their bonuses tied to firm profitability.

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103 *See* Daniel A. Farber, *Economic Efficiency and the Ex Ante Perspective*, *in* THE JURISPRUDENTIAL FOUNDATIONS OF CORPORATE AND COMMERCIAL LAW 54 (Jody S. Kraus & Steven D. Walt eds., 2000).

104 In limiting their analysis to firm-firm commercial transactions, Schwartz and Scott argue that most of contract law concerns firm-firm commercial agreements. Schwartz & Scott, *supra* note 23, at 547–49.

105 *Id.*

106 *Id.* at 546 ("An analysis of contract law . . . can assume the absence of externalities.").

107 It is this assumption that behavioral economists test.

108 ROBIN PAUL MALLOY, LAW AND ECONOMICS: A COMPARATIVE APPROACH TO THEORY AND PRACTICE 32 (1990).

109 This assumption also relies on switching costs being low. Particularly where a deal requires a large upfront investment in resources, this assumption may be suspect.

110 Schwartz & Scott, *supra* note 23, at 551.

There are, however, limits to the rationality assumption that are now well accepted. Studies have shown that parties, due to both intrinsic limits of cognition and limited availability of information, do not know, nor can know, all the feasible alternative actions open to them. And they may have reasons for making decisions apart from pure profit maximization. For instance, goals can bias beliefs. People overvalue things they own. And the way a choice is framed can alter decisions.[111] Therefore, actors are said to have bounded rationality.[112]

Nonetheless, where firm-firm commercial interactions are concerned, the rationality assumption continues to predominate. As Alan Schwartz and Robert Scott have stated, "it is a plausible working assumption that firms rationally pursue the objective of maximizing profits."[113]

2. Role of a Well-Functioning Market

Efficiency theory also assumes that parties transact in a competitive market. A competitive market has enough buyers and sellers such that each party has many alternative trading partners. It permits parties to make rational decisions to maximize their wealth because efficient markets are self-correcting and will counteract faulty decision-making. A competitive market also allocates resources efficiently and allows parties to reach efficient price terms.[114]

Market participants have greater incentives to maximize profit when they are subject to competitive pressures. Competition allows contracting parties to credibly threaten to take their business elsewhere.[115] Competition also creates pressure to generate information to permit comparisons of options.[116] Competition is said to create incentives for innovation and increased efficiency, at least in private markets.[117]

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111 The behavioral law and economics movement has identified a much longer list of ways in which people act contrary to the rational actor thesis. These are just a few examples. For a more thorough discussion, see Korobkin & Ulen, *supra* note 24; and Sunstein, *supra* note 24.

112 On the subject of bounded rationality, see Melvin A. Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 214 (1995); Herbert A. Simon, *Theories of Bounded Rationality*, in DECISION AND ORGANIZATION 161 (2d ed. 1986); Thomas S. Ulen, *Cognitive Imperfections and the Economic Analysis of Law*, 12 HAMLINE L. REV. 385, 385–86 (1989). It bears noting that studies have shown that "firms as institutions may depart from rationality, although at times in different ways and degrees than individuals do." Amanda P. Reeves & Maurice E. Stucke, *Behavioral Antitrust*, 86 IND. L.J. 1527, 1540 (2011).

113 Schwartz & Scott, *supra* note 23, at 551.

114 Robert Cooter & Thomas Ulen, LAW AND ECONOMICS 295 (5th ed. 2008).

115 *See, e.g.*, Minow, *supra* note 19, at 1243–44.

116 *Id.*

117 *Id.* at 1243 ("Whether these benefits of competition work well outside purely private markets remains a subject of much academic and political debate.").

Where there is market failure, economists argue that regulation may be (although will not necessarily be) merited. The most obvious example of market failure requiring regulation is monopoly, regulated by the laws of antitrust.

3. Absence of Negative Externalities

The third related assumption of efficiency theory is the absence of negative externalities.[118] An externality is an effect that a transaction between one set of parties puts on other parties who were not a part of the deal (and presumably had no say in the matter). Externalities may be negative or positive. A positive externality is a benefit to nonparties, whereas a negative externality imposes costs on nonparties. If a transaction has a negative externality, then the true cost of the transaction is higher than that paid by the parties. The classic example of a negative externality is pollution generated by a productive enterprise that negatively affects the public, but the cost of which was not internalized by the transaction.

Efficiency theory is typically applied "to contracts between firms that do not create externalities."[119] In the absence of externalities, and where there is a competitive market, economic theory states that efficient transacting occurs. On the other hand, when a negative externality exists in an unregulated market, contracting parties do not take responsibility for the costs their deal passes on to society (or to third-parties more specifically).[120] Thus, contract law cannot trust that a deal represents an efficient outcome because the price of the contract does not represent the true cost of the transaction.

4. Efficiency Theory and Default Rules

Efficiency theory cannot explain all of contract doctrine.[121] But the normative version of efficiency theory has been used extensively to argue what contract doctrine should be, particularly as to firm-firm commercial agreements. For example, efficiency theory has been

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118 *See* Benjamin E. Hermalin, Avery W. Katz & Richard Craswell, *Contract Law*, *in* 1 HANDBOOK OF LAW AND ECONOMICS 30 (A. Mitchell Polinsky & Steven Shavell eds., 2007) ("[T]he efficiency of markets and private contracting is contingent on there being no third-party externalities.").

119 Schwartz & Scott, *supra* note 23, at 549.

120 In general, to the extent parties do cause negative externalities, the laws of antitrust, employment, environmental, and even tort law control, but not contract law.

121 *See* WILLIAM LUCY, PHILOSOPHY OF PRIVATE LAW 38 (2007).

invoked to argue that contract law should prefer default rules over mandatory rules.

A perfect contract would provide for every contingency, but in the real world, contracts are incomplete. A default rule is one that fills a gap in a contract where the parties have not selected a different rule. Default rules can be contracted around if the parties make an explicit choice to do so. An example is awarding expectation damages—parties can specify a different measure of damages if they choose.[122] On the other hand, a mandatory or immutable rule is one that the parties cannot contract around. The most common example is the duty of good faith and fair dealing.

Efficiency theory, in general, supports the use of default rules, not mandatory rules. Indeed, law and economics scholars have long fought against the use of "immutable rules, including those based on public policy."[123] They argue that particularly where parties are rational actors functioning in a competitive market, the law should trust the parties to enter into a deal that maximizes the joint surplus. If the parties are prevented from certain outcomes due to the existence of mandatory rules, the result generally will be less efficient. Judge Frank Easterbrook has said that the imposition of mandatory rules "almost invariably ensure[s] that there will be fewer gains and more losses tomorrow" because "[a] right that cannot be the subject of bargaining is worth less, just as eagle feathers that cannot be sold are worth less to their owners."[124] And in their famous Article on filling gaps in incomplete contracts, Robert Gertner and Ian Ayres argued that "[i]mmutability is justified only if unregulated contracting would be socially deleterious because parties internal or external to the contract cannot adequately protect themselves."[125]

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122 Ian Ayres, *Default Rules for Incomplete Contracts*, *in* 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 585 (Peter Newman ed., 1998).

123 G. Richard Shell, *Contracts in the Modern Supreme Court*, 81 CALIF. L. REV. 433, 500 (1993); s*ee also* Stewart Schwab, *A Coasean Experiment on Contract Presumptions*, 17 J. LEGAL STUD. 237, 239 (1988). Even if it can be shown theoretically that an immutable rule might be efficient, economists have concluded that "there is small hope that lawmakers will be able to divine the efficient rule in practice." Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 733 (1992).

124 Frank H. Easterbrook, *Foreword: The Court and the Economic System*, 98 HARV. L. REV. 4, 10–11 (1984). Even default rules can affect party preferences. *See* Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608 (1998).

125 Robert Gertner & Ian Ayres, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 88 (1989). Note that not all economists decry all mandatory rules. Steven Burton famously defended the mandatory duty of good faith and fair dealing on economic grounds, arguing that the rule serves as a way to remedy asymmetries in information and opportunistic behavior, both of which add transaction costs and muddy the perfect contracting environment. *See* Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369 (1980). Judge Posner echoed Professor Burton's argument in *Market Street Associates Ltd. Partnership v. Frey*, 941 F.2d 588, 595 (7th Cir. 1991)

B. *Agency Theory*

Agency theory is a particular application of efficiency theory.[126] It focuses on the issues that arise when an agent carries out work on behalf of a principal, and the interests of the two parties do not coincide.[127] Efficiency theory predicts that in a well-functioning market, where there is perfect information and the ability to monitor, there should be little difficulty aligning incentives between principals and agents. If the principal is able to sufficiently monitor the agent's performance, it can design sanctions and incentives to encourage optimal behavior. Further, if the agent knows that the principal will become aware of poor performance, and there are switching options in the marketplace, the agent will be dissuaded from performing poorly.[128] The agent will also be concerned about reputational effects of poor quality service provision.

