Privatization, Policy Paralysis, and the Poor

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Having survived deep budget cuts and the partial dismantlement of their legal structure, subsistence benefit programs now face an even more severe threat to their existence: the dismantlement of the agencies that deliver these benefits. Some states are replacing the agencies operating Medicaid and food stamps with private contractors while others are simply dismantling the agencies and leaving low-income people on their own to find free or paid assistance with application procedures. The loss of these agencies will irreversibly limit the scope of assistance for the poor. To date, however, critics have focused on the problems with contracting rather than on the loss of programmatic capacity.

These programs long have privatized some functions. Whether the government should continue providing other services itself or should purchase them on the market is a “make-or-buy” decision familiar to the theory of the firm. The market is superior to internal production only when the transaction costs of arranging purchases are less than agency costs within the entity. With no competitive market for many of the functions required to operate a public benefit program, privatization is unlikely to be efficient. The earned income tax credit and disability benefit programs lose much of their benefits’ value by leaving low-income people on their own to find help navigating the application process.

Inappropriate privatization also can prevent programs from maximizing the electorate’s utility by ossifying policy-making, increasing information costs, and impairing public officials’ agency. Efficiency rather than ideology should determine the extent of programs’ reliance on the private sector.
INTRODUCTION

Anti-poverty programs require three things to operate. First, they need money. Second, they need principles for determining who is to benefit and by how much. And third, they need an administrative infrastructure to deliver the money (or what it buys) to the people the program intends to help. Over the past three decades, opponents have assaulted each of these components.

In the early 1980s, President Ronald Reagan attacked these programs in the most direct way, by cutting their funding. Claiming that it was crucial to revive a sluggish economy, President Reagan pushed through Congress a package of cuts in social programs of unprecedented depth and breadth.\(^1\) The principal targets were Aid to Families with Dependent Children (AFDC), Supplemental Security Income (SSI) for the elderly and disabled, and the Food Stamp Program, but many other programs took hits.\(^2\) After Congress had enacted the cuts, Office of Management and Budget Director David Stockman admitted that a supposed carefully-crafted economic plan did not, in fact, exist.\(^3\) As their human toll became apparent,\(^4\) Congress reversed many of the Reagan cuts and, by the early 1990s, anti-poverty spending was on the upswing.\(^5\) Because the programs' legal and administrative infrastructure remained, these restorations were relatively straightforward.

In 1995, Speaker Newt Gingrich and a new conservative Congress launched a second attack on social welfare programs. By stripping away their legal infrastructure, these changes made programs' funding levels arbitrary and hence much easier to cut in the future.\(^6\) As was the case during the Reagan era, supposed economic necessity formed a crucial part of the argument: welfare and food stamp caseloads were said to be rising "out of control,"\(^7\) requiring urgent action to safeguard the federal fisc. Congress completely eliminated the legal infrastructure of AFDC and most major federal-state child care and job training programs;\(^8\) it came within a whisker of doing so for food stamps (ultimately settling for another round of deep budget cuts in food stamps, SSI, and

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10. *Id.* Although federal law did not compel them to do so, states maintained a largely legalistic administrative structure for their cash assistance programs under the Temporary Assistance for Needy Families (TANF) block grant that replaced AFDC. The 1996 welfare law’s shift of financial responsibility for cash assistance from the federal government to the states did effectively prevent the cash assistance rolls from expanding to meet increased need in a recession for the first time since the Great Depression. The effects of the Deficit Reduction Act of 2005’s assault on Medicaid’s legal infrastructure remains unclear.


determination, with five more considering similar moves.\textsuperscript{14}

Like the budget cuts of the early 1980s and the disentitlements and further budget cuts of the 1990s, the privatization movement initiative motivates policymakers along fiscal as well as ideological lines. State budgets are facing simultaneous pressure from rising health care costs, increasing levels of incarceration, demands for more education spending, extensive federal cost-shifting, and politically powerful anti-tax movements. Program administration becomes a politically appealing target during cyclical fiscal crises, and may remain so, as governors and legislators seek to finance new spending or tax cutting initiatives. Administrative costs, however, consume relatively small shares of these programs' budgets. Thus, states must make radical cuts to show appreciable progress. Proposals to eliminate large numbers of eligibility workers can plausibly promise savings on that scale; more routine belt-tightening cannot. Like the earlier assaults on these programs, many privatization plans are being designed to backload most of their cuts: with few savings extracted in their early years, opponents have little practical harm to cite in seeking repeal. IBM has promised to save Indiana half a billion dollars of administrative savings—a staggering sum that could only come from massive reductions in staff—but almost none of it is in the first two years of the ten-year contract, and neither the state nor the company have made public any details about how those savings will eventually be obtained. Texas, by contrast, billed privatization as the solution to a short-term fiscal problem, sought to extract huge immediate savings, and quickly exposed the deficiencies in its plan.

As with the two earlier waves of assaults on subsistence benefit programs,\textsuperscript{15} a protective counter-effort has begun. In July 2007, the U.S. House of Representatives passed legislation that would prevent privatization of eligibility determinations and related functions in the Food Stamp Program.\textsuperscript{16} The provision survived, largely along party lines, votes on repeated efforts to strike it,\textsuperscript{17} leaving its ultimate fate unclear at this writing. Even if it becomes law, however, this provision would not affect any other public benefit programs, such as Medicaid. Should food stamp administrative funds become unavailable to pay for contracts with vendors, the administrative and financial feasibility of privatizing those other programs is unclear. Yet even if the food stamp anti-privatization amendment passes and becomes a de facto limitation on other programs as well, one increasingly prominent form of privatization would be unaffected: the dismantlement of much of the public eligibility


\textsuperscript{15} See Super, \textit{Quiet Revolution}, supra note 9, at 1315-22.


determination structure without replacement, leaving low-income people to either to purchase application assistance services on the private market or to struggle on their own without them. 18

Analyzing the privatization movement is particularly vital now because rebuilding agencies once they are dismantled will prove far more difficult than restoring budget cuts or recreating legal structures has been in the past. The cost in time, money, and political capital will likely be unaffordable: building excitement around restoring subsistence benefits or preserving procedural due process is far easier than motivating policymakers and voters to recreate bureaucracy. The lack of such a bureaucracy may prevent federal and state governments from targeting limited aid budgets to those most in need and from imposing sufficient assurances of program integrity to make programs politically viable. 19

To date, liberal academic criticism has focused less on economics than on public values. 20 Some have seen privatization as a threat to government service as a public-spirited profession. Others see important expressive values in publicly providing services to those in need. Still others focus on the danger that privatization will impair due process of law 21 and other modes of holding the government accountable for programs’ performance. 22 This focus of liberal criticism is ill-advised for political, ethical, and practical reasons.

Politically, arguments about broad public values necessarily talk past the privatizers’ key arguments. For many policymakers, the fiscal benefits promised from private administration will seem far more compelling than the subjective costs of estranging the people’s government from the dispensation of humanitarian aid. Moreover, to the extent that opponents of privatization raise claims that sound too ethereal for journalists and much of the public to

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18. The Senate-passed version of this legislation would require additional data and review of such changes, but would provide no new substantive bar to their implementation. H.R. 2419 (engrossed amendment as agreed to by the Senate).


appreciate, or too emotional to take seriously, they leave themselves open to charges that their true motivation is, at best, unjustified nostalgia and, at worst, shilling for public employee unions. Sensing this, privatization’s critics have focused their attacks on contractors’ reliability in the popular media, and now in Congress. Without a coherent theory as to why contractors are likely to be unreliable, these arguments are unlikely to win broad acceptance.

Ethically, categorical opposition to private contracting in all of its forms is unjustified. Few seriously argue that only public employees should distribute the food that the Food Stamp Program provides or deliver all health care under Medicaid. Private contractors’ role in providing data processing services is well-established and not especially controversial. Banks redeem vouchers in a variety of programs. Yet, the public values critique has difficulty distinguishing between these benign forms of privatization and the liquidation of agencies’ core administrative capacity. A useful theory of privatization must provide a basis for defeating destructive proposals without cutting programs off from genuine gains from dealing with the private market.

And practically, reliability arguments offer little guidance on responding to radical changes in program administration that do not involve the wholesale replacement of civil servants with private contractors. For example, Colorado dropped private eligibility workers early in the formulation of its “modernization” plan, but threw its programs into protracted chaos when it shifted most of the authority that eligibility workers had exercised to an ill-designed computer system. Florida abandoned private contracting when senior officials were forced to resign over ethical issues involving other state contracts, but proceeded with a “modernization” plan that has closed most of its offices and laid off two-thirds of the staff that determines claimants’ eligibility. In practice, this has meant that low-income people, unable to navigate the application process themselves, must seek out friends, neighbors,
or staff from local community organizations to help them. This is a different, even more radical, form of privatization, with those states leaving low-income people to identify and motivate replacements for eligibility workers. Eliminating eligibility workers entirely will make public benefits less accessible and reduce participation among eligible, needy people. This is the logical culmination of a regime of public benefits law that relies on deterring participation in lieu of rationing eligibility with explicit substantive rules.  

The real threat is not the use of unreliable private contractors but rather the destruction of stable structures that assist low-income people in establishing their eligibility. A critique that ignores what is being taken away and instead focuses on the inadequacies of the replacement being offered is almost certainly doomed. In late 1994 and early 1995, liberals attacked House Republicans' Contract with America  

for not stripping millions of low-income families of subsistence benefits, but rather for proposing to spend some of the savings on orphanages for children whose parents would no longer be able to care for them.  

The Republicans quickly dropped the orphanages but kept the benefit cuts and enacted them into law.  

Similarly, attacking private contractors but not the liquidation of the public bureaucracy is likely to leave low-income people with even less access to key benefits.  

Critics of the movement to dismantle the agencies administering public benefit programs should follow the example of the conservatives who turned the tide in the 1970s against persistent efforts to dismantle large corporations through antitrust law.  

Those scholars argued that policies promoted as increasing competition did just the opposite. They were dismayed that policies purporting to protect consumers were creating inefficiencies that would in fact hurt consumers.  

Similarly, they saw nostalgic attachment to family businesses driving policies that burdened small firms.  

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29. The Contract with America was the ten-point election manifesto on which Newt Gingrich led House Republicans to victory in the 1994 mid-term elections. One of its components was "welfare reform," which ultimately led to PRWORA.


33. See Bork, supra note 32, at 7.

34. See id. at 7-8; Areeda & Hovenkamp, supra note 32, ¶ 111e3.

35. See Bork, supra note 32, at 203-05; Areeda & Hovenkamp, supra note 32, ¶ 100b; Dominick T. Armentano, Antitrust and Monopoly: Anatomy of a Policy Failure 277-
condemned an ideologically-driven "nihilism" that demanded the break-up of large corporations, regardless of the cause or consequences of their size.\textsuperscript{36} They lamented that this populist attack on large corporations would have far-reaching consequences, destroying the means necessary for undertaking some of this country's most important activities.\textsuperscript{37} This challenge to the purported benefits of breaking up companies simply because of their size proved overwhelmingly successful.\textsuperscript{38}

Today, champions of programs for low-income people similarly need to show that policies purporting to promote competition would in fact have the opposite effect.\textsuperscript{39} They must dispel the nostalgic, unrealistic assumptions about the capabilities of small religious groups and other charities invoked to advance policies that would badly weaken those charities.\textsuperscript{40} They must expose the modern version of what Robert Bork termed "heedless nihilism."\textsuperscript{41} Just as conservative economists worried that overzealous antitrust enforcement would deprive this country of the means to make economic progress, those committed to a compassionate state have reason for concern that ill-conceived privatization will both harm vulnerable recipients in the short run and deprive this country of the basic infrastructure required to pursue a compassionate agenda.\textsuperscript{42}

This Article seeks to rectify the shortcomings of contemporary critiques of privatization. It tests privatization against its own measure of success: economic efficiency. Initially, this is the kind of "make-or-buy" decision familiar to the theory of the firm. Should the government decide to obtain services externally, it faces a second-order decision whether to contract for those services in bulk—for example, by hiring a private contractor to replace its network of eligibility offices—or to leave low-income people to contract for or secure donations of application assistance services individually. Because as many as ten distinct services are required to deliver public benefits, several different answers to these questions are possible—as well as several different

\textsuperscript{36} See Bork, supra note 32, at 5-6; Posner, Antitrust, supra note 32, at vii.
\textsuperscript{37} See Bork, supra note 32, at 4, 9-11 (accusing the Court of "destroy[ing] a broad spectrum of useful business structures and practices" and declaring then-current policies "ultimately incompatible with the preservation of a liberal capitalist social order").
\textsuperscript{38} See id. at ix-x; Richard A. Posner, Antitrust Law vii-x (2d ed. 2001) [hereinafter Posner, Antitrust 2d ed.].
\textsuperscript{39} See infra Part III.C.1.
\textsuperscript{40} See id.
\textsuperscript{41} Grover Norquist, an influential conservative leader, has declared his intention to "reduce [government] to the size where [he] can drag it into the bathroom and drown it in the bathtub." Interview by Mara Liasson with Grover Norquist, Morning Edition (NPR radio broadcast May 25, 2001).
\textsuperscript{42} Privatization has become a major component of coordinated conservative efforts to dismantle social welfare programs. See David Stoesz, Responding to the Crisis: Conservative Prescriptions, in Reconstructing the American Welfare State 43, 50 (David Stoesz & Howard Jacob Karger eds., 1992).
bundlings of these services.