Agency problems are often said to arise between the shareholders of a firm (the principals) and its managers (the agents). But efficiency theory ultimately dismisses these costs as being avoidable because both parties have an interest in the firm maximizing its profit.[129]

However, in many principal-agent relationships, there is information asymmetry in that the agent knows more about its actions than the principal does. The principal either cannot fully monitor the agent or it is too costly to adequately monitor the agent.[130] Moral hazard occurs when the agent acts in ways that the principal would not want it to act, if it knew fully what the agent was doing.[131]

Agency theory focuses on correcting for this type of opportunistic behavior. As it pertains to contracting, specifically, it focuses on the ways in which principals can try to align incentives through contract.

("The parties want to minimize the costs of performance. To the extent that a doctrine of good faith designed to do this by reducing defensive expenditures is a reasonable measure to this end, interpolating it into the contract advances the parties' joint goal.").

126 The term "agency theory" is used here in the economic sense and is distinct from principles of common law agency, where the same term may be found.

127 KIERON WALSH, PUBLIC SERVICES AND MARKET MECHANISMS: COMPETITION, CONTRACTING AND THE NEW PUBLIC MANAGEMENT 37 (1995).

128 *See generally* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 295–97 (1980) (discussing the extent to which market forces can discipline managers).

129 In actuality, agents' incentives are far more complicated. For instance, they may have an incentive to take actions that will be externally visible and enhance their attractiveness to future employers. Or they may have an incentive to exert little effort on tasks that will never be visible to shareholders. *See* Schwartz & Scott, *supra* note 23, at 602–03.

130 *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 309 (1976); Steven Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 BELL J. ECON. 55, 66 (1979).

131 Shavell, *supra* note 130, at 66.

For example, principals can pay for good outcomes or issue sanctions for bad ones, require compliance with certain specific performance measures, and/or invoke reporting procedures.[132]

Although agency issues come up in many contexts, private business outsourcing is an obvious example. Recent studies describe how parties engaged in business outsourcing confront issues of incentive alignment and control in practice.[133] For instance, one study reports finding a spectrum in contractual governance mechanisms that parties use to mitigate agency costs. At one end of the spectrum are "market-like" contracts that adopt fixed fees, weak or no incentive or penalty clauses, and pay little attention to service levels or monitoring rights—essentially low control contracts. At the other end of the spectrum are "firm-like" contracts that utilize extensive financial incentives and control rights, with considerable monitoring and economic consequences linked to performance.[134] In the study sample, firms pursuing simpler outsourcing functions (i.e., IT or call center work) tended to choose contracts at the market-like (less control) end of the spectrum. On the other hand, entities outsourcing more complex business functions with higher risk for agency costs used more firm-like (higher control) contractual governance mechanisms.[135] It is unsurprising that commercial parties facing potentially high agency costs are utilizing many of the control mechanisms suggested by traditional agency theory.

III. PROBLEMS IN PUBLIC-PRIVATE CONTRACTS

Efficiency theory postulates that contracts will be efficient where the assumptions discussed in the prior Part are satisfied. But efficiency theorists recognize that the traditional assumptions do not always apply.[136] For example, transacting parties sometimes cause negative

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132 WALSH, *supra* note 127, at 37.

133 *See* Margaret M. Blair, Erin O'Hara O'Connor & Gregg Kirchhoefer, *Outsourcing, Modularity, and the Theory of the Firm*, 2011 B.Y.U. L. REV. 263 (2011); George S. Geis, *An Empirical Examination of Business Outsourcing Transactions*, 96 VA. L. REV. 241, 271–72 (2010).

134 Geis, *supra* note 133, at 278. It is somewhat disingenuous to discuss these studies under the heading "Agency Theory" because this work investigates the implications of transaction cost economics (TCE). TCE shares certain similarities with agency theory in that it, too, is concerned with conflicts arising from a divergence of goals between contracting parties. TCE is generally invoked in the context of a firm's "make or buy" decision and considers the transaction costs involved in contracting out for a product or service rather than handling it "in house." Although there are important differences between agency theory and TCE, the distinctions are of little import to this Article, where the focus is on the problems that may ensue between principals and agents in a poor market where incentives are not aligned.

135 *Id.* at 290.

136 As Victor Goldberg noted many years ago, but which is still true to a lesser extent today: "The paradigmatic contract of economic theory (and of law) is a discrete transaction conveying

externalities that the law would want to deter. Or market failures challenge the assumption that the parties have efficaciously negotiated towards the most efficient outcome. As Schwartz and Scott state, "[t]hese objections would be troublesome for an efficiency approach that covered all contract types."[137] Indeed, these objections take center stage in public-private contracting.

In certain types of public-private contracting, uncontrolled agency costs, misaligned incentives, costs akin to negative externalities, market failures, and difficulty in specifying tasks lead to contracts that prioritize cost savings over quality service provision. The effect is that the contract imposes costs on service recipients that the contract price does not reflect.[138] Broadly speaking, there are two issues. First, particularly as to contracts for soft government services, the government has strong incentives to cut costs through outsourcing, but limited incentives to guarantee good service. Second, even if the government were incentivized to provide good service, it is difficult to align those incentives with those of the private service provider.

A. *The Government Has Strong Incentives to Cut Costs, but Limited Incentives to Guarantee Good Service*

Private service providers are motivated to maximize profit.[139] Usually when scholars debate the efficacy of privatization, they focus on whether private sector firms pursue their profit maximization goal by reducing service quality or by innovating to cut costs (in which case, service levels may continue to be high).[140] The answer to that question, at bottom, is an empirical one to which there is no good answer.[141] This Section focuses on a related but somewhat different question. Is the *government* motivated to ensure high-quality service provision? If the

a well-defined object (the ever popular widget) in exchange for cash." Victor P. Goldberg, *Regulation and Administered Contracts*, 7 BELL J. ECON. 426, 426 (1976).

137 Schwartz & Scott, *supra* note 23, at 545.

138 Essentially, contracts are underpriced. At least that is the case putting aside potential bargaining problems. Indeed, it is possible that even with the failure to internalize the cost of poor service provision, that the contract is still overpriced if the government is a poor negotiator.

139 Staunch supporters of privatization always point to the possibility that the private actor will innovate and more efficiently provide comparable or even higher quality services, but at bottom, few would dispute the primacy of profit maximization and cost-cutting goals for the private actor. *See* Schwartz & Scott, *supra* note 23, at 550–54.

140 Economic models on this issue are inconclusive. *See, e.g.*, *A Tale of Two Systems: Cost, Quality, and Accountability in Private Prisons*, *supra* note 2, at 1877–78 (detailing how early economic models predicted privatization would reduce both cost and quality, but recent literature argues that private contractors may be motivated to innovate in a way that cuts cost but not service quality).

141 *Id.*; s*ee also supra* note 81.

government is not acting in ways that promote quality service provision (for instance, monitoring or switching providers when performance is poor), it follows that quality service provision is significantly less likely to occur.

This Section argues that the government lacks motivation to ensure that private providers deliver high-quality service when certain services are outsourced because 1) its primary focus is on cost savings, and 2) market forces and political forces that would normally align incentives between the outsourcing company and the service recipient are lacking.[142]

1. Primacy of Cost-Cutting Goal

Privatization theory is primarily predicated on cost savings. It argues that by subjecting government services to market forces and competition, costs will be driven down.[143] Scholars debate privatization's effect on service quality, but in the United States, most of the dialogue about privatization centers on the potential for cost savings.[144]

There is ample evidence that governments outsource in order to cut costs. For instance, in a survey conducted in 2007, eighty-seven percent of local government respondents stated that their primary reason for choosing privatization was an "attempt[] to decrease cost."[145] Fifty percent of respondents said they were also motivated by "external fiscal pressures, including restrictions placed on raising taxes."[146] The Reason Foundation also confirms that state agencies have ramped up

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142 As Martha Minow correctly notes:

> With social services . . . accountability becomes especially important but also recalcitrant, because those most directly affected by the services or failures to provide services are politically and economically ineffectual. Treatment of vulnerable populations simply does not work well in markets that depend upon consumer rationality or upon political processes that demand active citizen monitoring.

Minow, *supra* note 19, at 1262.

143 *See* Oliver Hart, Andrei Shleifer & Robert W. Vishny, *The Proper Scope of Government: Theory and an Application to Prisons*, 112 Q.J. ECON. 1127, 1143 (1997) ("Costs . . . are always lower under private ownership. Quality . . . may be higher or lower under private ownership.").

144 *See* Adrian Moore, *Making Privatization Work for State Government*, REASON FOUND. (Aug. 1, 2002), http://reason.org/news/printer/making-privatization-work-for ("Here in the United States we have traditionally privatized services for the money . . . ."); *see also* JOSEPH I. HALLINAN, GOING UP THE RIVER: TRAVELS IN A PRISON NATION 167 (2001) ("The success of private prisons . . . is driven by a single premise: They are cheaper than their public counterparts."); Dolovich, *supra* note 93, at 471–72 ("As for the state, in the American context, the central aim is to save money on the cost of corrections.").

145 *See* Warner & Hefetz, *supra* note 1, at 16.

146 *Id.*

their use of privatization as a means of cutting costs and balancing tighter budgets.[147]

The strong link between privatization and cost cutting is unsurprising, particularly because state laws and local ordinances often *require* proof of cost savings prior to permitting privatization.[148] For instance, an Ohio statute requires that contractors "convincingly demonstrate" that they can provide at least a five-percent savings over the cost of public service provision.[149] Florida similarly requires that "[t]he Department of Management Services may not enter into a contract or series of contracts unless the department determines that the contract or series of contracts . . . will result in a cost savings of at least 7 percent over the public provision of a similar facility."[150]

The same is often true at the local level. In California, one county's charter requires that the contracting agent determine that services be provided "more economically and efficiently" by a private contractor than by the government before it is permitted to enter into a contract.[151] Further, contracting officers are sometimes required to award contracts to the lowest responsible bidder.[152]

The rhetoric of government officials only confirms government's focus on the bottom line in making privatization decisions. In a news conference last year, the elected official responsible for privatizing prisons in Essex County, New Jersey, addressed his decision to free up beds in county prisons to "rent" those beds to the federal government: "My chief responsibility is to bring in revenue for this county, and we've done it very, very well."[153] He also noted his motivation to "keep the taxes low."[154]

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147 *See generally* Leonard Gilroy & Harris Kenny, *Annual Privatization Report 2011*, REASON FOUND. (May 1, 2012), http://reason.org/news/show/annual-privatization-report-2011.

148 Presumably these requirements are grounded in efforts to dissuade corruption and cronyism.

149 OHIO REV. CODE ANN. §9.06(A)(4) (LexisNexis 2013).

150 FLA. STAT. § 957.07(1) (2013); *see also* TENN. CODE ANN. § 41-24-104(c)(2)(B) (2013) (requiring contracting cost at least five percent less than the state's cost).

151 *See* Giles v. Horn, 123 Cal. Rptr. 2d 735, 741 (2002) (citing San Diego County Charter, art. IX, § 916, as amended in 1986).

152 *See* 81A C.J.S. *States* § 286 (2013) (citing Lewis & Michael, Inc. v. Ohio Dep't of Admin. Servs., 724 N.E.2d 885 (Ohio Ct. Cl. 1999)), *available at* Westlaw CJS; *see also* Balsbaugh v. Commonwealth Dept. of Gen. Servs., 815 A.2d 36, 41 (Pa. Commw. Ct. 2003)). This requirement may lead to underbidding, which usually equates to lower wages for workers and ultimately lower quality of service. *See, e.g.*, Goldberg, *supra* note 136, at 442–43 (noting problems with competitive bidding when quality is an issue); Stevenson, *supra* note 19, at 117.

153 *See* Dolnick, *supra* note 44.

154 *Id.*; *see also* Lisa Belkin, *Rise of Private Prisons: How Much of a Bargain?*, N.Y. TIMES, Mar. 27, 1989, at A14 ("I'm an old state bureaucrat . . . . I don't have any philosophies. If they can do it cheaper than the state can, more power to them." (quoting Bob Owens, internal auditor for the Texas Department of Corrections)); Nzong Xiong, *Private Prisons: A Question of Savings*, N.Y. TIMES, July 13, 1997, at C5 ("I think as long as it does not cost any more than it costs the state then we should consider privatization . . . . We should compare and explore the

While some states do require consideration of both cost savings *and* quality in the privatization decision, the number of such states is small.[155] Even where quality improvements are supposed to enter into the calculus, they end up subservient to cost reduction because quality improvements are difficult to contract for *ex ante* and difficult to monitor *ex post*.[156] Relatively speaking, it is much easier to ascertain whether privatizing has succeeded in cutting costs than whether it has succeeded in improving quality.

2. The Government Has Limited Incentive to Effect Good Service Where Service Recipients Lack Economic and Political Power

There are other reasons that government actors lack adequate incentive to care about quality. While some government actors may be altruistic, or have public policy beliefs that cause them to promote high-quality services,[157] rational, self-interested government actors have limited incentive—either economic or political—to promote high-quality service, particularly where the service benefits a small, disenfranchised segment of the population.[158]

a. The Economics

In the private sector, where there is a competitive market, customers can affect the quality of product and service offerings. "[A] hypothetical consumer chooses one product over another, drawing resources to the better product and leading to the improved outcomes and efficiencies that the market model promises."[159] Public-private contracting for soft government services does not work in the same way.

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options out there that would save the taxpayers money." (quoting Donald Campbell, Commissioner, Tennessee Department of Corrections)).

155 *See A Tale of Two Systems: Cost, Quality, and Accountability in Private Prisons*, *supra* note 2, at 1873–74 (citing three states whose statutes require consideration of quality in addition to cost); *see also* CHARLES L. RYAN, BIENNIAL COMPARISON OF "PRIVATE VERSUS PUBLIC PROVISION OF SERVICES" REQUIRED PER A.R.S. § 41-1609.01(K)(M) (2011), *available at* http://www.azcorrections.gov/ARS41_1609_01_Biennial_Comparison_Report122111_e_v.pdf.

156 The Government may also lack incentives to care about quality when it provides these services directly. *See infra* Part III.A.3. See also *infra* Part III.B.2 for a discussion of difficulties in specification and monitoring.

157 For further discussion about appealing to social norms to yield better results, see *infra* Part IV.B.

158 These problems inhere in direct government service provision, as well, but see *infra* Part III.A.3 for a discussion of why outsourcing makes these problems worse and has the capacity to make them better.

159 *See* Bach, *supra* note 64, at 299.

An analogy to private outsourcing will help frame the issue. Consider a hypothetical example where Macy's, the department store chain, outsources its website support operations to an Indian company, Tata Consultancy Services (TCS). Macy's owners may have difficulty controlling its managers and Macy's may have trouble controlling TCS. These agency costs are mitigated by market forces that align profit maximization goals and contract control mechanisms, such as specifying tasks and monitoring.[160]

Macy's and its customers will undoubtedly have divergent interests, as well, but Macy's is motivated in some real sense to keep its customers happy. If its customers are not happy, they will choose to shop at a different department store. Without customers buying its products, Macy's cannot be a profitable business. As long as Macy's can convince TCS to keep its customers happy, agency costs are not debilitating.

Now let's carry the analogy through to public-private contracting using the Indiana-IBM outsourcing example. There, Indiana is the purchaser (like Macy's). Indiana's citizens are akin to Macy's shareholders. IBM, the service provider, is equivalent to TCS. And Indiana welfare beneficiaries are essentially the customers.[161] The same two agency costs that occur in private outsourcing might also occur in the public-private example. Indiana's citizens might have trouble controlling their government, and Indiana might have trouble controlling IBM. But in public-private contracting, there is an additional difficulty. Unlike the interests of Macy's and its customers, the interests of welfare beneficiaries and Indiana citizens more generally tend to be diametrically opposed. This is particularly true for soft government services, which affect only a small portion of society.[162] The public, for the most part, will want the government to prioritize saving money (and reducing taxes) over providing high-quality prisons or welfare administration.[163] Simultaneously, the beneficiaries desire high-quality

160 *See infra* Part III.B.

161 The beneficiaries are also citizens of Indiana, so to complicate matters, they are part of both the "shareholders" group and the "customers" group.

162 Note that the soft versus hard distinction is particularly important in the "serving two masters" context. With hard services that affect the entire public, the entire public has an interest in quality service provision. If the government contracts for a hard service and quality is poor, it is likely that the larger public will become aware of the issue, and that the collective public will be able to use its political power to force the government to effect change.

163 Of course this is not always true and, arguably, should not be true. When prisons are poorly run and people escape, that affects the general public. And when people do not obtain access to Medicaid benefits, they cannot pay for health care, and that ultimately imposes larger costs on the system. Consider the larger debate about the Affordable Care Act on this point. However, as a matter of relative preferences, most non-service beneficiaries will care more about their taxes being as low as possible, and less about the quality of service offered to welfare applicants. Even further, the general public may not know when prisons have poor security or the welfare system functions poorly.

service and care little about the cost. Even if the public is altruistic, or understands the negative implications for larger society by these services failing, they may never know if private parties are running low-quality prisons or poorly administering welfare benefits.[164] They will, however, know if their taxes go up.

The "customers" in public-private contracting lack the economic power that they have in the private analogue. For one, the government is not motivated by gaining market share. And "customers" (welfare beneficiaries) have no market to access for services.[165] If they do not like how IBM is administering the system, there is no other choice. As such, the service recipients have almost no economic power to force the government to care about their interests.[166] The next question, then, is whether they can instead invoke their political power.

b. The Political Story

Politically, governments are accountable, at least in theory, to the public at whose behest they serve. But the public-private contracting scenario begs the question of which "public" the government serves. Essentially, the government must serve two masters whose interests are at odds.[167]

Because the larger public wields more political power than the service beneficiaries, the government will feel added pressure to prioritize cost savings over quality service provision. Indeed, groups like criminals and poor people decidedly lack political power. Felons cannot vote and are generally powerless to effect change using political means.[168] And for a variety of reasons, low-income people are less likely to vote than their wealthier counterparts, and even less likely to mobilize politically as a group.[169] This problem is unique to soft government

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164 The press coverage of the IBM-Indiana and CEC-New Jersey contract failures are the exception, not the rule.