Part II considers the range of possible allocations of responsibility between the public and private sectors in the operation of means-tested public benefit programs, programs that base eligibility on claimants' incomes and sometimes resources. It concludes that neither complete public administration nor complete privatization are realistic options and, despite the sweeping rhetoric on both sides, neither is under serious political discussion. Instead, with one set of functions almost inevitably public and another set firmly entrenched in the private sector, debates about privatization of public benefit programs in fact focus on a relative handful of activities, albeit important ones.

Part III examines economic considerations affecting state and federal governments' ability to benefit from competition for these aspects of program operations. It identifies the structural issues the government must resolve to foster competition either by contracting with one or several companies to provide all of a program's needs for a particular good or service for a specified period of time, or by allowing private vendors to compete on an on-going basis to provide each unit of service required. It also examines the programs' experience with each route, in particular those of the one major federal means-tested program that lacks a full public eligibility determination bureaucracy: the Earned Income Tax Credit (EITC).

Part III then frames this discussion in the broader context of what the theory of the firm teaches about optimal modes of business organization. Specifically, it explores the circumstances under which coordination of activities within one entity is likely to produce superior results than competition between outside firms for the opportunity to provide needed goods and services. It finds that in many of the aspects of program operations subject to current privatization debates, conditions are not propitious for competition.

Finally, recognizing that proposals for partial privatization of programs' operations are, in effect, efforts to break up the large integrated entities—local, state, or federal agencies—that now run these programs, Part III proceeds to draw lessons from the branch of law devoted to ensuring that large combinations of economic power do not obstruct competition: antitrust. It finds that the agencies now administering many means-tested programs are, in many respects, horizontally integrated, vertically integrated, and conglomerates. Still, Part III finds that much antitrust scholarship suggests that action against this sort of combination is unwarranted. It also finds that tying of some sort—providing one product jointly with another that one wishes to promote—is a major objective of many of those on both sides of the privatization debate. The appropriateness of tying the services in public benefit programs to other public and private services, increasing the likelihood that participants in one program will obtain other services from the same provider, is largely a normative one involving the propriety of the government promoting consumption of one kind over another.
Part IV moves to the impact privatization may have on the efficiency of policymaking for means-tested programs. Chiefly, it considers the impact of contractors treating program information as propriety on the public’s access to information about the program and hence the ability to make informed decisions about the program’s direction. It also considers the potential that lobbying by those operating a program—public employees or private firms—could distort political decision making.

Part V concludes with a narrow discussion of safeguards that might be prudent if a political decision is made to continue contracting out additional aspects of public benefit programs’ operations. It also offers some broader observations about commonalities between this particular privatization debate and others involving Social Security, other government services, and war-making. It finds that many of the oft-overlooked factors militating against additional privatization of public benefit programs’ administration also counsel against radical shifts in the manner in which the government performs those other functions.

II OPTIONS FOR PRIVATIZATION

When scholars or policymakers debate privatization of government-owned businesses, their meaning typically is clear. Before privatization, the government owned the mine, utility, railroad or bank, made or delegated all short- and long-term decisions about the business’s operation, and absorbed its profits or losses. After privatization, one or more individuals outside the control of the government own the business, make its short- and long-term decisions, and collect its profits or incur its losses.

Debates about “privatization” of public welfare programs typically operate as if the process under discussion were similarly crystalline. It is not. As this Part shows, government financing ensures that a substantial public role will remain under any configuration. Thus, privatization in the context of public benefit programs involves sharing rather than transferring responsibilities. The differences between possible methods of sharing responsibilities may be even more significant than the difference between “privatization” and traditional methods of administration. Accordingly, much of what is understood about privatizing enterprises that sell goods and services in the market is inapplicable to the privatization of public benefit programs.

Analyzing proposals for privatizing the operation of public benefit programs requires an understanding of the functions required for those programs to deliver aid to their intended beneficiaries and how these programs currently divide the various functions between the public and private sectors. Section A offers a simple typology of those functions. Section B then divides those functions into three groups: those almost inevitably performed by the government, those likely to continue to be performed by private businesses, and
those on which current debates center.

A. The Functions of Public Welfare Programs

Public debates over privatization of government programs tend to have a misleadingly binary character. Either a program will be privatized, we are told, or it will not be. More sophisticated analysts may recognize that varying degrees of private involvement are possible, but fearing or desiring slippery slopes, advocates on both the left and the right prefer to draw lines in the sand.

Virtually every significant social welfare program is partially privatized; operating these programs without private entities performing some important roles is virtually unthinkable in our political culture. On the other hand, complete privatization is rarely a serious possibility. Indeed, if it were, the law would provide no obstacle. The fundamental question, then, is which functions should be assigned to the government and which to private entities. Once this is resolved, a host of subsidiary questions arise about how the relationship between public and private participation should be managed.

Operating a public benefit program entails several distinct functions. Any attempt to list them is inherently arbitrary. Nonetheless, most programs require eight or ten major steps to deliver benefits to people in need.

First, prospective claimants require some assistance in applying for the program. Claimants require assistance—both at the outset of their participation and at periodic eligibility reviews. The extent of the help required varies: some may require only a copy of the application form and information about when and where to submit it; others may need help completing the form and gathering information required to complete the form or to persuade the program to accept the assertions on the application. The extent of these needs may vary with the complexity of substantive and procedural requirements, the extent of its measures to prevent incorrect awards of benefits, and the characteristics—such as education, disability, and living arrangements—of the individual claimant. Some programs value eligible persons' participation sufficiently to conduct outreach to inform prospective claimants of the procedures for

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43. A similar false dichotomy affects discussions of changing relationships between federal and state governments. PRWORA, supra note 8, is commonly described as "turning welfare over to the states." In fact, states already had vast control over the Aid to Families with Dependent Children (AFDC) program that preceded PRWORA's TANF block grant, see 42 U.S.C. §§ 601-608 (1994) (repealed 1996), and the federal government continued to exercise substantial control and to provide an even greater share of the funding for TANF. See, e.g., 42 U.S.C. §§ 608, 609 (2000) (imposing detailed work requirements on states and providing for a range of penalties on states not meeting various federal requirements).

44. Completely privatized public benefit programs are called charities. Apart from some measures to ensure transparent financing, the law does not limit private charities' distribution of benefits. Only partial privatization, the combination of public financing with private administration, raises legal issues.

Second, someone must set eligibility criteria and procedures. The first step in this process is typically legislation authorizing the program. Beyond that are a wide range of definitional questions relating to the substantive criteria and important details that must be supplied on procedural matters. Some of these decisions are promulgated in formal regulations, but the volume of issues that must be resolved is sufficiently large that senior administrators typically must decide which to address in manuals and which to leave to the discretion of those charged with making eligibility determinations. To inform policymaking, someone typically conducts at least informal research into the program’s operations and effectiveness.

Third, someone must determine whether each claimant meets those eligibility criteria and procedural requirements. In some programs, this function may be divided between an initial or presumptive determination and a subsequent, final decision made by a more responsible authority or one with better information.

Fourth, someone must keep records of those eligibility decisions. These records are important to carry out those decisions and to allow for challenges both by claimants that believe they received too little and by auditors checking to see if claimants received too much.

Fifth, someone must issue benefits to claimants found eligible. To reduce the risk of corruption, this normally should be someone other than the person that determines whether individuals are eligible.

Sixth, in many programs, someone must convert the benefits issued into a form that is useful to the claimant.

Seventh, in many programs, someone must arrange the reimbursement of

46. See, e.g., id. § 272.5 (setting out food stamp policies on disseminating program information).
47. See, e.g., 7 U.S.C. §§ 2013(c), 2014(b) (2000) (granting USDA authority to regulate the food stamp program).
48. See, e.g., id. § 2026 (authorizing policy research in the food stamp program).
49. See, e.g., 7 C.F.R. §§ 273.2(g), (i), 273.10 (2007) (setting out food stamp procedures for determining eligibility).
50. See, e.g., id. §§ 272.1(e)-(f), 272.10, 273.2(f)(6) (imposing record-keeping requirements on states administering the food stamp program).
51. See David A. Super, Are Rights Efficient? Challenging the Managerial Critique of Individual Rights, 93 Calif. L. Rev. 1051, 1097-1117 (2005) [hereinafter Super, Efficient Rights] (arguing that audits or “counter-entitlements” typically have a greater influence on programs than claimants’ due process rights).
53. See, e.g., id. § 274.3(d)(2).
54. See, e.g., id. §§ 278.1-278.4 (setting out procedures for purchasing food with food stamps). Even in programs providing cash to recipients, someone must cash the recipient’s check or deliver cash to the recipient in response to an electronic authorization.
the providers that convert the benefits for the claimant.  

Eighth, someone must resolve disputes with claimants concerning eligibility and issuance.  

Ninth, someone must pay for the benefits.  

Tenth and finally, someone must review performance at each of these steps to protect the program's integrity.  

B. The Inevitability of Mixed Administration of Programs

Complete privatization of all these functions would essentially end the public character of a program. Terminating a public program is the truest form of privatization. Numerous such wholly-privatized programs do exist: private charities. Federal and state law subsidize these private programs' operations with tax breaks for contributors. When reducing or eliminating a program, politicians sometimes argue that private charities can pick up the slack. Little evidence, however, supports the assumption that private charities have sufficient excess capacity to replace public programs aiding low-income people. Indeed, the scope of private charitable giving to low-income people pales relative to either public spending or need. Thus, current debates start from the practical reality of partial privatization.

Another sweeping approach is to pay for benefits not with public tax dollars but rather with moneys extracted from one segment of the public through regulation. Thus, rent control can be considered a housing subsidy program funded through regulatory transfers rather than taxation. In a similar vein, public utility rate regulation that imposes artificially high rates on one segment of consumers to subsidize services to another privatizes payment for benefits. Economists, however, tend not to give these schemes high marks for efficiency, and champions of privatizing public benefits have shown little interest in adopting this model. Moreover, although the funding of these

55. See, e.g., id. §§ 278.5-278.8 (establishing redemption system for used food stamps).
56. See, e.g., id. § 273.15 (setting out food stamp fair hearing procedures).
57. See, e.g., id. §§ 271.5(a), 278.5(a)(1) (establishing the federal government's obligation to pay all food stamp benefit costs).
58. See, e.g., id. pt. 275 (requiring states to operate a performance monitoring system under federal oversight).
63. Rate-setting to cross-subsidize particularly needy groups is not discussed in major works on privatization of human services. See, e.g., The Privatization of Human Services:
subsides is private, the invocation of the government’s regulatory power effectively compels it to play a substantial policy-making role to determine how much should be extracted from one segment of consumers and provided to another.

Although complete privatization of public benefit programs is not plausible, public programs depend heavily on the private sector. Private firms and individuals almost always transact benefits, providing rental housing in exchange for Section 8 vouchers, food in exchange for food stamps, and medical care to persons presenting Medicaid cards. Private contractors also commonly design and operate automated record-keeping systems, issue benefits, design and distribute outreach materials, design and operate systems to reimburse providers, and conduct program evaluation studies. Indeed, public benefit programs’ reliance on the private sector has increased substantially over the years and with little controversy. The most significant difference between the Food Stamp Program and the commodity distribution programs that preceded it, as well as today’s TEFAP, is privatization of the distribution of food through commercial food retailers. That decision sharply reduced program costs and increased recipients’ choices among foods. Thus, the question about whether private contractors should have a role in the operation of public benefit programs has never been seriously in doubt.

The debate about privatization thus centers on relatively few of the functions required to operate a program, albeit important ones. If the government is going to pay for a program’s benefits (the ninth function on the list in Section A), few question that it must have the means for overseeing the integrity of the use of taxpayers’ funds (the tenth function). Controlling the outflow of funds also requires substantial policymaking (the second function). On the other side, opponents of privatization seem little interested in reclaiming for the public sector many of the functions that the government long ago entrusted to private entities. Issuance, conversion, and redemption of benefits—the fifth, sixth, and seventh functions—were privatized decades ago. Private companies also have played steadily increasing roles in developing and maintaining automated record-keeping systems for programs (the fourth function). Although problems have arisen in each area, no broad movement to restore these functions to the state appears to be in the offing.

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65. The House legislation restricting privatization of the Food Stamp Program contains exceptions for each of these functions. See supra note 16.