165 *See* Edward Rubin, *The Possibilities and Limitations of Privatization*, 123 HARV. L. REV. 890, 897 (2012) ("[T]he competitive process that supposedly renders private enterprise more efficient than public agencies cannot be effectively implemented in many cases because there is no nongovernment market for the product in question.").

166 This is also a problem with direct service provision. *See infra* Part III.A.3.

167 *See, e.g.*, Davidson, *supra* note 22, at 272 ("Public officials, for example, are accountable to the general public, although difficult and subtle questions can arise as to the relevant 'public' to which officials must respond.").

168 Paul L. Posner, *Accountability Challenges of Third-Party Government*, *in* THE TOOLS OF GOVERNMENT: A GUIDE TO THE NEW GOVERNANCE 523 (Lester M. Salamon ed., 2002); Susan Sturm, *Resolving the Remedial Dilemma: Strategies of Judicial Intervention in Prisons*, 138 U. PA. L. REV. 805, 824–26 (1990) (stating that inmates are powerless to effect change); Developments in the Law, *One Person, No Vote: The Laws of Felon Disenfranchisement*, 115 HARV. L. REV. 1939 (2002) (noting that felons lose the right to vote for life).

169 THOM FILE & SARAH CRISSEY, U.S. CENSUS BUREAU, CURRENT POPULATION REPORTS:

services. If a private service provider failed to pick up a city's garbage, everyone would notice and everyone would care. Not so with soft government services affecting a small subset of the populace.

There are other reasons, as well, that government actors tend to lack the political incentive to ensure quality service provision. For instance, government actors are unlikely to be in office when poor service starts to matter politically.[170] One of Governor Chris Christie's first responses to the poor halfway house publicity in New Jersey was to blame the prior administration.[171] And some individual government actors will make decisions motivated by opportunities after public employment, to boost their fame or reputation, or to increase chances for reelection or promotion.[172]

This Article does not discount that government actors are boundedly rational and therefore will, at times, be motivated by notions of altruism or other social norms. Indeed, the more government actors who are motivated in altruistic ways, perhaps the more likely projects are to succeed. But nonetheless, there is a systematic bias based on the economic and political incentives of government actors to favor contracts that cut costs yet sacrifice quality.

3. Why This Is a Contracting Problem

So far, many of the reasons provided for the government's lack of incentive to provide high-quality "soft" services would apply as equally to direct government service provision as they do to government outsourcing. When a government directly runs a prison or administers welfare benefits, it too will have limited incentive outside the altruistic, public service ones, to provide quality service. Outsourcing to private providers is supposed to ameliorate those problems. And yet, the government's lack of incentive to ensure high-quality service pervades the public-private contracting relationship, as well.

VOTING AND REGISTRATION IN THE ELECTION OF NOVEMBER 2008, at 4–5 (2012), *available at* http://www.census.gov/prod/2010pubs/p20-562.pdf (reporting than in the 2008 election, low-income people, minorities, and renters were less likely to register and to vote than their wealthier, white, home-owning counterparts).

170 *See* Jon D. Michaels, *Privatization's Pretensions*, 77 U. CHI. L. REV. 717, 739–40 (2010); Nicholas Miranda, *Concession Agreements: From Private Contract to Public Policy*, 117 YALE L.J. 510, 523–24 (agreements tend to last longer than the official's term in office).

171 Press Release, N.J. Office of the Governor, Statement from Governor Chris Christie on Halfway House Oversight and Accountability (June 18, 2012), *available at* http://www.state.nj.us/governor/news/news/552012/approved/20120618a.html.

172 Clayton P. Gillette & Paul B. Stephan, Richardson v. McKnight *and the Scope of Immunity After Privatization*, 8 SUP. CT. ECON. REV. 103, 111, 125 (2000).

But the foregoing analysis begs an additional question: why does the contracting relationship matter? Does outsourcing lead to *worse* service provision than government-service provision?

The empirical evidence on this is both preliminary and mixed.[173] Mixed results are unsurprising, in part because quality is difficult to assess and comparisons between public and private enterprises (consider prisons more specifically) are difficult to fairly make.

Nonetheless, there are reasons to believe that contracting out does decrease the incentive to provide good service even beyond what has already been addressed. For one, there are occasions when poor service provision does come to the attention of the general public and poor service provision affects the broader public. In the New Jersey halfway house example, it was reported that inmates were escaping and committing violent crimes. When something like that happens, the government gains some political insulation from the fact that the private service provider erred and not the government directly. As Jody Freeman argues, the government can point its finger at the private entity and avoid political backlash.[174]

It is hard to know how often this occurs and with what success, but at the very least, there are instances of states attempting to put blame on the private contractor rather than accept responsibility. The Indiana-IBM case is a good example. Although the court's final order in that litigation blamed, in part, Indiana's role in designing a faulty welfare administration system, Indiana's rhetoric post-decision continues to point the finger at IBM:

> We believe the court's view that IBM's concededly bad performance did not materially breach the contract is wrong, and cannot be

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173 *See supra* note 81; *see also* PROGRESSIVE STATES NETWORK, PRIVATIZING IN THE DARK: THE PITFALLS OF PRIVATIZATION & WHY BUDGET DISCLOSURE IS NEEDED, WITH A 50-STATE COMPARISON OF PRIVATIZATION TRENDS (2007), *available at* http://www.progressivestates.org/files/privatization/PrivatizationReport.pdf (noting lack of reliable quality data, but finding "at least one analysis of privatization of state and local services over the last 20 years found the majority of such projects failed because of deteriorating quality of service"); Dolovich, *supra* note 93, at 504–05 (citing a study in Oklahoma finding over a three-year period that "private prisons recorded more than twice as many incidents as public ones. Similar findings were also made in an earlier study commissioned by the Tennessee Department of Corrections . . . ."); *cf.* FRANCOIS MELESE, REASON FOUND., PRIVATIZING PUBLIC HOSPITALS: A WIN-WIN FOR TAXPAYERS AND THE POOR (2005), *available at* http://reason.org/files/c635128ff5b1b3eb0b66748b152c155a.pdf; *A Tale of Two Systems: Cost, Quality, and Accountability in Private Prisons*, *supra* note 2, at 1875–76 (noting difficulty in comparing quality across public and private prisons, but arguing that "none of the more rigorous studies finds quality at private prisons lower than quality at public prisons on average" (footnote omitted)).

174 *See* Freeman, *supra* note 5; *see also* Matthew Diller, *The Revolution in Welfare Administration: Rules, Discretion, and Entrepreneurial Government*, 75 N.Y.U. L. REV. 1121, 1210 (2000) ("When problems arise, government officials and private contractors can point fingers at each other, leaving the public with little means of knowing who is really at fault."); Super, *supra* note 29, 400 (same).

> squared with the overwhelming evidence of poor performance . . . . IBM's own senior executive called it an "abomination," and IBM executives repeatedly admitted the State had good reasons to be dissatisfied.[175]

Second, while the prior Sections discussed why self-interested government actors have little incentive to provide good service, it is possible that the prevalence of altruistic actors is greater amongst government employees than private actors. While government actors may not have the economic or political incentive to provide quality service, scholars have argued that they are more inherently likely to provide quality service than private actors who are highly motivated by maximizing profit.[176] Also, in the private sector, workers' bonuses are often tied to the overall profitability of the company. Individual private sector workers who are self-interested will therefore be motivated to cut costs and maximize profit. Government employees may have the same motivations (in particular by having to stick to tight budgets), but in general, government employees are not financially rewarded by cutting costs. This is one of the arguments as to why the private sector may be able to deliver services more cheaply. But it is also a reason that private service providers might be even more motivated than government actors to provide low-quality service.

Finally, even if both government service provision and private service provision suffer equally from low incentives to provide high-quality service, nonetheless, contracting out opens the door to contract-based solutions that align incentives to improve quality. In this sense, contracting provides an opportunity.[177]

4. Implications

The government is motivated to cut costs and lacks adequate motivation to care about the quality of service being provided. There are arguably many reasons to care about this result from a fairness and public policy perspective. But so too is the result undesirable from an economic perspective because the government is entering into contracts with private parties that impose costs on non-party service recipients—costs that the contracting parties do not bear.

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175 Jon Murray, *Indiana Must Pay IBM $12M for Canceled Contract, Judge Rules*, INDIANAPOLIS STAR (July 18, 2012), http://www.governing.com/news/state/mct-indiana-must-pay-ibm-for-canceled-contract.html; *see also* Dan McFeely, *Oops: BMV Passes Blame, Exposing a New Problem*, INDIANAPOLIS STAR, Feb. 22, 2003, at 1A ("Under fire for botching the license plate renewals for more than 200,000 Hoosiers, the Bureau of Motor Vehicles is changing its original story and shifting the blame from the agency to a private contractor.").

176 *See, e.g.*, Freeman, *supra* note 5, at 188.

177 *Id.* at 201–07.

Technically, this may not be a negative externality because the service recipients are members of the public who are also the principal to the government as agent. But regardless of the terminology, the effect is the same. If Buyer *B* and Seller *S* enter into a contract to produce a widget for $100, efficiency theory assumes that $100 is an efficient price that has made neither party worse off. If *S* and *B* pollute the environment as a result of their transaction, and the pollution negatively affects non-parties to the contract, then $100 does not reflect the true cost of the transaction. Instead, the cost of the transaction is really $100 plus the cost of the pollution. The parties' transaction should account for that cost. This is the logic behind environmental legislation and other forms of regulation that force parties to internalize costs. Because the government and the private service provider do not account in their contract for the cost of poor service provision, their contract is essentially underpriced.

But these failures between the government and the beneficiaries are not the only ones that trouble public-private contracts. The next Section discusses the problems between the government and the private service provider.

B. *Government Difficulties in Effectuating Good Service*

The second major problem in public-private contracting is that even were the government motivated to obtain high-quality service from its contractor, it is difficult to accomplish that goal using traditional tools to control agency costs. Economic theory predicts that market forces will motivate agents to perform well. Further, agency theory predicts that contract specification and monitoring will align party incentives. But the realities in public-private contracting are different.

1. Lack of Market Competition

Law and economics theory predicts that competition fosters efficiency. Market competition forces agents not only to control costs, but also to deliver quality services.[178] If a private provider fails to deliver quality service, the contracting party will choose another service provider at contract renewal.[179] Because agents want future business,

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178 *See* Rubin, *supra* note 165, at 917 (2010) ("More generally, it can be argued that a competitive market operates as a powerful constraint that makes direct accountability less critical.").

179 *See* JOHN D. DONAHUE, THE PRIVATIZATION DECISION: PUBLIC ENDS, PRIVATE MEANS

they will provide high-quality services.[180] Agents are also concerned about reputational effects in the marketplace. Therefore, they are incentivized to perform well.

Whereas private outsourcing agreements generally benefit from the agency cost-reducing effect of market competition, certain types of public outsourcing contracts do not benefit, at least to the desired extent. Governments face shallow markets for privatizing certain services.[181] In the Indiana example, IBM and its subcontractors submitted the only bid for its welfare outsourcing project.[182] When Arizona privatized its state welfare system, only one company offered a bid.[183] In New Jersey, there was only one bidder for a contract to run a 450-bed immigrant detention center.[184] The list of outsourcing contracts entered into after a single bid, or a low number of bids, is a long one.[185]

Perhaps it is not surprising, then, that market forces fail to force high levels of performance in government outsourcing contracts as efficiency theory would predict.[186] True market conditions require that both buyers and sellers have options in contracting partners and that there be relatively low barriers to entry in the marketplace.[187] There is always at least one other seller option in the sense that the government could choose to take a service back in house, but that option, even

218 (1989) (emphasizing the "cardinal importance of competition" in privatization, and stating that "[m]ost of the kick in privatization comes from the greater scope for rivalry when functions are contracted out, not from private provision *per se*"); JEFFREY D. GREENE, CITIES AND PRIVATIZATION (2002).

180 Rubin, *supra* note 178, at 917 ("Firms that compete for government contracts will necessarily strive to achieve the goals that the agency sets so that the agency will renew the contracts or grant them other contracts in the future.")

181 ELLIOT SCLAR, YOU DON'T ALWAYS GET WHAT YOU PAY FOR: THE ECONOMICS OF PRIVATIZATION 92 (2000) ("In privatization debates, beneficial competition is treated as analogous to a common and hardy lawn weed that sprouts whenever its seeds touch the earth. A more accurate analogy would be to a rare orchid, whose beauty is undoubtable but only blossoms under very special conditions.").

182 State *ex rel.* Ind. Family & Soc. Servs. Admin. v. Int'l Bus. Machs. Corp., No. 49D10-1005-PL-021451, at 6–7 (Ind. Super. Ct. July 18, 2012).

183 Stevenson, *supra* note 19, at 90–92 n.37.

184 Sam Dolnick, *Reversing Course, Officials in New Jersey Cancel One-Bid Immigrant Jail Deal*, N.Y. TIMES, Aug. 15, 2011, at A15.

185 In Connecticut, Colonial Cooperative Care, Inc. was the only bidder for its contract to determine eligibility for disability-based cash assistance. *See* Stevenson, *supra* note 19, at 90–92.

186 HARTNEY & GLESMANN, *supra* note 94, at 11 ("[L]ack of competition . . . also contributes to the likelihood of inadequate performance once a contract is executed. If a particular industry only has a few providers, the government's ability to realize cost savings is considerably lessened and it is difficult to effectively replace one provider with another, if the need arises.").

187 ROBERT S. PINDYCK & DANIEL L. RUBINFELD, MICROECONOMICS 271–73 (7th ed. 2009) ("The inability of any given buyer or seller to affect the price of an item is one of the hallmarks of a perfectly competitive market."); Rubin, s*upra* note 178, at 918 (2010) ("Ideal competition occurs when the government is one of many buyers for a product that has many sellers."); Stevenson, *supra* note 19, at 90–91; David Lowery, *Consumer Sovereignty and Quasi-Market Failure*, 8 J. PUB. ADMIN. RES. & THEORY 137–72 (1998) (arguing that quasi-markets often fail to meet efficiency objectives due to in part to market failure).

assuming it is a realistic one, does not make a market "competitive." Much of the proof of shallow competition is anecdotal, nonetheless, studies have confirmed that competitive markets are lacking. For instance, a 2007 survey of city and municipal governments found that, on average, there are fewer than two provider options for city service contracts.[188] State governments also experience thin markets as they increase their reliance on contracts for service delivery.[189]

Not all types of outsourcing see low levels of competition. This is another point in the analysis where the distinction between hard and soft government services matters.[190] For one, soft services require higher relationship-specific investments because there tends to be no equivalent in the private, commercial market. There are no commercial owners of prisons or administrators of public benefits.[191]

Also, the buyer-side market (governments) is usually much smaller than it is in private outsourcing markets, dampening interest in the seller-side market to develop expertise.[192] For instance, it has become clear that there is demand on the private buyer side for outsourced call center services. Therefore, companies are incentivized to develop this expertise. There is enough work to go around. In contrast, the demand for private prisons is not nearly as robust.

Second, it typically requires a very large, resource rich company to take on the sorts of projects that fall into the "soft" services category.[193]

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188 *See* Mildred E. Warner & Amir Hefetz, *Service Characteristics and Contracting: The Importance of Citizen Interest and Competition*, *in* MUNICIPAL YEAR BOOK 2010, at 19–27 (2010).

189 For a good summary of studies (survey and interview methods) on competition in local and state-level outsourcing, see David M. Van Slyke, *The Mythology of Privatization in Contracting for Social Services*, 63 PUB. ADMIN. REV. 296, at 299 tbl.1 (2003); *see also* Jocelyn M. Johnston & Barbara S. Romzek, *Social Welfare Contracts as Networks: The Impact of Network Stability on Management and Performance*, 40 ADMIN. & SOC'Y 115 (2008); Mildred E. Warner & Germa Bel, *Competition or Monopoly? Comparing Privatization of Local Public Services in the U.S. and Spain*, 68 PUB. ADMIN. REV. 723 (2008).

190 David M. Van Slyke, *Agents or Stewards: Using Theory to Understand the Government-Nonprofit Social Service Contracting Relationship*, 17 J. PUB. ADMIN. RES. & THEORY 157, 161 (2007) ("There are significant differences among contracted services, such as social services and refuse collection, in terms of the market and political ideology supporting or opposing alternative service delivery arrangements, the level of market competition that exists, and the ease of defining, measuring, and observing outputs and outcomes."); *see also* Donohue, *supra* note 2 (supporting outsourcing of commodity or hard services and not custom or soft services because private entities can be as inefficient as the government in a noncompetitive market).

191 Rubin, *supra* note 178, at 923 ("There are certain activities of government, however, that have no market analogue, either because no one would buy them or because no one would sell them. Punishment is an example of the first, and welfare benefits (free money) are an example of the second."); *see also* Davidson, *supra* note 22, at 271.

192 The buyer-side market is short of a monopoly because there are many states and counties that may desire private prisons. Nonetheless, the market is necessarily limited.

193 This is not always true. For instance, there are smaller contracts to be had for social services, but this Article focuses on the problems that inhere in larger contracts for soft government services, which are pervasive.

A "mom and pop" local business owner cannot realistically bid to administer welfare benefits for the entire state of Indiana or to operate a 1000-bed halfway house. Therefore, "[t]he size and complexity of the programs significantly limit the number of new entrants to the market, . . . stifling the only source of competition."[194]

In addition, because of the nature of the services being provided and the requirement of large relationship-specific investments up front, contracts tend to be long-term. Once a provider wins a contract and provides a service for a long period of time, it is even harder for other providers to compete.[195] Buyers often find the costs of changing suppliers problematic, such that they exercise the option to switch only in extreme circumstances. The first party to make the investment required to administer a complicated government program often gains quasi-monopoly advantages.[196] One study in Los Angeles observed that agencies typically renewed their contracts for family preservation programs over many cycles, and that over time, the private providers began to look and function like monopolists.[197]

Third, even in markets where there are multiple participants to start, vertical consolidation tends to happen over time. Consolidation permits advantage through economies of scale. And where there is only one buyer, consolidation decreases risk of losing out on a lucrative contract.[198] Corruption and cronyism in public-private contracting can also narrow markets.