66. Interestingly, Texas, which for a decade has been a leader among states seeking to privatize responsibility for determining eligibility in the Food Stamp Program, partially restored state control over food stamp issuance after becoming dissatisfied with what private contractors were offering.
The debate attaches primarily to proposals to shift part of one function and part or all of three others from the government to private firms: assisting claimants with the application process, making substantive and procedural policies, determining eligibility, and resolving disputes (the first, second, third, and eighth functions in Section A’s list). Many privatization proposals involve only some of these activities or would divide some between the government and private entities. The four disputed activities are different enough from one another that a sensible allocation of responsibility for one may provide little guidance as to how another should be handled. Moreover, important differences among programs may suggest different allocations of responsibility. Finally, the fact that the government or the private sector may have bungled assigned responsibilities on some occasions is not definitive evidence that it should not be entrusted with those responsibilities. If the source of the problems can be identified as springing from particular structural flaws that could be avoided in the future, the only conclusions drawn should be about the flawed structure.

The remainder of this Article seeks to combine theory and available experience to identify the circumstances under which private operation of public benefit programs may be efficient and those where it may lead to difficulties. As an initial point, it is necessary to determine which of the four public benefit program operations at issue are most efficiently performed internally by the government and which are best organized through the price mechanism on the open market.

III
THE ECONOMICS OF CONTRACTING OUT PUBLIC BENEFIT ADMINISTRATION

Some functions of public benefit programs are most efficiently performed by the government directly; others are best contracted out. The key to maximizing the electorate’s return on the resources it invests in public benefit programs is to identify which kinds of activities fall in each category rather than to allow an ideological preference for or against privatization force an unwise decision.

An initial caution is in order. Private businesses’ reputation for efficiency owes much to their ability to focus on clear, unitary objectives. Where providing a good or service cost-effectively is the sole objective, and where success can readily be measured in dollars, that focus is highly desirable. If the goal of a mine is to produce as much ore as possible while keeping the marginal costs of extraction below the marginal value of the ore, politicians’ interest in using mining jobs for patronage, or in limiting competition with a less-efficient mine owned by their political allies, only gets in the way. Thus, the effects of privatizing government-owned industries are easy to measure monetarily—and likely to be positive.
The goals of public benefit programs, however, are rarely unitary. The same laser focus on the bottom line that makes private business the most efficient way of providing most goods and services can hinder and distort the administration of government programs with multiple and shifting objectives. The satisfaction of the electorate, the owner and investor in public benefit programs, likely depends not on the magnitude of the dollar return on that investment but rather on achievements in several quite diverse areas, many of which are difficult to measure: the amount of hardship averted, the amount of positive behavior (however defined) stimulated, the success in limiting fraud and other kinds of undesirable behavior, and so forth. The "bottom line" for these programs is neither simple nor static.

With this caveat in mind, this Part applies economic and legal theory to determine which functions required to operate public benefit programs are most efficiently performed internally by the government and which are best organized through the price mechanism on the open market. Section A applies the economic theory of the firm to identify criteria determining whether production of a good or service is best organized within an organization or on the market through the price mechanism. It then applies those principles to determine when the government can most efficiently perform public benefit programs, which are best purchased from the private sector through long-term contracts, and which are best obtained through spot purchases as needed on the private market. Section B considers the possibility of an on-going public-private competition to provide services public benefit programs require. Finally, section C views the concentration of many functions of public benefit programs in the government through the lens of antitrust law.

A. Programs' Three Options for Obtaining Goods and Services

Shorn of the emotive rhetoric that surrounds privatization, this debate essentially concerns the "make-or-buy" decision familiar to businesses and economists. After seven decades, Ronald H. Coase's article on The Nature of the Firm remains the starting point for these inquiries. Coase noted that while decentralized actors guided by the price mechanism controlled the allocation of resources between firms in the market at large, within a firm a centralized command and control system determines where resources will go. Recog-
nizing that firms were not necessarily inefficient means of organizing production despite their failure to rely on competition and the price mechanism, he sought to understand the circumstances under which a firm can most efficiently produce goods and services internally, relying on its managers' allocations of resources, and those under which the firm can obtain goods and services more efficiently on the open market.  

The "make-or-buy" decision for the government typically comes down to three choices.  

First, the government may make a factor of production—a good or service required to operate one of its programs—internally, with public employees. Second, the organization may sign a long-term contract with one or a few providers to meet its needs for the desired good or service. And third, it may purchase the commodity on the open market each time it has a need. Thus, for example, Texas provides security for its legislature itself, it has a long-term contract with the Daughters of the Texas Revolution to provide tours of the Alamo, and presumably it buys paper clips as needed on the open market.

This section considers each of these options. Subsection 1 begins by identifying eight significant factors that economic theory has identified as determining whether internal production or purchases on an external market are the most efficient method of obtaining needed goods and services. Subsection 2 then considers what those factors can teach us about the optimal organization of means-tested public benefit programs.

1. Privatization and the Theory of the Firm

Coase and his successors concluded that the transaction costs of purchasing goods and services on the open market are the main factor that makes firms an efficient method of economic organization. "Were markets costless to use, there would be no need to give up the flexibility and independence of exchange when cooperation with others is advantageous."
Put simply, internal production avoids the costs of determining the best price, misestimating future needs, negotiating contracts, monitoring the contractor's performance, and insuring against the contractor's non-performance. Applying this analytical framework to privatization debates is logical since state coordination long has been recognized as a means of overcoming transaction costs.

The theory of the firm identifies several factors that determine whether internal production is more efficient than obtaining a needed good or service on the open market. First, where the transaction costs of purchasing through the market are relatively low, internal production will be a less appealing alternative. Conversely, firms will tend to internalize production more "the less the costs of organizing and the slower these costs rise with an increase in the transactions organized" internally.

Second, purchases in external markets are more likely to be advantageous where the government is purchasing "products or services [that] are essentially the same . . . because unit prices and units of products and services can be measured, and measured relatively well. Many of the routine service requirements [of the government] fit into this category, [such as the] internal supply of labor and consumables used to provide services." Put another way, the transaction costs of ascertaining a fair price for a well-defined product are lower than the costs of pricing one that does not have a well-developed market. Similarly, the transaction costs of enforcing contracts for standardized products are lower than for those costs subject to complex, and possibly subjective, specifications. Conversely, where the goods or services sought are complex, with important features that are difficult to set out in contractual terms, internal production can prove beneficial because of managers' greater opportunities for oversight. Internal control mechanisms

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77. See id. at 41.
78. See Ricketts, supra note 71, at 35-36.
79. We are concerned with only that aspect of theory addressing the optimal size for an enterprise. Except to the extent that Part IV, infra, discusses how partial privatization can cause agency problems for the electorate, we are not concerned with the elaborate theory of which organizational and financial structures would best serve particular kinds of businesses. Nor need we attempt to characterize the nature of a firm, whether as a nexus of partial contracts or otherwise. See generally Michael C. Jensen, A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS, AND ORGANIZATIONAL FORMS (2000).
80. Coase and others appropriately rejected the simplistic notion that whichever method of organizing production yields the lowest nominal price is superior. Not only is determining the true cost of internal production difficult, but also "[c]ompeting through product quality, contractual arrangements, and institutional innovation . . . all become meaningful." Demsetz, supra note 76, at 18.
81. Coase, supra note 70, at 45; See also Demsetz, supra note 76, at 25, 32-34.
83. See Ricketts, supra note 71, at 25-27.
84. See id. at 27-29, 214-16.
85. See McCaffery & Jones, supra note 82, at 324 (finding internal production
can organize production where detailed contracts are impossible.  

Third, where the available market is relatively competitive, it will be more likely to offer prices lower than the firm’s internal production costs. On the other hand, markets with few suppliers and high access barriers may demand substantial rents. “Where no market exists, there is no advantage to contracting because there is no competitive dynamic to force efficiency in production or supply.”87 A firm may find internal production an advantageous alternative to paying those rents.

Fourth, where production of a good or service requires a process relatively different from those the firm already performs internally, the costs of developing the capacity to produce that item may exceed the costs of obtaining it on the open market.88 If General Motors suddenly needed a different kind of axle, it likely has skilled staff it could assign to the task; if it suddenly needed to stage opera performances, its start-up costs would be far more daunting and an external contract more appealing. Conversely, if the likely outside suppliers of a good or service would have to develop capacity, with which its staff has limited expertise to produce a good or service that a firm has been making internally, the firm may see lower costs by maintaining internal production.

Fifth, as a firm grows past a certain point, the costs of organizing its functions internally may exceed the costs of organizing them through the market.89 Expansion typically involves either increasing the range of activities in which the firm is engaged or increasing the geographic dispersion of those activities; both create additional managerial challenges.90 As a firm expands, aggregating and collating information from its far-flung operations and making appropriate adjustments for changing conditions affecting their production will become increasingly difficult.91 Moreover, diversification may complicate the task of finding managers sufficiently competent in its full range of activities. Allocating resources effectively may become increasingly difficult. The resources misallocated internally may equal or exceed those wasted on transaction costs in external procurement.92 Coase notes that technological advances improving managers’ abilities to supervise remote locations can tilt the scales in favor of greater internal production.93

86. See Ricketts, supra note 71, at 18-19.
87. McCaffery & Jones, supra note 82, at 324.
88. See Coase, supra note 70, at 43.
89. See id.
90. Some see the prototypical entrepreneur as an expert in local markets. See Ricketts, supra note 71, at 59.
91. See Coase, supra note 70, at 43-45.
92. See id. at 43 n.26.
93. Id. at 46. This effect can be counterbalanced if the advance also reduces the costs of using the price mechanism to organize production. Id.
Sixth, and related, the firm's command-and-control allocation mechanism is likely to suffer from agency costs: managers pursuing the best interests of their particular units at the expense of those of the firm's owners. These agency costs can be seen as a different type of transaction costs. In addition to having to determine the best price for the employees and facilities required to produce the item internally, the firm must oversee managers' work to keep them aligned with the firm's priorities. The larger the firm, and the less senior managers (who are closest to ownership) know about lower-level managers' actions, the greater the agency costs are likely to be.

Seventh, a firm's attitude towards risk can affect the desirability of producing goods or services it uses internally. Internal production gives a firm greater ability to adapt to unforeseen circumstances. Internal production therefore may be more appealing in cases where significant, difficult-to-foresee changes are possible. The more factors of production the entity produces internally, the fewer potential causes of sudden increases in costs. Coase suggests that internal production will be more appealing for services than for commodities since the former can vary in many more important dimensions than the latter. An entity whose output is sold in a market where highly elastic prices limit its ability to recover sudden cost increases may prefer internal production for this reason.

Finally, economies of scale can help determine whether internal or external production is most efficient. If economies of scale are apparent at a much greater level of production than that required to meet the firm's own needs, the firm will have to choose between purchasing the item on the open market, producing it internally at an inefficiently low level, or producing it internally and selling off the excess. The last may be difficult if other firms needing the item are competitors that may be reluctant to buy from the firm. If, however, production of the item in question is a natural monopoly with steadily declining unit costs, the firm may prefer to be that monopolist, but may succumb if another firm already established itself as the producer.

97. Even if an external supplier would be indifferent as to which of two possible sets of specifications it uses, the purchaser may not be able to tell much in advance which of the two it desires. Id. If the contract specifies one, the supplier is in a position to extract some economic rents if the purchaser later wishes to switch to the other.
98. Ricketts, supra note 71, at 47-49.
99. Coase, supra note 70, at 40.
100. Economies of scale occur when the average costs of production fall as the quantity produced increases. Economies of scale are typically greatest for goods and services whose production requires large fixed costs.
101. See Hughes et al., supra note 95, at 54.
102. See Levmore, supra note 94, at 228.
will be unlikely in any event on the open market.\textsuperscript{103}

Whether a firm chooses to make a good or service internally, or to buy it on the market, it has additional choices about how to proceed. If the firm elects to make a factor of production internally, it may either expand its existing operations or acquire an independent firm that does or can produce that item. If the firm elects to purchase on the open market, it can purchase through a long-term contract or through a series of short-term contracts. Purchasing on the open market each time it is needed leaves the organization largely at the mercy of producers' choices about the design and complicates budgeting. On the other hand, it offers the maximum benefit of competition. Long-term contracts, joint ventures, and similar arrangements occupy intermediate positions in both regards. Accordingly, an automobile manufacturer may decide to open a new production facility to produce its own steering wheels, to buy out a glass company capable of making its windshields, to contract with a particular tire company to supply it for the next several years, and to invite advertising agencies to bid for its business each time it needs a new campaign. Ignoring any of these options risks a suboptimal decision.