Whereas effective markets can help overcome principal-agent problems in private outsourcing, public-private contracting markets are thin. Markets therefore do not help constrain opportunistic behavior on the part of the agent as efficiency theory would suggest.[199]

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194 Stevenson, *supra* note 19, at 91.

195 Rubin, *supra* note 178, at 919.

196 Walsh, *supra* note 127, at 35.

197 Elizabeth A. Graddy & Bin Chen, *Influences on the Size and Scope of Networks for Social Service Delivery*, 16 J. PUB. ADMIN. RES. & THEORY 533, 548–49 (2006) ("Thus, just as we find in franchise arrangements, this structure could create long-term contracts that begin to look like monopolies.").

198 *See* Bach, *supra* note 64, at 299–301; Gilman, *supra* note 19, at 642; Barbara S. Romzek & Jocelyn M. Johnston, *State Social Services Contracting: Exploring the Determinants of Effective Contract Accountability*, 65 PUB. ADMIN. REV. 436 (2005); Mark Schlesinger, Robert Dorward & Richard Pulice, *Competitive Bidding and States' Purchase of Services: The Case of Mental Health Care in Massachusetts*, 5 J. POL'Y ANALYSIS & MGMT. 245 (1986) (describing the multiple forces encouraging consolidation among contractors for mental health services in Massachusetts, such as economies of scale in both provision and bidding).

199 *See* Walsh, *supra* note 127, at 35.

2. Specification and Monitoring Problems

In addition to markets constraining agency costs, agency theory also suggests that agency costs arising between a buyer and its service provider should be controllable by clearly specifying performance requirements and benchmarks and then monitoring to ensure compliance.[200] These control mechanisms can work well in private outsourcing, however, they are difficult to implement in public-private contracting.

a. Specification Difficulties

A common complaint amongst government officials is that it can be difficult to "writ[e] clear contracts with specific goals against which contractors can be held accountable."[201] This is particularly true in contracts for soft government services:

> 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). 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.[202]

The point is probably intuitive, but almost by their definition, soft government services are complicated endeavors.[203] Particularly where tasks involve direct involvement with clients, they may be unpredictable and difficult to evaluate.[204]

Sometimes the choice to try to define specific performance metrics or outcome-based goals is problematic in and of itself. This is because service providers will work to comply with the requirements of the contract, but will ignore other elements of service quality or adherence to broader program goals. This is called "shirking."[205]

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200 Mildred Warner, Mike Ballard & Amir Hefetz, *Contracting Back In: When Privatization Fails*, *in* MUNICIPAL YEAR BOOK 2003, at 35 (2003).

201 Gilman, *supra* note 19, at 600 (citation omitted).

202 Freeman, *supra* note 5, at 171 (citation omitted).

203 Private companies may also outsource complicated services, but lack of market competition and the fact that beneficiaries have limited economic and political power to effect good service exacerbate this problem in the public context.

204 Gilman, *supra* note 19, at 600–01; Davidson, *supra* note 22, at 271; Warner, Ballard & Hefetz, *supra* note 200, at 30–36 ("[S]ome services are inherently hard to specify in contract.").

205 Davidson, *supra* note 22, at 306 (recognizing that public law norms are inherently difficult to capture in contractual terms and that the risk of shirking is ever-present); *see also* Sclar, *supra* note 181, at 122.

John Donahue explains the problem with reference to education:

> The problem is that higher math test scores, fewer dropouts, more frequent recitations of the Pledge of Allegiance, and other such measurable results are not all that we expect of our schools. "Education" also includes subtler factors that are hard to specify, harder still to monitor, and this limits the ability of a school district to easily choose the most attractive bidder among education contractors.[206]

When it is difficult to specify quality, it only contributes to incentives for service providers to cut costs at the expense of quality because in doing so, they may not technically be violating the terms of the contract.[207] A related problem is that focusing on outcomes can cause profit-seekers to "cream," or select those who are easier to serve or more likely to be successful, avoiding the harder cases. Accordingly, it is difficult to force compliance with overall service provision goals solely through more detailed requirements or even outcome-based rewards.[208]

Even if goals could be adequately specified, monitoring presents additional hardships and costs.

b. Difficult and Costly to Monitor

In the absence of adequate market competition and defined performance standards, agency theory predicts that adequate monitoring should force good performance. And yet sufficient monitoring is seldom seen in public-private contracting.

A 2007 study found that fewer than half of the responding municipal governments reported doing any monitoring.[209] And those who did monitor reported evaluating fewer aspects of contractor service than in the same survey conducted in 2002.[210] Also in 2007, an analysis of municipal data on new contracting out and contracting back in (returning to direct government service provision) found that contracting back in was primarily associated with problems with monitoring.[211]

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206 JOHN D. DONOHUE, THE PRIVATIZATION DECISION 219 (1989).

207 This problem is referred to in the economic literature as "shading."

208 Economists refer to the difficulty of specifying quality as "non-contractability." *See, e.g.*, Meeting Minutes from the Wis. Works (W-2) Contract and Implementation (C&I) Comm. (July 18, 2008), *available at* http://dcf.wisconsin.gov/w2/ci/2008/pdf/07_08/july_08_ci_final_notes.pdf (specifying issues with performance standards in Wisconsin).

209 Warner & Hefetz, *supra* note 1; *see also* Dolovich, supra note 93, at 491 (describing a December 1997 survey of state and federal government agencies reporting that almost thirty percent did no monitoring at all).

210 Warner & Hefetz, *supra* note 1.

211 Warner, Ballard & Hefetz, *supra* note 200, at 36.

Governments lack the incentive to monitor because doing so is costly and may undermine the cost savings that prompted privatization in the first place. While it is also costly in private outsourcing, the cost is more justifiable in that context where the satisfaction of the ultimate customer motivates the outsourcing party to monitor the service provider. In the private example, if customers are not satisfied, it will negatively affect the profitability of the outsourcer. The same is not true in government outsourcing, where beneficiaries do not pay for the service and have limited ability to force the government to internalize the costs of poor service. As a result, governments tend to under-monitor.[212]

Also, as a practical matter, monitoring is difficult, particularly for soft government services that are large, complicated, and removed from the public eye.[213] While government officials can make unannounced visits to private prisons, it would be difficult to adequately observe the goings on at entire institutions. Monitoring also requires expertise, which government officials often lack.[214]

The difficulties of monitoring private contractors only encourages governments to focus even further on cost savings rather than ensuring quality of service. This move is self-perpetuating, particularly if you believe that companies cut costs by lowering service quality. Governments essentially end up rewarding companies that choose not to invest in quality service.

In sum, the mechanisms that economic theory predicts will control agency costs and align incentives between the government as principal and the private service provider as agent, are lacking in public-private contracting. It is not surprising, then, that public-private contracts result in poor quality service provision.

John Donahue has suggested that where tasks are difficult to specify, quality is difficult to assess, and there is no competitive market, it is simply not efficient to outsource those services.[215] He may be correct. But governments *are* outsourcing these precise services. In light of that reality, the next Part discusses a potential contract-based solution to better align both the interests of 1) the government and the service beneficiaries, and 2) the government and the private service provider.

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212 *Id.*

213 *See* Trevor L. Brown & Matthew Potoski, *Transaction Costs and Contracting: The Practitioner Perspective*, 28 PUB. PERFORMANCE & MGMT. REV. 326 (2005); Warner & Hefetz, *supra* note 1 ("The easiest-to-manage services are similar to the ones with low asset specificity: street lot cleaning, garage and parking lot operation, cemetery maintenance, parking meter maintenance, vehicle towing, secretarial services, and solid-waste collection. Services that have low asset specificity and are easy to manage are good candidates for contracting out.").

214 *See* Richard Frankel, *Regulating Privatized Government Through § 1983*, 76 U. CHI. L. REV. 1449, 1499 (2009).

215 *See* Donahue, *supra* note 2, at 49.

IV. PROPOSING A CONTRACT-BASED SOLUTION: A MANDATORY DUTY THAT PARTIES ACT IN FURTHERANCE OF THE PUBLIC INTEREST

Part III detailed a number of systematic biases that tend to cause government outsourcing agreements to prioritize cost savings over quality service provision. Governments and private service providers fail to internalize the costs they impose on service beneficiaries. Therefore, putting bargaining problems to the side, contracts will often be underpriced. This Part suggests a potential solution to force the parties to account for the cost of poor service provision. Namely, the transacting parties should be subject to a mandatory duty to act in furtherance of the public interest, and service beneficiaries should be able to sue to enforce breach of the duty.

One of the most significant problems with public-private contracting for soft government services is that neither the private service provider nor the government has a great enough incentive to ensure quality service provision.[216] Relatedly, governments have difficulty controlling private service providers who are motivated by maximizing profit and not by adherence to the overall program goals.

Typically, efficiency theory assumes that mandatory restrictions on contracting parties are inefficient because parties cannot bargain around them when the mandatory rules impose inefficiencies. However, as mentioned earlier, scholars have recognized exceptions. For instance, Robert Gertner and Ian Ayres have argued that regulation in the form of mandatory rules may be justified to protect nonparties to the contract who cannot adequately protect themselves.[217] And it is generally agreed that "[t]he inefficiency of the market when externalities are present can justify restrictions on private contracts."[218] These requirements will often be met in cases of public-private contracting because the people who receive the services will typically be unable to make governments internalize their needs. Therefore, a contracting restriction may be justified.