2. Applying These Factors to Public Benefit Programs

The same factors that determine whether internal organization of production or resort to the price mechanism is efficient for a firm also determine the most efficient course for a government agency seeking to obtain some good or service necessary to carry out one of its programs: internal production by public employees or purchasing the service in the market. The one exception may be that mergers and acquisitions are rarely an option for governments in this country. Even with the power of eminent domain, the government rarely purchases its suppliers.\textsuperscript{104}

This Subsection applies the economic principles just developed to the privatization of public benefit programs. Subdivision a considers long-term contracts with private for-profit or non-profit organizations as an alternative to having public employees provide the four services in whose performance is most contested in privatization debates: application assistance, policymaking, eligibility determination, and dispute resolution. Subdivision b, in turn, explores the circumstances under which these same four functions can be purchased on an as-needed basis.

103. See id. at 207-09.

104. The federal government does, however, sometimes contract with state or local governments to provide services for it on terms where federal policymaking, rather than that of the entities providing the service, predominates. For example, to reduce the size of the federal workforce and take advantage of lower state public employees' salaries, the federal government contracts with state disability determination services (DDSs) to make decisions initially and at the first level of appeal on applications for Social Security Disability Insurance and Supplemental Security Income disability benefits.
a. Long-Term Contracts with Private Entities

One of the main advantages commonly cited for privatization is increased competition. The government, privatizers say, has held a monopoly on performing these functions for too long. Inviting private contractors to bid for the right to provide those services is thought likely to drive innovation that will allow the program to obtain better services for a lower price. The benefits of competition to government programs should not be taken lightly: in numerous areas, public-private partnerships have yielded impressive results. For instance, requiring infant formula companies to compete for the Special Supplemental Nutrition Program for Women, Infants, and Children (WIC) produces $1.5 billion per year to serve additional low-income women, infants, and children.

Competition for the right to administer a program, however, differs from competition to provide fungible products in some important respects. These differences may significantly undermine the value of that competition, particularly when the government commits itself to a long-term contract. The eight subsections below apply each of the criteria distilled from the theory of the firm to contracting for the administration of public benefit programs.

i. Transaction Costs Associated with Contracting Private Administration

Transaction costs are pivotal to the rationale for the firm. Such costs are similarly central to determinations of what privatization is prudent for public benefit programs' administration.

Although some transaction costs of contracting are obvious, many are not. The magnitude of the enterprise requires a massive request for proposals (RFP), massive proposals from bidders, and massive review teams for the contracting authority. Each bidder will have to include some allowance for the possibility it is not selected—and hence that its bidding costs will be wasted—in determining the price it will charge if selected. The amount of money involved will require additional costly measures to protect against corruption, and the chance that those measures may fail creates a risk of devastating scandal.

The transition from public to private administration, or from one contractor to another, also entails considerable costs. Some investments in

105. See generally Matthew Diller, Form and Substance in the Privatization of Poverty Programs, 49 UCLA L. REV. 1739 (2002).
106. See Tim Evans et al., Daniels Set to OK $1B Welfare Plan, INDIANAPOLIS STAR, Nov. 29, 2006, at 1.
108. States have encountered serious difficulties when trying to make other sharp changes in the way they administer other benefit programs analogous to the shift from direct provision of services to contract management. For example, Medicaid's conversion to managed care required state health departments to switch from working to prevent the overuse of services to trying to
equipment, intellectual property, and training will have to be abandoned before the end of their useful lives. Both the new and old systems must operate simultaneously while cases are switched over, and a host of compatibility problems and claimant confusion must be resolved. If the new system cannot immediately bear the load, the prior system’s life must be extended piecemeal and possibly at great cost.\textsuperscript{109}

Uncertainty about bidders’ capabilities is perhaps the greatest source of transaction costs in contracting. At the time the competition takes place, private bidders generally lack the present capacity to offer those services. No company rents offices and hires eligibility workers on the \textit{chance} that it will be selected to run a program. Thus, the government agency acting on the bids must essentially speculate about what sort of infrastructure the agency will be able to build if it wins the bid. That sort of speculation is inherently error-prone, as the value of any improvements in service and price must be weighed against the risk that the contractor will be unable to perform as promised.

Designing an RFP that allows the state to award the contract based in part on its estimates of the likelihood that a particular bidder will develop sufficient infrastructure is a difficult and time-consuming process, and one that may increase the likelihood that the final award will become subject to litigation.\textsuperscript{110} Yet the risks of not doing so are substantial. For example, many of the notorious problems in military contracting—defective weapons, cost overruns, and so

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\textsuperscript{109} Texas, the would-be leader in privatizing Medicaid and food stamp administration, has had this problem for several years with the new computer system around which its privatization plan is built. When assisting people Hurricane Katrina displaced, it had to rely on its old system because the new one lacked sufficient flexibility. David A. Super, \textit{Against Flexibility} 33 (forthcoming 2008).

forth—result neither from incompetence at the Defense Department nor from the venality of defense contractors. Instead, they result from the inherent difficulty of predicting a new weapon’s capabilities and problems in advance of its construction and deployment.

**ii. The Difficulty of Specifying in Detail the Work to be Performed**

Administering a public benefit program is multifaceted; changes in both demographics and policy frequently give rise to new demands. If the contracting authority cannot properly specify what needs to be done in ways that are subject to measurement, the electorate will lose substantial value. Moreover, if the contracting authority fails to anticipate changes that may occur over the life of the contract, it finds itself locked into a program it may not want, overpaying for services, or even faced with a collapse in the program’s administration.

Developing specifications subject to accurate measurement is a challenge endemic to contracts for complex goods and services. All long-term relationships with private contractors and government goods and service suppliers rely to some degree on ex ante controls. But flexible-price, cost-plus type contracts and appropriated budgets require considerably higher levels of reliance on ex ante controls and also on monitoring and enforcing compliance. And the cost of tightly held budget execution control is high.  

Part of this cost is designing reliable accounting devices to ensure that the government is charged only for expenses appropriate to its contract. “Still, accurate accounting does not guarantee efficiency.” A strong accounting system will show what did happen, but it will not show what might have happened had managers made different decisions. Overseeing contractors’ decisions on complex matters requires government officials to “regulate, duplicate, or replace the contractor’s managerial efforts.” This is costly and can bring conflict with the contractor, but is essential to counter perverse incentives inherent in such contracts.

The government will have difficulty measuring contractors’ performance and ensuring quality. If an infant formula company delivers expired or otherwise substandard formula to WIC, the program’s managers can promptly detect the problem and assess a penalty. If the problem persists, the government

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111. McCaffery & Jones, supra note 82, at 329.
112. Id.
113. Id. at 330.
114. See id.; see, e.g., Jeffrey Zornitsky & Mary Rubin, Abt Assocs., Establishing a Performance Management System for Targeted Welfare Programs 37-38 (1988) (describing agencies’ incentives to serve the least disadvantaged individuals to achieve the highest rates of employment).
will know and can cancel the contract. The enforcement of contracts of this kind is easy because the products the government seeks to procure are fairly straightforward to specify.

By contrast, the quality of public benefit programs' administration is difficult to assess. It entails some relatively objective acts: keeping offices open during prescribed hours, processing applications and delivering benefits by set deadlines, and the like. It also involves other activities, such as payment accuracy, avoiding improper denials, and claims collection. These activities are measurable, but it may be difficult to agree upon appropriate standards. It includes some efforts that are almost impossible to quantify, such as providing accurate responses to eligibility questions, preventing the application process from discouraging eligible claimants, promoting sound nutrition, and encouraging increased work effort. At best, a contract may specify some specific actions the contractor must take in these areas, but that provides no protection against a contractor whose staff is going through the motions. Objective contractual terms are most unlikely to provide meaningful guidance on striking the right balance between competing objectives, such as payment accuracy and program access.

No program administration, public or private, will excel in all of these areas. Assessing the quality of program administration is very much a matter of subjective judgment, weighing deficiencies in some areas against strengths in others. These assessments typically depend on a wealth of informal communications among various units within the system—a type of communication that contractors will have strong incentives to control tightly. Even if most observers would regard a particular contractor's performance as deficient, the state is unlikely to have objective evidence that is legally sufficient to impose penalties or to terminate the contract. Absent such evidence, the prospect of costly and protracted litigation is likely to deter states from even attempting action against contractors. Although automated systems lend themselves far more readily to objective performance measures than does overall program administration, states have rarely if ever recovered damages from automation contractors even when systems' catastrophic failures caused huge increases in error rates and workload for eligibility staff. The difficulty of measuring performance under contracts to administer Medicaid or food stamps is likely to prevent states from enforcing most quality assurances the contractors provide. Competition thus offers little prospect of improving the quality of program administration or even of allowing states to identify the highest-quality bidder when getting the contract.

Because contractors will pursue their bottom lines, the government must

find a way to align the contract's payment mechanisms with its priorities. Reconciling these objectives is exceedingly complex. Most obviously, although a lump sum payment will ensure against cost overruns, it will give the contractor no incentive to accomplish any particular outcome in its interactions with claimants.

Yet this is not the end of the problem. Not only can appropriate specifications be difficult to craft at the outset of the contracting process, but also even initially sound specifications may become counter-productive if circumstances change. For example, Mississippi found that the job placement measures it established when it first privatized the Temporary Assistance for Needy Families (TANF) administration failed to work once the more job-ready recipients had left the program. Because its miscalculation worked to contractors' disadvantage, they voluntarily abandoned their contracts. In theory, the state could have held the firms to their contracts, but the political consequences of assured failure far exceed any windfall the state might have achieved from the contracts. Had the contractual requirements become much easier to meet because of changed conditions, the state would have been obliged to overpay for their services. Hence, contracting under conditions of great uncertainty for programs in which government officials have a large stake effectively becomes a one-sided bet, with the state vulnerable to changes in one direction but unlikely to reap any benefits from changes in the other.

iii. The Lack of an On-going Competitive Market for Comparable Administrative Services

Stephen Goldsmith, the former mayor of Indianapolis and a leading champion of privatizing public services, advocates the "Yellow Pages Rule" for contracting: services already available through the Yellow Pages should be the ones contracted out. In other words, a market that comes into being purely to compete for the government's contracts is unlikely to be very competitive. Even avid privatizers concede that no market exists for many of the services they wish to consign to the private sector. Thus, the classic type of on-going

118. See Breaux, supra note 110, at 49.
119. See id. at 53-54.
120. See id.
competition that one sees between Ford and GM, between ABC and CBS, between Coke and Pepsi, etc., is impossible when programs contract out responsibility for eligibility determinations. In other natural monopolies, like the provision of gas or cable television services, public operation or public regulations often have proven necessary to restrain costs. Public benefit programs can invite genuine competition at the time they let contracts, but monopoly conditions exist during the life of those contracts. In those periods, the system will remain as impervious to market signals as it is in the current, state-run system.

This lack of on-going competition springs in part from economies of scale that make public benefit programs’ administration virtually a natural monopoly, as explained in Subsection h. It also results from two factors addressed here: entry barriers resulting from the start-up costs required to undertake that administrative work and exit barriers making termination of even a deeply flawed contractor costly for the government. Moreover, contracting on the uncompetitive market for integrated administrative services is likely to deprive the government of the opportunity to purchase some components of the needed services on markets that are competitive.

Administering a public program requires significant, irreducible up-front expenditures by each new vendor, including the costs of hiring staff, months of designing policies and procedures for the program and training the new staff in those policies and procedures, and the time required to rent and furnish offices before they can be put into use. A company having to hire an entire staff of people with the intellectual and social skills to learn and implement complex program policy in a short period of time is likely to have to pay a premium for that staff or to compromise on quality far more than an agency that only needs to replace its occasional losses to retirement and attrition. For a contractor to improve the cost or quality of a program’s administration, it will need to achieve enough new efficiencies to offset these considerable capital costs.

These start-up costs will occur each time a new entity takes over administration of the program. Once the state contracts out a program’s administration, the contractor will have a substantial advantage over any competing bidder (including the former public agency, which by then will have had to dismantle its administrative infrastructure). This allows the incumbent contractor to submit a higher bid when the contract comes up for renewal and

124. See generally Oliver E. Williamson, Franchise Bidding for Natural Monopolies—in General and with Respect to CATV, 7 BELL J. ECON. 73 (1976).

125. Much of the best of Texas’s staff responsible for determining claimants’ eligibility for public benefits either were laid off or found other work on their own when the state announced that privatization was imminent. Those that stayed, or that remained available to be called back, when Texas abandoned its contract presumably had fewer skills to attract other employers. Even if Texas is able to hire talented new people to replace the ones it lost—an uncertain prospect given its need to staff up again so quickly—its more senior staff, from which supervisors will be drawn, has been bled of many of its most talented members.
still defeat prospective competitors, whose bids will have to cover these start-up costs. Indeed, private contractors may increase the start-up costs of public agencies and other private contractors by requiring their more skilled employees to sign anti-competition contracts promising not to work for other vendors in the state for some length of time.

If a contractor providing relatively fungible products, such as WIC infant formula, fails to perform its contractual obligations, the state has other options and can consider voiding the contract and seeking new bids. By contrast, if an administrative services vendor is performing deficiently, the costs and disruption of selecting a new contractor and having that contractor build up the infrastructure required to operate the program may leave the state with no other alternative but to stay with its existing contractor.\(^\text{126}\) If a contractor is performing so badly that a state feels compelled to seek new bids in the midst of a contract, other potential bidders will assume that the state is desperate and likely will set their prices accordingly. Knowing all of this, in turn, may reduce contractors’ incentives to comply fully with their contracts.