Contract law can force the parties to internalize the cost of poor service provision. It can also align the goals of the parties. Requiring the parties to act in furtherance of the public interest, both in entering into contracts intended to benefit the public and in performing these contracts, will serve these ends.

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216 *See supra* Part III.A.

217 Gertner & Ayres, *supra* note 125, at 88.

218 Hermalin, Katz & Craswell, *supra* note 118, at 30.

A. *What Would the Public Interest Standard Require?*

The proposed public interest standard would require both contracting parties to take steps to provide service that is in the best interests of the public. The "public interest" currently only plays a limited role in contract doctrine.[219] After all, contract law is conceived of as "private law." But a public interest requirement is also not completely without precedent. Government contracts tribunals have recognized that "because of its size, power, and potential ability to manipulate the market place, the government may have obligations of fairness beyond those of the ordinary citizen."[220] And there is a doctrine of contract interpretation under which a meaning that serves the public interest is generally preferred when choosing among reasonable meanings of an agreement.[221]

The concept of the "public interest" is also prevalent in certain regulatory regimes. For instance, the "public interest doctrine" is a central tenet of communications law.[222] The doctrine is said to originate from English common law, where there was a principle that "businesses affected with the public interest" take on certain social responsibilities enforceable by the law.[223] There are two historic justifications for the doctrine—that certain businesses exhibit a degree of monopoly control[224] and that they "hold out" service to the public at large.[225] These justifications are similar to those that would prompt a public interest standard in public-private contracting.

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219 For instance, the Restatement of Contracts states: "A promise . . . is unenforceable on grounds of public policy if . . . the interest in its enforcement is clearly outweighed in the circumstances by a public policy against the enforcement against such terms." RESTATEMENT (SECOND) CONTRACTS § 178 (1981).

220 Frederick W. Claybrook, Jr., *Good Faith in the Termination and Formation of Federal Contracts*, 56 MD. L. REV. 555, 556 (1997).

221 *See* RESTATEMENT (SECOND) OF CONTRACTS § 207 (prioritizing considerations of public policy over the probable intentions of the parties); *see also* Eyal Zamir, *The Inverted Hierarchy of Contract Interpretation and Supplementation*, 97 COLUM. L. REV. 1710, 1723–24 (1997) (enumerating situations where the rule has been invoked).

222 The phrase "public interest" appears repeatedly in the current version of the Communications Act. *See* Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (codified as amended in scattered sections of 47 U.S.C.).

223 For an interesting account of the evolving meaning of "public interest" in communications policy, see William D. Rowland, Jr., *The Meaning of "The Public Interest" in Communications Policy, Part I: Its Origins in State and Federal Regulation*, 2 COMM. L. & POL'Y 309 (1997).

224 See the discussion of "virtual monopoly" in *Munn v. Illinois*, 94 U.S. 113, 127–134 (1877).

225 *See* Charles K. Burdick, *The Origin of the Peculiar Duties of Public Service Companies, Part I*, 11 COLUM. L. REV. 514, 531 (1911); Joseph W. Singer, *No Right to Exclude: Public Accommodations and Private Property*, 90 NW. U. L. REV. 1283, 1304, 1321 (1996).

There are undoubtedly objections to a public interest duty. The first is that it is difficult to define.[226] At bottom, the "public interest" standard should prevent the parties from providing poor service to the intended service beneficiaries who are not parties to the contract.[227] Perhaps the easiest way to define the requirement is by reference to examples given earlier in this Article. For one, a private jail or halfway house failing to provide adequate security to prevent inmate escapes or to protect inmates in custody would be in breach of the public interest standard. Or in the welfare-to-work context, failing to serve all applicants and instead prioritizing the easier-to-resolve cases would be a breach of the public interest standard. Accordingly, the term "public" in the standard should be construed broadly, but with particular emphasis on the segment of the population most directly affected by the contract (e.g., prisoners or welfare beneficiaries in the examples). Further, the "public interest" standard should require that the contracting parties equally serve all those who the service is intended to benefit.

A related objection is that vagueness may give the courts too much power to decide disputes along ideological lines.[228] But this is not crippling. The purpose of inferring the public interest duty is not to encourage litigation where courts would be forced to parse the meaning of the term.[229] Rather, it is to force better conduct from the parties in negotiating and performing the contract. Parties who are required to promote the public interest will, in theory, be incentivized to behave better and to provide better service in order to *avoid* litigation.[230] Also, it is rare for contracts such as these to result in litigation.[231] And there are

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226 Generally, "economists believe that markets require clear rules about property, contracts, and fraud to assure that goods and services will move to users who are willing to pay the highest price for them." Shell, *supra* note 123, at 499.

227 One admitted difficulty in defining "public interest" is that there is no universal public interest. For instance, as discussed in Part III.A.2, the taxpayers and the service beneficiaries have conflicting interests, although both are a part of the "public." But the point of imputing the public interest standard is to force the parties to internalize the cost of poor service provision to the segment of the public at whom the service is aimed. Therefore, transacting parties cannot satisfy the duty to further the public interest by appealing to the fiscal interests of taxpayers alone without addressing the need for quality service provision for beneficiaries.

228 Vagueness may also impede adequate monitoring, but as discussed in Part III.B.2, monitoring is already problematic and governments are not engaging in much of it.

229 The threat of litigation, however, is necessary to affect behavior during contract performance.

230 This is the logic of the good faith and fair dealing requirement: imposing the mandatory rule will discourage the parties from acting opportunistically. *See, e.g.*, Burton, *supra* note 125. This Part implicitly assumes that the threat of litigation will deter the undesired behavior. Although this is a common assumption, it is an area that is ripe for empirical assessment.

231 The Indiana-IBM and Texas-Accenture examples seem to be the anomalies. A search of case law revealed very few similar cases. This is unsurprising. Where there are limited switching options or high switching costs, governments may be hesitant to cancel contracts and even more hesitant to bring costly litigation. Or for the reasons detailed in Part III.A, the government may not have an incentive to take actions to ensure high-quality service provision.

other contract doctrines that defy precise definition. Good faith and fair dealing is one such example.[232] Nonetheless, the good-faith requirement is thought to serve the purpose of preventing opportunism (although it is also the subject of much critical literature).[233] The concept behind the public interest requirement would be similar but not identical. This is particularly so because the good-faith requirement applies to the transacting parties, while the public interest duty reaches out to protect third-parties to the contract.

Another potential objection is that imposing a mandatory duty would likely increase the cost of the contract. Providing better service (and also increasing potential liability) *will* be costly to the service provider. The service provider, in turn, is likely to try to pass on at least some of that cost to the government. In a sense, though, this is the desired result. Parties to the agreement should be forced to internalize the cost of poor service provision. If the transaction costs more, then that is what efficiency dictates. If the duty increases the cost of the contract such that it is no longer efficient to contract out, that is an indication that contracting out was not the efficient choice in the first instance.[234]

Another potential objection is the mandatory nature of the duty, which the next Section considers.

B. *Why a Mandatory Duty?*

The duty to act in furtherance of the public interest should take the form of a mandatory duty that is implied in all government outsourcing contracts, just as the implied duty of good faith and fair dealing is implied in all contracts. However, economically-oriented scholars generally disfavor mandatory or immutable rules. The traditional justification for opposing mandatory rules, discussed in more detail in Part II.A.4, is that such "rules are inconsistent with the commitment to party sovereignty,"[235] as well as to overall efficient contracting.

Permitting third-party beneficiaries to sue would likely increase litigation, at least to the extent that third-parties can afford to bring suit.

232 *See* Robert S. Summers, *The Conceptualization of Good Faith in American Contract Law: A General Account*, *in* GOOD FAITH IN EUROPEAN CONTRACT LAW 119, 196 (Reinhard Zimmermann & Simon Whittaker eds., 2000) (noting that no unifying meaning of good faith can be devised).

233 *See, e.g.*, Burton, *supra* note 125, at 371.

234 Frankel, *supra* note 214, at 1504–05 ("If it is too expensive for a private company to perform public functions in a way that adequately safeguards federally protected rights, then perhaps those functions should be left to the government to perform."); *see also* Donahue, *supra* note 2, at 49.

235 Schwartz & Scott, *supra* note 23, at 609–10.

And yet there are instances where mandatory rules are necessary. For instance, if the contract imposes third-party effects, or is subject to other market failures, the parties' choice of a contract term "might no longer coincide with the rule that would in fact be most efficient."[236] Such is the case in public-private contracting.

Instead of using mandatory rules, we could consider using default rules that remain in force unless parties decide to contract out of them. But this solution is troubling in the privatization context because parties would likely contract around the default, just as they explicitly disclaim third-party beneficiary suits.[237] Permitting abrogation would defeat the purpose of forcing the parties to internalize the cost of poor service provision. A mandatory rule would not be necessary, of course, if government contracting agents choose to voluntarily insert the clause into their contracts. The government has the bargaining power to do it. The concern is whether they have the incentive to do so.[238]

Assuming that the duty must be mandatory, in a sense, it can be justified in similar terms to the duty of good faith and fair dealing, which is equivalent to a prohibition on opportunistic behavior. The difference is that the public interest duty would prevent opportunistic behavior that negatively impacts third parties, not parties to the contract.