This lack of active competition has forced several states to keep automation contractors whose systems were causing chaos in the administration of their programs. The states reasoned that switching contractors would cause considerable disruption and that any new contractor’s system might have comparable problems. The failure of new automation systems caused huge increases in the food stamp quality control (QC) error rates in Florida, Indiana, Michigan, and Los Angeles County, among other places. More recently, a failed computer system has wrought havoc in the Food Stamp Program, Medicaid, and other social services programs in Colorado for months at a time.\(^\text{127}\) Asking a new contractor to set up a revamped eligibility determination infrastructure, with different offices, staff, computers, etc. is far more burdensome than the disruption, cost, and risk of switching automation systems. Therefore, states may feel compelled to stay with administrative contractors even if their work is far worse than the disastrous automation systems that states have endured in the past.

Indeed, the government’s high costs of shifting from one contractor to another or rebuilding its administrative infrastructure may prevent it even from reaping the benefits of the contracts it signed. In particular, the state is extremely vulnerable to contractors’ possible bankruptcies. Contractors bid based on speculation about what administering these programs will cost. Once they actually rent and furnish offices, hire staff, etc., they may find themselves significantly under-budgeted. If such a contractor threatens to declare bank-

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\(^\text{126}\) See Patrice Sawyer, Collection Firm’s Contract Set to Expire, CLARION-LEDGER, Aug. 16, 2000, at 1A (describing threats of interruptions in child support payments as motivation to renew contract).

ruptcy, and the state judges that threat to be credible, it may have no choice but to increase its payments to the contractor. Thus, the state effectively must assume most of the risk of the inherent uncertainty about the costs of shifting administration to a private contractor: if the contract price proves excessive, the contractor keeps the profits, but if it proves insufficient, the contractor has leverage to extract an increase. States’ inability to avoid such one-sided bets largely negates any of the benefits from competition.

Contracting with a private firm to administer the Food Stamp Program also eliminates opportunities for the state to benefit from competition in providing goods or services for administering programs, such as new application forms, office space, computer terminals, telephone service, etc. At present, states regularly take bids for these items and reap the benefits of competition. By contrast, once the state contracts with a private firm for overall program administration, it will have to negotiate with that contractor for any modifications or additions to the program not anticipated in the original contract. Because no other company can plausibly bid on the work, the contractor will have the leverage to extract a high price from the state. The contractor may then elect to seek bids from printers, landlords, or other vendors for the goods or services required to perform the additional work the state wants, but the savings from that bidding will accrue to the contractor, not the state.

iv. Existing Infrastructure: Similarity with Other Governmental or Contractors’ Functions

One key criterion for determining whether the public or private sector can more efficiently provide a particular service is determining which one has the necessary infrastructure. The Food Stamp and WIC Programs rely on private stores to distribute the food they purchase because these stores already have effective food purchasing, distribution, and storage systems; the government would duplicate their investments if it had to build a parallel system for the food assistance programs. Medicare and Medicaid rely primarily upon private hospitals, doctors, and other health care providers in part because of the inefficiency of developing a duplicate health care delivery system. Similarly, states efficiently contract out data processing for states’ eligibility determination systems because private companies have already invested in the massive servers required to perform that work: a contractor may schedule a batch of calculations in between similar runs for large corporations or other

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128. In the early 1990s, vendors of electronic benefit transfer (EBT) services—debit card-like systems for delivering welfare payments, child care subsidies, food stamp benefits, and other aid—negotiated contracts that paid them on a per-transaction basis. Because participation had been rising rapidly, they assumed these contracts would prove highly advantageous. In actuality, participation plummeted after 1994 and these contracts proved unprofitable. Some vendors suggested that they might abandon their contracts, putting great pressure on the states and United States Department of Agriculture (USDA) to renegotiate these contracts.
governmental agencies. Early electronic benefit transfer (EBT) demonstration projects cost far more to deliver food assistance benefits than paper food stamps; once the private sector developed the infrastructure to support electronic purchases in grocery stores to serve credit card customers, costs to the Food Stamp Program plummeted. On the other hand, where the government already has the necessary infrastructure in place, and where private contractors have few other present or future uses for that kind of infrastructure, paying to have the wheel reinvented rarely makes sense.

Although not as conspicuous as state parks or universities, the infrastructure states have developed to administer public benefit programs also reflects a substantial investment. Selecting, renting, and furnishing offices, developing policies, forms, and computer systems, hiring, training, and supervising staff, and myriad other steps are necessary to establish a system for determining households' food stamp eligibility. Numerous problems arise in administration that agencies' staff learn to handle by trial and error; that experience represents an investment. A private contractor could eventually reproduce that infrastructure, but why we should want it to do so is unclear. No economies of scale are present: the contractor is unlikely to be able to perform work for other customers with the food stamp eligibility determination infrastructure the way mega-servers handle work for private companies with data processing needs or check-out stand terminals process non-food stamp customers' credit card purchases.129


A common argument in favor of privatization is that governmental managers lack access to the draconian sanctions with which private employers may motivate their employees to maximize performance.130 Public administration experts, however, argue that managers can shape their agencies' behavior with other tools to train their staffs and reinforce the kinds of behavior they seek.131 These experts point to the welfare transformations over the past decade that have removed unprecedented numbers of recipients from cash assistance programs as evidence that the culture of even the most entrenched welfare offices can be changed.132

129. Particularly in light of the recent devolution of policy-making authority, the requirements for operating a program in one jurisdiction is likely to be too different from those in another to allow contractors to sell the same business model across the country the way a contractor might sell solid waste removal services to several neighboring communities.


131. See Riccucci, supra note 130, at 86-90.

More fundamentally, however, whether the government administers programs itself or contracts them out, public employees will play critical roles. The key question, then, is which function are they likely to perform best: direct service or contract administration. The two roles are quite different. Where previously the government was required to administer the program, now it becomes responsible for framing requests for bids, negotiating contracts, monitoring performance, and enforcing compliance. Both administration and contracting are functions that the government sometimes does well and sometimes does poorly. The vast majority of government administration and procurement go well and largely unnoticed. Just as some agencies are accused of providing shoddy service to the public, so too are other agencies criticized when they overpay for hammers, toilet seats, and other routine items or when their contractors provide poor service to the public.

The skills required to administer programs and manage contracts are quite different. Good administrators must have strong leadership skills and superior judgment of people. Such administrators must be flexible enough to adapt rapidly to changing circumstances and problems, and be able to translate policies into instructions their staff can implement. By contrast, getting a sound contract for program administration requires more analytical skills, including meticulous attention to detail. Contracting officers must anticipate problems that have yet to arise because they will not have the flexibility to respond to them once the contract is signed. Quite different interpersonal skills, such as negotiating prowess, are necessary to be an effective contract officer. Contracting offices must also have the ability to translate policies into contractual specifications that will cause the contractor to act as the agency intends.

The combination of skills required to be an effective contracting officer is elusive. Many excellent administrators are ill-equipped to negotiate important contracts.133 Alternatively, many people skilled at drafting contracts lack the operational expertise to anticipate all the contingencies that a contract for program administration must address. Contracting effectively requires a team, but even if a state agency has the right combination of talents to make an effective team, the novelty and enormity of the proposed transfer makes significant problems inevitable: some important aspects of program administration will be taken for granted and some contingencies will not be anticipated.

Designing effective contracts for the administration of Medicaid or the Food Stamp Program is particularly difficult because it requires accommodating many different policies that partially conflict. The state presumably wants eligibility workers to verify applicants' statements about their income, but not to the point of pestering low-wage workers' employers, or requiring workers to take so much time off the job that they are fired, denied

133. See DONAHUE, supra note 130, at 128-29.
promotions, or discouraged from applying for benefits. States can provide financial incentives for contractors to achieve one goal or another, but achieving the right blend of incentives to induce the contractors to strike the right balance between those objectives—particularly where some, such as service to low-wage workers, are difficult to measure—may be impossible. At best, it will require extensive trial and error, with each attempt separated from the last by several years.

Contract terms must be particularly clear because litigation with contractors can profoundly disrupt a program's administration. If a state terminates a contractor that is not performing up to par, the contractor is likely to sue for the fees it would receive under the remainder of the contract. If the state misjudged in terminating the contract, or if its lawyers perform badly, the state could end up having to pay twice for administering the program during the same period: once to do the work itself (or through another contractor) and again to the dismissed contractor. No state's budget can readily absorb this kind of blow. Moreover, states will be unable to plan effectively (and to make long-term hires or enter into any new long-term contracts) during the months or years required to resolve the litigation. States therefore are likely to be extremely reluctant to terminate even the worst contractors—and quite eager to settle any litigation that does arise. As a result, any contractual term that is not susceptible of very precise measurement is unlikely to be enforced. Nonetheless, ideological supporters of privatization, or simply officials seeking to encourage innovation, may limit public managers' ability to structure private contractors' operations in such a way that they become susceptible to performance measures.\textsuperscript{134}

The intense demands on public managers do not end with the execution of a contract. Measuring the quality of contractors' work in several key areas is exceedingly difficult and error-prone. Eligibility determinations made against objective criteria can be audited. The quality of assistance with completing the application process, however, is all but impossible to measure objectively since it entails complex interpersonal interactions. Surveys of low-income people who might need the service are likely to lead to misassessments for a host of reasons: some individuals may not have needed much help while others needed more help than the contractor was tasked to provide; some may blame the contractor for their substantive ineligibility while others may assume they are substantively ineligible when in fact the contractor bungled their case.\textsuperscript{135}

Other measures of contractors' behavior can be equally problematic. In some instances, their direct and indirect costs may well outweigh their benefits. In addition to having substantial costs to implement, measures also may create


\textsuperscript{135} See \textit{Kelly & Rivenbark}, supra note 116, at 114-16.
pervasive incentives for the contractor. 136 For example, if the contractor’s staff has trouble communicating with claimants whose primary language is not English, the contractor could either hire bilingual staff or try to drive away those claimants before they become part of the set of cases on which the contractor’s performance is measured. Education and training programs may have the greatest long-term impact on a participant’s employability, yet they invariably result in lower employment in the first half-year than job search or workfare programs, simply because participants often are still in training at the six-month mark. Measuring a contractor’s success in running a work program primarily based on participants’ employment in the first few months will drive the contractor to pursue a short-sighted course.

Even where programs’ multiple objectives do not conflict, program managers have had difficulty finding measures of quality that are both meaningful and clear enough to be enforceable. Proprietary child care centers designed to operate on government subsidies have had persistent quality problems. 137 Inducing staff to allocate time among several components of their jobs requires managers to establish a performance monitoring system that provides equal marginal rewards for each of those activities when the optimum allocation has been reached. 138

In addition, the proxies for performance on which most metrics rely introduce their own sources of error. 139 A contractor that induces claimants to make a large number of job contacts may appear to be promoting self-sufficiency effectively, but if the claimants are pursuing jobs for which they are manifestly unqualified, or are so hurried that their applications are perfunctory, nothing constructive is accomplished. Although many credit outcome measures as freeing public administration from the rigidity of procedural rules, 140 most favorable and unfavorable outcomes of human services programs have multiple causes; determining whether the program’s administration is responsible is commonly impossible. 141 If food stamp recipients experience more food insecurity than other low-income people, is that because the program is failing or because their pre-existing food insecurity drove them to apply for food stamps? A related concern is that legal, ethical, and financial constraints may limit the contractor’s ability to change outcomes. 142 Lifetime disqualification of claimants that miss appointments is likely to increase the efficiency of

136. See id. at 145.
139. See Martin, Social Policy, supra note 137, at 146.
140. See, e.g., Zornitsky & Rubin, supra note 114, at 34-36.
141. See Martin, Social Policy, supra note 137, at 146-47.
142. See id. at 147.
scheduling eligibility workers' time, but it is unacceptable for moral and (in most programs) legal reasons. One-on-one instruction in interviewing technique would no doubt improve claimants' success in obtaining employment, but even the most efficiently run contractors are unlikely to be able to afford that. Designing performance objectives that contractors can meet, but are not assured of doing so, is exceedingly difficult, particularly because the very fact of contracting out aspects of the program's operations changes the nature of the program.

All of these problems, of course, apply also to senior government managers trying to measure their own subordinates' work. But because managers' discretionary internal directives to their staffs do not have to sustain the kind of legal scrutiny that assertions of contractual non-performance do, they are free to rely on a broader range of measures of performance, including some quite subjective ones. Performance measurement within an organization is less likely to be so adversarial as to be counterproductive—the way it can be between a government agency and a contractor that could face sanctions or termination for negative outcomes. The very civil service protections commonly blamed for slowing change when deficiencies are detected also can give employees enough sense of security not to obstruct attempts to identify and measure those shortcomings. Even if one or two individual government employees might face reassignment or even dismissal for particularly bad results, most employees in a unit are likely to survive. By contrast, a private firm that loses an important contract may lay off most or all of the employees hired to carry out that contract.

Conversely, many obstacles to improving the public sector may be little-changed in the private sector. A lack of resources to pay enough to attract and retain qualified employees is likely to carry over once an activity is contracted out. If the government agency lacks the analytical and decision-making capacity to act on problematic performance data, it is likely to have at least as much difficulty identifying and acting on deficiencies in a contractor's behavior.

vi. Agency Costs of Public and Private Administration

In some important respects, contractors' performance may be inherently more difficult to assess and improve than that of government employees providing similar services. The greater heterogeneity of contractors may make

143. See id. at 154-58, 174-77.
144. See Super, Efficient Rights, supra note 51, at 1117-29.
145. See Kelly & Rivenbark, supra note 116, at 179.
146. Id. at 179. This may be less true if the problem was a rigid government pay scale that would not apply to a contractor. Nonetheless, even in that case, the contractor is likely to require more resources to achieve equivalent results.
147. Id. at 178-79.
comparison of performance data from different locations less helpful in identifying problematic performers.\textsuperscript{148} Public managers also can pursue continuous improvement in their agencies' processes.\textsuperscript{149} Improvement in processes contracted out may be concentrated around the time the contracts come up for renewal. If the government switches to a different contractor, many of the lessons its predecessor learned may be lost.

\textit{vii. Risk Avoidance}

Transferring responsibility to a new entity entails risks both in the transition and over the long term if the contractor proves not to be up to the task. Our willingness to contract out a function depends in significant part on our tolerance for risk that that function will be performed badly. Decisions about whether to contract out administration of Medicaid and food stamps to companies currently lacking the necessary infrastructure therefore implies in part a willingness to contemplate those contractors failing and leaving many eligible low-income families without access to health care or food aid for some period of time.

\textit{viii. Economies of Scale}

Critics argue, in effect, that public agencies suffer diseconomies of scale.\textsuperscript{150} Whatever the merits of this contention in other contexts, it would seem to have little application to the administration of public benefit programs. Indeed, a strong case can be made that administration of these programs is a natural monopoly. The overhead required to maintain facilities, develop policies and procedures, train staffs, etc., make it uneconomical for multiple entities—the state and a private contractor or more than one contractor—to operate eligibility determination systems simultaneously. States seeking to privatize tacitly admit this when they seek bids only for sole-source administrative contracts. This argument therefore provides no basis for distinguishing between public and private administration. Moreover, as the next subsection shows, efforts to escape these asserted diseconomies of scale with smaller purchases of administrative services raise several serious issues in addition to most of the same problems that afflict sole-source privatization.

\textit{b. Purchasing Services As Needed}

The method of obtaining goods and services that would seem to offer the greatest promise of competition is to purchase those items from the vendor

\textsuperscript{148} See \textit{id.} at 164 (describing the increasing popularity of this approach).

\textsuperscript{149} See \textit{id.} at 158-61; see also PETER M. KETTNER ET AL., \textsc{Designing and Managing Programs: An Effectiveness-Based Approach} 126-53 (1990).

offering the best deal when that service is needed. To be sure, negotiating a single long-term contract may entail fewer transaction costs than arriving at numerous short-term contracts.\(^{151}\) Purchasing services as needed, however, maintains continuous competitive pressure on all vendors and brings innovations into play as soon as they become available.

Some privatization proposals for public benefit programs purchase administrative services as needed, particularly the service of assisting applicants with preparing applications and occasionally that of making eligibility decisions.\(^{152}\) USDA has announced plans for a pilot program in Illinois in which low-income households could apply for the equivalent of food stamps at emergency food providers, who could approve up to 45 days of benefits while sending them to regular food stamp offices for on-going aid. H&R Block has explored various arrangements under which it would determine families’ eligibility for food stamps when it prepares their tax returns. Although the pending privatization plans in Texas, Indiana, and several other states revolve around a single contractor whom the state would assign to assist households with making applications, it also has sought to enlist non-profit community groups to provide additional free help to applicants needing more than the contractor is prepared to provide.\(^{153}\) Most significantly several states, including Florida and Kansas, have closed many of their local offices, leaving prospective claimants largely on their own for obtaining help with the application process.

Privatization of this sort is already taking place in some programs. On a small scale, community health centers and disproportionate share hospitals (DSHs) may take Medicaid applications and make “presumptive” (temporary) decisions concerning the eligibility of certain pregnant women and children.\(^{154}\) The management of each low-income housing project subsidized under Section 8 takes applications and makes eligibility decisions (including the maintenance of their own waiting lists). In each case, however, only a modest share of claimants apply through the private entities.

Four major public benefit programs that rely on individual purchases of application assistance are Social Security Disability Insurance (SSDI), Suppose-
mental Security Income (SSI) disability benefits, the Earned Income Tax Credit (EITC), and Guaranteed Student Loans (GSL). In SSDI and SSI, claimants may retain an attorney or another representative or may forego paid assistance and go through the application process themselves. Similarly, individuals may hire commercial tax preparers to help them file for EITC or may attempt to do so themselves. GSL applicants must apply through a financial institution but have a wide choice among institutions. The experiences of each of these programs are instructive.

Purchasing administrative services as needed is an alternative to internal governmental production of those services. As such, the "make-or-buy" decision would depend on the same factors developed in the two preceding sections. This section explores some additional major issues that would have to be resolved to privatize components of public benefit programs' operations by purchasing services on an as-needed basis. Subsection i addresses the problem of which of the two consumers of administrative services—the claimants that receive the services, and seek to establish their eligibility for the underlying benefit, or the government that authorizes the program—should make the purchasing decisions. The nature and terms of the competition will differ considerably depending on who is selecting the winners. Subsection ii considers how the designated purchaser will obtain enough information about providers to make an intelligent selection. If purchasing decisions do not reflect the relative performances of the vendors, the value of competition will be lost or distorted. Subsection iii explores the issues of cost: whether paying for administrative services separately from benefits is likely to increase or decrease total costs. Subsection iv probes the impact of this competition on programs' integrity. Finally, subsection v identifies key design features that facilitate some programs' privatization of administration in this manner. It argues that those features significantly impede the programs' substantive missions and as such would be unwise to replicate in other programs.

i. Determining Who Will Act as Purchaser

In most instances where a commodity is purchased on an as-needed basis, the purchasing agent's identity is obvious. That is not necessarily the case with some services in public benefit program administration. Both claimants and the government have interests in the goods and services purchased because the program separates financing and consumption. For example, recipients of food assistance have an interest in obtaining something appealing to eat; the

155. In SSI and EITC, legal services offices and Volunteer Income Tax Assistance (VITA) services respectively provide some free legal service. (Congressional restrictions on legal services offices' taking potentially fee-generating cases have largely eliminated free representation for SSDI claimants since 1995.) In neither case, however, is the supply or extent of free assistance remotely sufficient to meet the needs of all claimants or even those claimants with the greatest need.
government has a fiscal interest in restraining the price and perhaps a paternalistic interest in the food purchased providing enough nutritional value to justify the program's cost. One or the other, participant or the government, must make the final purchasing decision. Potential providers of goods or services therefore have reason to compete only in those dimensions that will appeal to whichever one will decide on a purchase. This will require the government to decide in which sphere it seeks competition and to accomplish its objectives in the other through command-and-control means, if at all.

This tension over whether the claimant or the government is the purchaser has been resolved in varying ways. Public housing programs select architects and construction companies; those companies have no incentive to consider potential residents' satisfaction except to the extent that the housing authority's rules impose minimum standards; competition occurs exclusively on the basis of price, schedule, and other matters important to the housing authority. The Food Stamp Program, on the other hand, allows recipients largely unfettered market choice: apart from prohibiting purchases of a few items that arguably are not food and prohibiting some kinds of exceptionally uneconomic transactions, USDA largely allows recipients to expend the benefits allotted to them. USDA limits the dollar value of purchases by each household, giving recipients an interest in low prices. Food vendors do not, however, have any incentive to compete on matters of paternalistic concern to the USDA or to restrain practices that capitalize on information failures afflicting recipients but not the government.156

Purchases of eligibility determination services raise even more vexing issues. Where the government offers limited help in completing the application process, claimants have the choice of attempting to negotiate that process themselves or expending some of their prospective benefit to purchase those services from private vendors. With claimants deciding whether to purchase any services at all, and if so from whom, competition focuses on them, not the government agency. Thus, competition is likely to occur over price, perceived effectiveness in securing the benefit, and customer service. Competition will not occur over matters important to the government, such as integrity of the service provided by the vendor. In fact service providers will then be able to

156. Nutritional information that misleads claimants, but that would not have misled the USDA's nutritionists, may induce recipients to spend their food stamps. Occasionally, elaborate arrangements may allow some limited competition in both spheres. In WIC, food manufacturers and retailers must market to both government and recipient: the government applies nutritional standards to strictly limit the kinds of foods that participants may obtain with vouchers and awards exclusive contracts to provide some foods, notably infant formula, to low bidders. Within these constraints, participants choose where and precisely what to buy. This effort to bifurcate competition has not been without its problems. Although competitive bidding effectively limits the wholesale price of infant formulas, retailers have competed for the patronage of price-in-different consumers by offering exquisite service and free merchandise while taking monumental mark-ups. See generally Zoë Neuberger & Robert Greenstein, Ctr. on Budget & Policy Priorities, WIC-Only Stores And Competitive Pricing In The WIC Program (2004).
profit from information failures (e.g., claimants’ misperceptions of their effectiveness in securing benefits or of their fees for these services relative to the market—concerns that would not have afflicted the government.) The government can attempt to influence these factors by setting minimum standards for the service providers with which it will interact. In practice, however, many providers of application assistance can operate effectively without directly interacting with the government.

As a general matter, requiring private entities to simultaneously accommodate two sets of demands—here, from the government and participants—is likely to prove inefficient. Although this is particularly true where the division of control over purchasing decisions between the two is unclear, concern about the inefficiency of dual regulation has led the courts to find local and state regulation preempted, respectively, by state and federal laws, even where no express conflict exists.  

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\[\text{information Problems}\]

Competition for business in providing assistance in the application process will produce efficient results only to the extent that those making purchasing decisions have sufficient information to differentiate among potential vendors’ integrity and effectiveness. If the purchaser is the state, the problems with purchasing these services on an as-needed basis approximate those discussed above pertaining to long-term contracts. Indeed, if the state picks a single vendor, the functions would be substantially identical. If, instead, the state maintains a list of vendors whose services it would reimburse and allows claimants to select among them, both the state and claimants will need information to make their respective choices. And if the state leaves the selection of vendors entirely up to claimants, the competition’s effectiveness will depend entirely on claimants’ having sufficient information to make elections that serve their interests.

Assuming that claimants have either constrained or unconstrained choices among providers, two questions are likely to arise: which factors are likely to be important in making their choices, and how easily accessible information about those factors is to claimants. Presumably, one consideration will be the vendor’s rate of success in obtaining benefits and its effectiveness in securing relatively large awards. Where the vendors are competing to provide eligibility determinations, even provisional ones, the government may have a strong interest in obstructing the flow of this information: vendors competing over their success in extracting money from the government may tempt them to aid

\[157. \text{See, e.g., } Gade v. Nat’l Solid Wastes Mgmt. Ass’n, 505 U.S. 88 (1992) (plurality opinion) (applying a presumption that Congress seeks to avoid parallel federal and state regulation of the same activity even when the two regulatory schemes do not conflict); In re Generic Investigation into Cable Television Servs., 707 P.2d 1155, 1161 (N.M. 1985) (finding state regulation sufficiently comprehensive to imply preemption of local authority).\]
their clients in unethical ways and may lead to "creaming"—selecting only clients with simple, winning claims who may not actually need their assistance—a practice that allows little access to vendors' services for those claimants with less obviously meritorious claims. Even if the service at issue is merely application completion, the government may fear the risks of fraud should it help claimants reward providers based on their success rate. Yet the government's withholding of information on vendors' true effectiveness will not stop some from advertising claims that claimants have little capacity to appraise.

Another obvious criterion claimants use in selecting a vendor is cost. Where the government reimburses vendors or issues a standardized price schedule, claimants will have no incentive to select on the basis of cost. Yet, even where a genuine consumer price difference exists, competition may be unavailing. Without an intimate understanding of the eligibility determination process, claimants may have difficulty determining the adequacy or comprehensiveness of the package of services a vendor is offering at a given price. A vendor with a low initial price may be a bad deal if it charges extra to resolve many kinds of problems that routinely arise in the application process.