In addition, just as good faith is said to "save parties the cost of negotiating and drafting express contractual provisions that prevent opportunistic behavior,"[239] so too would the public interest duty save

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236 RICHARD CRASWELL, CONTRACT LAW: GENERAL THEORIES 3 (1999); *see also* Cooter & Ulen, *supra* note 114, at 295 (stating that a perfect contract requires no regulation, but an imperfect contract may require mandatory rules, a form of regulation); Schwartz & Scott, *supra* note 23, at 618 (stating that rules should be mandatory only when "the parties' contract creates an externality or is the product of market failure."). There are other ways to respond to externalities and market failure. For instance, requiring disclosure can sometimes abate a negative externality. And there are ways to cure market failures. But none of these seems to be a viable option in this context.

237 Interesting literature has posited that default rules can be "sticky," meaning that parties are influenced in their choices based on the choice of default. *See* Korobkin, *supra* note 124, at 608. Nonetheless, a mandatory rule is preferable, here, because the parties have a clear incentive to contract around the rule to avoid increasing the cost of the contract and the cost of future litigation.

238 If contracting agents cannot be entrusted to require the clause in outsourcing contracts, the other possibilities are an expansion of the common law or legislative action. Good faith and fair dealing came about through the common law. *See* Burton, *supra* note 125, at 369. An expansion of that duty in the context of public-private contracts is possible. Or perhaps the legislative branch (with different interests than the executive branch), might pass regulations to the same ends. Conceivably, the legislature, reacting to negative publicity about low service quality, could require that a public interest duty be read into outsourcing contracts. Federal government contracts are highly regulated (in the government's favor). It is not a stretch to imagine that state legislatures would want to regulate state outsourcing contracts, as well.

239 Simone M. Sepe, *Good Faith and Contract Interpretation: A Law and Economics Perspective* (Ariz. Leg. Stud. Discussion Paper No. 10-28, 2010), *available at* http://papers.

the parties the cost of bargaining for specific contractual provisions to define what behavior would be in the best interests of the public. Specifying contracts is costly and difficult to accomplish. Without specification, one concern is that service providers will take advantage and act opportunistically.[240] However, requiring parties to act in furtherance of the public interest minimizes that risk.

C. *Enforcement*

Another potential constraint of the public interest duty is that it may not effectively deter the imposition of costs on third parties unless the threat of litigation is real. Put another way, if neither the government nor the private service provider were incentivized to provide quality service under the old regime, neither will be incentivized to sue to enforce the duty under the proposed regime. Therefore, this Section suggests that members of the public for whose benefit the service was being provided—and who are harmed when service provision is poor—should be permitted to sue as third-party beneficiaries for breach of the public interest duty.[241]

The standard (commercial) third-party beneficiary rule provides that a party who is not a signatory to a contract can sue to enforce the contract in limited circumstances. Typically, the nonparty must establish that the contracting parties intended to benefit him or her through the contract.[242] Because parties to a contract can create a right in a third person, the third-party beneficiary rule is said to enhance judicial economy by permitting a direct action against the promisor.[243]

But the standard for achieving third-party beneficiary status to a government contract is more stringent than the commercial contract standard. It is not enough for a third party to show that the purpose of the government contract was to benefit the public. Rather, the terms of the government contract must directly provide for *liability* to the third party.[244]

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ssrn.com/sol3/papers.cfm?abstract_id=1086323; *see also* Market Street Assocs. Ltd. Partnership v. Frey, 941 F.2d 588, 595 (7th Cir. 1991) ("Good faith is a compact reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties.").

240 *See, e.g.*, Richard Speidel, *The Characteristics and Challenges of Relational Contracts*, 94 NW. U. L. REV. 823, 846 (2000) (similar to the concept of the public interest duty, advocating expansion of duty of good faith to help parties maintain long-term relational contracts).

241 *See, e.g.*, Patience A. Crowder, *More Than Merely Incidental: Third-Party Beneficiary Rights in Urban Redevelopment Contracts*, 17 GEO. J. ON POVERTY L. & POL'Y 287, 289 (2010).

242 *See* RESTATEMENT (SECOND) OF CONTRACTS § 302 (2009).

243 *Id.* § 304.

244 *Id.* § 313.

The heightened standard is usually justified on the basis that the government typically contracts on behalf of the entire public. Therefore, almost anyone could allege standing to sue for breach of contract. The example that is often given is that the government might contract with a private provider to heat a public building. If the heat goes out and a member of the public catches a cold, he should not be permitted to sue the heating company. Put another way, the stricter rule is thought to prevent private parties who contract with the government from limitless litigation.[245] It avoids the situation where private parties will choose not to enter into contracts with the government because of the risk of litigation.

Under current law, then, it is very difficult for a third party to gain standing to sue under a government contract. This is particularly so where there is an express clause disclaiming the intention to benefit third parties, as is often the case in such contracts. "No third-party beneficiary" clauses are almost always controlling.[246]

But the objections to a broader right of third-party suit under government contracts do not hold water here. First, contracts for the provision of soft government services generally do not affect the entire population, but rather a narrower segment of the population.[247] The majority of the population will never be an inmate in a prison or apply for welfare benefits. The segment of the population that is most affected by these services typically lacks financial resources (at least in the welfare and prison examples). Therefore, the onslaught of litigation pictured by proponents of the stricter rule is unlikely.[248]

Second, permitting third-party suits will increase the cost of the contract. However, that increased cost reflects the true cost of the bargain between the parties. If the increased price means the contract is no longer efficient for the parties to enter into the contract, then the contract should not be formed in the first place.[249]

The current system (absent the mandatory duty) benefits companies who reduce quality to reduce cost. Essentially, companies who underbid and then perform poorly win out over companies that

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245 *See* Michele Estrin Gilman, 55 VAND. L. REV. 799, 844 (2002) ("Especially where government contracts are concerned, courts are hesitant to grant enforcement rights to the public at large, fearing a limitless class of plaintiffs.").

246 *See* Crowder, *supra* note 241, at 303.

247 Even under the current regime, where the beneficiaries constitute a more discrete and identifiable class, they have greater success in enforcing public contracts. *See, e.g.*, Anthony Jon Waters, *The Property in the Promise: A Study of the Third Party Beneficiary Rule*, 98 HARV. L. REV. 1109, 1186 (1985) (citing various cases where third parties gained standing to sue for breach of government contracts).

248 It is presumed that the threat of some litigation will still have a deterrent effect. This is particularly true to the extent that class actions are possible.

249 *See* Frankel, *supra* note 234, at 1504–05.

would bid more accurately and then perform better. Permitting third-party suits would ultimately benefit companies providing high-quality services. Companies usually get sued when they harm service beneficiaries. To the extent that the mandatory duty imposes costs, it exacts the greatest cost increases on the poorest performers.[250]

In sum, a contract mechanism can force the parties to internalize the cost of poor service provision and prompt better quality service from the private provider. A mandatory duty to act in the public interest will align the objectives of the government and the private provider and force them to consider the cost of poor service provision to beneficiaries.

CONCLUSION

Privatization advocates urge that introducing market competition into government services will result in both cost reduction and better quality service. They argue that private providers have expertise, are better able to innovate, and are unconstrained by government bureaucracy. But while privatizing may reduce costs, it also often results in poor quality service provision.

Public law scholars have explored this problem, but their analysis is incomplete because it does not consider these issues from a commercial law, and in particular an efficiency theory, perspective. Doing so sheds light on the systematic reasons for these failures. First, the government does not have adequate incentive to force the service provider to provide quality service. The government is caught serving two masters—the service recipients who want high-quality service and the rest of the public that prefers that less be spent on such services. The service recipients have little economic or political power. Therefore, the government is incentivized to prioritize cost cutting above all else. Laws requiring that government outsourcing cut costs over government provision enforce this result. Government actors are also not likely to be in office long enough to see the effects of poor service, and even if they are, they can point their finger at the private service provider for errors.

Second, even if the government were adequately concerned about providing high-quality service, it is difficult to control the private service provider where competitive markets are lacking, tasks and desired outcomes are difficult to specify, and monitoring is both difficult and costly. As a result, the contracting parties tend to impose a cost on

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250 *Id.* at 1504 (noting that in context of expanding respondeat superior liability to government contractors, and that cost increases most affect those firms that are the biggest civil rights violators).

service beneficiaries in the form of poor service provision. There are inadequate mechanisms to force the parties to internalize this cost.

Because these unregulated contracts are inefficient and impose costs similar to negative externalities, contract restrictions are necessary. This Article suggests that a mandatory duty to further the public interest should be imposed on the parties to government outsourcing contracts. Those who are harmed by poor service provision should be permitted to sue for breach as third-party beneficiaries to the contract. Although state and local-level outsourcing agreements suffer from the effects of poor markets and agency costs, these problems can be addressed and abated using contract mechanisms.