Claimants' lack of information leaves vendors to compete largely on various aspects of convenience. In some instances, these will be significant. For example, public human services offices are often located in remote or dangerous areas, in order to take advantage of low property values. Moreover, although increasing numbers of public human services offices maintain early, late, or weekend hours to accommodate low-wage workers, one can readily imagine private vendors offering longer hours. Although civil rights laws require agencies to accommodate both persons with disabilities and linguistic minorities, vendors could plausibly provide better accommodations, particularly if they specialize. Information about each of these factors is relatively inexpensive to disseminate and easy to interpret. Other elements of convenience—the clarity and courtesy of communication by a vendor's staff, waiting times, the number of visits required to complete the process—may be difficult for claimants to measure in advance and indeed difficult to standardize across any given vendor's operations. Competition, then, seems unlikely to improve vendors' performance much in those regards. An important question, then, is whether the benefits of competition in reducing these sorts of transaction costs outweigh the transaction costs of having claimants purchase these services incrementally.

In practice, generating meaningful competition has proven difficult. For example, both the government and beneficiaries participate in selecting vendors in the Guaranteed Student Loan Program, with the government playing a weak role. Many financial institutions vie for students' business, with few regulatory constraints on entering the market. In practice, this broad choice is narrowed because many universities promulgate lists of "preferred" lenders, from which
most students select. Thus, much of the competition among lenders is to get on as many of these lists as possible. The result is that vendors are competing in ways that benefit neither the program's financial supporter, the government, nor its student consumers. Even apart from the role of universities in skewing the competition, it is unclear what important values the competition among lenders could be hoped to advance: rates and eligibility rules are standardized (and must be) to meet the government's budgetary constraints, risk is largely eliminated by the government's guarantee, and procedures for pressing delinquents to pay also are standardized to prevent unnecessary defaults from draining the government's coffers. Perhaps some lenders are more courteous or expeditious than others, but this hardly seems a matter of such importance as to require the government to bear the considerable transaction costs of the private system. Skepticism that this competition would result in either reduced costs or improved services led Congress to expand direct student loans in 1993, moving back toward governmental provision.

The new Medicare prescription drug benefit also relies on a dual selection model, with claimants choosing from a list of authorized providers. Beneficiaries are required to select among competing private firms for assistance in applying for the benefit, for eligibility determinations, for issuance of the benefit, and for some policymaking. Low-income Medicare beneficiaries seeking subsidies for the program's substantial cost-sharing requirements also may choose whether to apply at state human services offices or through the Social Security Administration. As the new prescription drug benefit moves toward implementation, Medicare beneficiaries have expressed considerable confusion and frustration about the difficulty of determining which vendor offers the best deal.

iii. The Costs of Assistance with the Application Process

The costs of administering public benefit programs inevitably are divided between claimants and the government. This becomes apparent from an examination of the steps required to comply with the requirements of tax or public benefit programs' rules. Potential claimants must learn about the program's requirements, keep records of information relevant to their eligibility, and prepare the application or return. Claimants bear some of these costs—record keeping and at least part of the costs of learning a program's rules and


159. Id. In tax systems, they also may need to change their practices to meet the requirements of specific tax expenditures. Id. Similar planning may be required in public benefit programs involving large amounts of money, such as Medicaid for long-term care. In many other programs, complying with behavioral requirements, such as making a required number of job contacts or seeing mandatory videos, imposes a somewhat analogous burden and raises the cost of applying. See Super, Invisible Hand, supra note 28, at 825-30.
completing its application—in many programs. For example, EITC claimants bear virtually all the costs of applying. The IRS has no system of local offices to help claimants apply, to answer their questions about the program’s rules, or to examine verification of their eligibility. Apart from very limited help it provides over the telephone, the IRS leaves claimants to prepare their returns themselves, to spend a portion of their benefits on commercial tax preparation assistance, or, if they are fortunate, to find a free charitable return preparer, commonly through the Volunteer Income Tax Assistance (VITA) program.

SSDI and SSI disability determinations involve a somewhat more limited version of claimant-selected privatized administration. Claimants’ representatives—often, but by no means always, lawyers—will help claimants apply for benefits, gather medical evidence, and present that evidence to SSA’s adjudicators. This form of private administration is supplemental: SSA will, by itself, perform all necessary functions for the claimants. SSDI and SSI claimants presumably hire representatives if they believe that SSA will not provide adequate or fair administration. Many do, even though the cost is high: an applicant’s representatives can obtain up to one-third of any retroactive SSDI payments a claimant receives when SSA ultimately approves her application.

In cash assistance, food stamps, and Medicaid, the government traditionally has borne the costs of helping claimants complete applications. Typically, the agencies operating these programs receive funding for benefit costs and administration separately. Where private vendors compete to provide administrative services on an as-needed basis, however, the choice of how to allocate administrative costs is less obvious. The government can decide to continue paying those costs. To retain budgetary control, this presumably would require a standardized price schedule. Such a schedule, however, would eliminate any competition as to price. Alternatively, the government can leave payment for administration to claimants, as it does for the EITC, SSDI, and SSI.

160. In some states, Medicaid is a partial exception to this. By accepting claimants’ self-attestation as to their incomes and following up with computer matching, agencies largely lift the burden of record-keeping from claimants.

161. Indeed, the entire tax system could be considered a very large means-tested program that leaves in private hands the task of submitting applications. Its numerous tax expenditures are available only to persons that “apply” for them successfully.

162. SSI claimants also may retain representatives. In practice, however, few are able to do so because SSA’s regulations do not allow attachment of retroactive SSI awards. The same is true of SSDI recipients whose eligibility SSA is redetermining: without a lump sum to be diverted, representatives have been reluctant to take cases. Representation is rare in cash assistance, food stamp, and Medicaid cases not involving large payments for institutional care.

163. TANF allows states to spend up to fifteen percent of their block grants on administration. 42 U.S.C. § 608(a) (2000). A variant on this approach is WIC, which allocates roughly twenty-five percent of its funds for the combination of administration and one segment of program benefits: nutrition education. Id. § 1786(d)(3).
This latter approach to privatization raises several issues. Most obviously, requiring claimants to purchase administrative services will result in a significant number becoming even more impoverished after interacting with the public benefit program than they would have been had they not interacted in the first place. Budgetary constraints cause programs' eligibility rules to deny aid to many indisputably needy claimants.\(^{164}\) Few claimants that purchase application assistance have sufficient knowledge of the eligibility rules to recognize their probable ineligibility. If they did, they likely would apply on their own or not apply at all. Thus, unless the private administrative vendor operates on a contingency basis, unsuccessful claimants paying those vendors' fees would be significantly worse off for having applied for benefits than they would be had the program not existed. The notion that an anti-poverty program could exacerbate poverty is disquieting.

Shifting administrative costs to claimants also distorts political decision-making. Public benefit programs inevitably have both benefit and administrative costs. The administrative costs of application assistance exist whether the government hires or contracts with staff to provide that assistance or leaves claimants to purchase that assistance on their own. Thus, programs like EITC and SSDI provide smaller net benefits than their gross amounts might suggest because claimants must bear the cost of that assistance themselves.\(^{165}\) The question then arises which is the most efficient way of paying for those costs: through separate government appropriations or as an implicit component of gross benefit costs. If the cost of the two approaches was equivalent, a political argument could be made that the electorate may be more willing to set aside money for benefits than for administration. Thus, instead of spending $9 on benefits and $1 on administration, the electorate might be disposed to spend somewhat more than $10 on benefits in the absence of a separate administrative line.\(^{166}\) On the other hand, misleading the electorate to believe

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164. See, e.g., H. COMM. ON WAYS & MEANS, 2000 GREEN BOOK: BACKGROUND MATERIAL AND DATA ON PROGRAMS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS 381-82, 1284 (Comm. Print 2000) (showing that the maximum cash assistance grant in every state is far below the federal poverty line).

165. Even when a worker prepares her own tax return, or represents herself in a disability determination, she bears a cost in the form of an increased risk of an incorrect, unfavorable eligibility determination.

166. One of President Reagan's first acts was to freeze civil service hiring in most agencies. Robert W. Hartman, Federal Employee Compensation and the Budget, in THE FEDERAL BUDGET: ECONOMICS AND POLITICS 263, 266 (Aaron Wildavsky & Michael J. Boskin eds., 1982). Congress, too, has imposed crude caps on federal employment. Id. Far from achieving their professed goal of increased efficiency, personnel caps absent a reduction in the work expected have forced agencies to contract for basic government functions whether doing so was cost-effective or not. Id. Also, by treating costly professionals and inexpensive clerical staff equivalently, caps tend to encourage managers to skew the federal workforce toward the former. Id. at 266-67. This antipathy toward public employment crosses partisan lines: the Clinton Administration treated reductions in the size of the federal workforce as one of the chief accomplishments of its "reinventing government" initiative. See Super, Quiet Revolution, supra
the gross amount of benefits is available to meet recipients' needs is likely to cause the public to question a program's efficacy: it may wonder why recipients are not doing as well as their gross benefit levels suggest they should be.\textsuperscript{167}

The reduction in recipients' purchasing power could be considerable.\textsuperscript{168} SSA will withhold up to one-quarter of retroactive SSDI (but not SSI) benefits to pay the fees of representatives.\textsuperscript{169} It also authorizes its adjudicators to determine the propriety of the fee the representative charges in each case. Solid data is unavailable on the amount of the fees approved; certainly if they approach one-third of retroactive benefits, they could make SSDI and SSI's total administrative costs (including SSA's internal costs of limited application assistance and adjudication of claims) substantially greater as a proportion of benefits than those for Medicaid and food stamps.\textsuperscript{170} This may be appropriate given the complexity of disability determinations, but it provides no basis for predicting that privatizing application assistance would produce savings in other programs. In SSDI continuing eligibility review and SSI cases, fees appear lower and more difficult to collect (without the ability to collect from retroactive SSDI awards), with representation less widely available.

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\textsuperscript{167} See Super, Political Economy, supra note 6, at 704 (analyzing distortions resulting from programs that appear to be available to more people, or to provide more benefits, than is the case).

\textsuperscript{168} To be sure, inter-program differences provide evidence of costs from programs that purchase application assistance on an as-needed basis, but cannot provide direct evidence of what those costs would be in programs that now maintain a staff to provide application assistance. On the one hand, applications for food stamps and Medicaid are likely to be significantly simpler than the Social Security Administration's (SSA's) disability determinations. On the other hand, many successful applicants in these two programs must reapply and navigate an eligibility re-determination process sooner than those in programs relying on private application assistance. See 7 U.S.C. §§ 2012(c), 2014(c) (2000) (requiring most food stamp households to file reports at least every six months and to undergo full eligibility reviews at least every twelve months). GSL and EITC operate on annual eligibility determinations; SSI conducts financial reviews annually but it and SSDI typically review disability status much less often.

California, Illinois, and a few other states pay some community-based organizations flat fees, commonly $50, for each Medicaid and SCHIP application they prepare and submit. Because these groups have altruistic motives for helping low-income people apply, however, this does not demonstrate that $50 is sufficient to attract for-profit firms to provide such aid or that it funds sufficient staff to make this assistance available to all prospective claimants in need, even in the areas these non-profits serve. Moreover, these arrangements currently operate in addition to the traditional public application assistance and eligibility determination structure. If that structure was dismantled, the task of assisting claimants to apply for these programs would become considerably more demanding.


\textsuperscript{170} Good data also is unavailable on the typical amount of retroactive benefits accrued when a represented claimant finally prevails. Obviously this fee arrangement gives claimants' representatives incentives to proceed somewhat slowly.
EITC claimants spend an estimated $1.75 billion per year out of their $30 billion credits to purchase services very similar to those performed by food stamp eligibility workers. Although substantial, this represents only a fraction of the program’s total administrative costs. The IRS spends additional funds processing the tax returns (essentially applications) that claimants submit. The IRS also maintains a telephone service to try to answer claimants’ questions. Moreover, the IRS backloads substantial costs of EITC eligibility determination. Initially, the taxpayer, often aided by a tax preparer, determines her own eligibility. Subsequently, however, the IRS audits returns, demands additional documentation, and pursues a variety of costly and intrusive collection mechanisms.

This approach also has substantial non-monetary costs. The criteria on which the IRS selects returns to be audited are highly controversial, fraught with accusations of favoritism, racism, and political retaliation. The perception that these factors taint program administration has a significant non-monetary cost to the electorate, which cannot feel as satisfied with a program operating under such a cloud. The IRS’s back-end administration of EITC also has a substantial economic cost. In 1995 President Clinton proposed and Congress enacted an extra $100 million per year targeted specifically on auditing EITC claimants, in addition to substantial fractions of its general audit and compliance funds. As a result, although the amounts of money at stake are far smaller, the IRS audits more than twice as high a percentage of the returns of low-income EITC claimants than it does the returns of partnerships or of persons making over $100,000. This high rate of audits surely contributes to the large and steadily increasing share of EITC claimants surrendering a significant fraction of their potential benefits to professional tax preparers.

Finally, the impact of leaving claimants to purchase application assistance in a public benefit program depends not just on the incidence and amount of those costs but also on how those costs are distributed within the population of claimants. Claimants will have to choose, not just which provider to use, but whether to sacrifice some of their prospective award on any provider at all. This method of privatization appears likely to produce a significantly regressive distribution. Some of the neediest eligible claimants, who feel they cannot afford to pay for an administrative service provider, may be denied benefits based on the incompleteness of their applications. These lost benefits

171. DAVID CAY JOHNSTON, PERFECTLY LEGAL: THE COVERT CAMPAIGN TO RIG OUR TAX SYSTEM TO BENEFIT THE SUPER RICH—AND CHEAT EVERYBODY ELSE 141 (2003).
172. See PAYNE, supra note 158, at 35-85.
174. JOHNSTON, supra note 171, at 132.
175. Id. at 134-35.
176. See PAYNE, supra note 158, at 28, 154.
effectively represent an administrative cost, even if they are not received by any vendor.

In addition, the least sophisticated claimants are likely to need the most assistance negotiating the application process. These unsophisticated individuals are likely to be disproportionately the poorest and, hence, those on whom denial of a meritorious claim is likely to create the greatest hardship. Moreover, these claimants may be the least effective at selecting competent representatives or at negotiating competitive fees with the representatives they do select.

In all of these respects, even if a shift to recipients’ purchase of application assistance did not reduce aggregate net benefits available to claimants, it likely would shift those benefits from the most to the least vulnerable. This seems inconsistent with the goals of a means-tested program.

iv. Impacts of Privatization on Program Integrity and Design: Lessons from the EITC

Privatization has varying effects on the integrity of public benefits programs. For example, EITC claimants determine not just whether to pay for any administrative services at all, but also which services to purchase: return preparation, tax advice, and/or risk advice. Different tax preparers may provide these services in varying degrees. Future claimants under privatized Medicaid or food stamp application processes will likely face a similar array of choices.

These choices are important. IRS research shows some variation in taxpayer compliance with program requirements based on how the return was prepared. The most reliable returns appear to be those that taxpayers prepare for themselves, followed by those prepared by attorneys. National tax preparation chains were about average, with local tax services and informal paid preparation producing the most problematic results. This may reflect the fact that some tax preparers combine the functions performed in other programs by eligibility workers and by dishonest friends.

Because claimants determine who will perform important EITC administrative functions for them, tax preparation firms naturally advertise. Some service providers may find it advantageous to maintain reputations for integrity and to minimize disputes with the IRS. As a result, these firms may

179. See id. at 173. These figures are for all taxpayers, not just those claiming the EITC. Since the data does not control for income level or the complexity of the return, it is only suggestive. See id. at 175.
180. See id. at 173.
actually understate the claimant’s EITC, or overstate her tax liability.\textsuperscript{181} This serves the program’s interest in integrity but undercuts its interest in aiding eligible claimants to the full extent of the law. Other service providers may promote themselves on the basis of their supposed ability to maximize the taxpayer’s refund.\textsuperscript{182} They may pursue risky or even overtly unlawful schemes to maintain this image. Here again, one program objective may be served at the expense of another. Still other providers may seek to compete on the basis of price. To keep unit costs down, these preparers may cut corners resulting in errors in both directions. Overall, although the tax preparation market appears quite competitive, it is difficult to see how this competition reliably advances the program’s goals.

Commodification of program administration can have other effects that are more difficult to measure. Research indicates that personal integrity and a commitment to social fairness plays a major role in encouraging taxpayers’ compliance.\textsuperscript{183} The IRS seeks to promote the public’s esteem for the tax system’s fairness (and hence worthiness of compliance) through program information activities, which seek to aid low-income taxpayers.\textsuperscript{184} Contact with a public eligibility worker, who explains program rules and the importance of compliance\textsuperscript{185} could heighten this sense of civic duty in public benefit programs.\textsuperscript{186}

EITC’s history of “perceived” integrity problems should be caution against heedless emulation of its administrative model. A series of reports have criticized the EITC’s high error rate.\textsuperscript{187} Yet, without eligibility workers to interview claimants, the IRS has no reliable way of knowing, in any particular case, whether errors result from honest misunderstandings of the program’s rules\textsuperscript{188} and how many represent deliberate fraud. Overall, however, IRS and General Accounting Office (GAO) reports suggest that the vast majority of discrepancies in the EITC result from honest errors rather than fraud.\textsuperscript{189}

Although some tax preparation firms have relatively low error rates, others do quite badly. Some claimants try to file on their own, but they may

\begin{footnotes}
\footnote{181. Id. at 193.}
\footnote{182. Id.}
\footnote{183. Id. at 118-22.}
\footnote{184. See id. at 169.}
\footnote{185. See, e.g., Office Operations and Application Processing, 7 C.F.R. § 273.2(e)(1) (2007) (requiring food stamp eligibility workers to explain claimants’ rights and responsibilities during application interviews).}
\footnote{186. In addition, taxpayers apparently feel more pressure to comply from their friends than from the IRS’s enforcement apparatus. See Taxpayer Compliance Vol. 1, supra note 178, at 112-13. Also, if friends see the program’s human face when they apply, this may increase the community’s collective commitment to program integrity.}
\footnote{187. See Johnston, supra note 171, at 132-38.}
\footnote{188. These rules can be arcane indeed, in some instances applying different definitions of common terms to the EITC than to other individual filers. See id. at 138.}
\footnote{189. See id. at 137-38.}
\end{footnotes}
have difficulty getting through to the IRS's telephone service for answers to their tax questions. Some surveys have found that the advice dispensed over the telephone is incorrect a great deal of the time. 190 But because a claimant generally does not have any on-going relationship with any particular IRS representative, she or he has no way of holding that representative accountable for erroneous advice on which the claimant relied in committing an error.

This history holds important lessons for Medicaid and the Food Stamp Program. The lack of the kind of on-going contact with claimants that food stamp eligibility workers currently have has left the IRS with insufficient information about the nature and extent of errors. It also denied the IRS and Congress adequate warning about the consequences for the EITC's error rate that new, complex rules to refine the EITC's targeting seeks to address. These led to additional errors as newly-ineligible claimants misunderstood these new rules. Although state agencies commonly argue against changes in food stamp rules that increase complexity and errors, 191 commercial tax preparation firms have no incentive to lobby against similar policies in the EITC: they can simply raise their fees to cover any additional burdens.

More recently, the IRS has responded to error rates by requiring millions of claimants to be “pre-certified” for the EITC before they may receive a tax refund. This is essentially an eligibility verification system, abandoning the self-attestation and audit approach relied upon in the rest of the tax system. EITC pre-certification, however, is both far more intrusive and far slower than any other public benefit program's verification system. In many instances, fully-eligible taxpayers simply will not have any of the specified pieces of documentation and will be denied the EITC accordingly. Because the IRS lacks a network of local offices to assist taxpayers or to interview them to resolve inconsistencies in their circumstances, pre-certification is likely to deny benefits to many eligible taxpayers and to require others to spend larger portions of their refunds on services from preparation firms, some of which will be up to the task and some of which will not be.

If a state turns administration of Medicaid or the Food Stamp Program over to a private contractor, it will give up much of the information it relies upon to maintain a balance between access and program integrity. If its error rate climbs, it may have little reliable information about the cause. Presumably contractors will be in no hurry to point fingers at themselves. If the error rate becomes unacceptable, the program's options for responding are likely to be limited. With the public administrative infrastructure dismantled, the state is likely to lack the immediate capacity to resume holding face-to-face interviews

with claimants. Instead, it may feel obliged to impose draconian verification measures that bar many eligible households and, because of the state’s lack of experienced staff, are likely to result in long delays and additional errors. The EITC’s place in the tax system may have made any other administrative approach infeasible. Medicaid and the Food Stamp Program, however, are not so constrained.

Privatization has compromised the EITC’s design in other ways. Several of the EITC’s substantive features that help make private administration possible also significantly impede its effectiveness in helping low-income people avoid hardship. Most significantly, the EITC almost always comes in the form of a single lump sum, rather than on-going payments to meet living expenses. This gives the EITC by far the largest mismatch of any anti-poverty program between the financial difficulties that trigger the benefit and the arrival of aid to meet those difficulties. Although performance of some additional administrative steps can result in up to sixty percent of the ultimate EITC being paid on an on-going basis, less than one percent of claimants do so, presumably in part because it has not proven profitable for tax preparers to offer help with these steps. If Medicaid and the Food Stamp Program similarly discontinue providing application assistance to claimants, those programs’ design will increasingly depend on which services private vendors find profitable to provide.

B. Private Administration in Competition with Public Administration

Some states have tried to have public agencies compete with private firms for the opportunity to provide administrative services. For the most part, this has consisted of government agencies bidding for sole-source administrative contracts, either alone or in consortia with private firms. This competition also could take place between public and private providers of administrative services within the same jurisdiction. In a sense, VITA projects compete with private tax preparation firms. Legal services offices competed with private lawyers to assist SSDI claimants until 1995, when Congress prohibited those offices from taking cases that could generate fees. Superficially, this would seem an appealing solution to the privatization

192. See Johnston, supra note 171, at 138.
193. See generally Alstott, supra note 19.
194. For example, Wisconsin allows county welfare departments to bid against private non-profit and for-profit entities for contracts to operate its cash assistance program. In rural areas, counties have faced few competitors, but private entities won contracts for all six areas of Milwaukee. See Kaplan, supra note 121, at 106. Before the Clinton Administration rejected Texas’s application for waivers to privatize administration of dozens of public programs, see Ricucci, supra note 130, at 18-19, two of the three consortia bidding for the contract paired a state agency (the welfare department or the labor department) with large computer services and program management companies.
debate: allowing the market to determine whether a public or private organization is most efficient. For several reasons, however, this competition seems unlikely to be more than an illusion. First, as discussed above, the question of whether government or beneficiary should be the purchaser poses vexing questions. Whichever way these issues are resolved will necessarily limit the scope of the competition, privileging some objectives for program operation and undervaluing others.

Second, defining the public entity that will compete entails difficult problems. In particular, the amount of capital each competitor commits will have a major impact on what it can offer. The cost of capital committed to administering a program will significantly affect private competitors’ profitability; a contract will only be profitable if the contractor can obtain an adequate return on money spent up front to design forms and automated systems, to buy office space, and complete other set-up procedures. The government, on the other hand, already has assets well-adapted for running public benefit programs. If the public agency bidding for the administrative contract is allowed to use those assets, it will have fewer costs than its private competitors. Consider, for example, a public agency that owns several local welfare offices. Allowing it to keep those—while its private competitors must pay to rent space—would give it a huge advantage. Denying the public agency those offices would help level the playing field but would also saddle the rest of the government with real estate for which it may have little use and for which little market may exist. Perhaps the most sensible approach is to charge the bidding agency rent for the offices. But with little private market for large office spaces in depressed communities, setting the amount of this rent will be essentially arbitrary—and will have a powerful impact on the ultimate outcome of the competition. An arbitrary decision made within the government, rather than a truly free-market competition, will determine who wins the contract. Little evidence suggests that the government is any better at valuing items for which no private market exists than it is at allocating resources in the current system of public administration. Moreover, if a private competitor prevails over the public agency, the government will likely suffer a loss—because its real estate holdings are now largely useless—that will not show up in a simple accounting of the program’s operational costs. Similar problems will arise in connection with office equipment, policy manuals, pension obligations, and the agency’s other assets and obligations.

Finally, and most importantly, proposals for public-private competition tend to overlook conflicting interests, and resulting agency problems within the government. Public choice theory typically treats bureaucracies as “black

196. See supra Part III.A.2.b.
197. The private bidders also may want to rent some of these offices. If so, setting their rents—particularly if they want only part of the space—will introduce another element of arbitrariness.
boxes" whose primary goal is to maximize their own budgets.\(^{198}\) Whatever the validity of this crude aggregation under other circumstances,\(^{199}\) it badly obscures divergent motives that are likely to hobble public agencies in this competition.

For example, a bureaucracy's political leaders may be chosen for their ideological commitment to privatization.\(^{200}\) This may trump any empire-building temptations. Alternatively, they may feel that their political advancement to the next, more appealing post (or their obtaining work with a contractor) depends on their successful privatization of their current bureaucracy's work. More broadly, if they are convinced that the proper outcome of any competition is that the private contractors prevail, they may feel that any investments in the bureaucracy's competitiveness are futile.

Career managers might prefer higher budgets, but first and foremost they will seek to retain employment.\(^{201}\) Thus, if reducing the budget is crucial to avoiding the dissolution of the agency in favor of a private contractor, they may do so in ways that have an adverse impact on performance. Their expertise, and often their knowledge of the people judging the bids, may allow them to design cuts whose adverse consequences are difficult to measure. Alternatively, if their political masters clearly favor privatization, they may see that outcome as inevitable and their zealous pursuit of it crucial to retaining employment in the rump of an agency that remains to administer the contract—or crucial to gain employment with the winning bidder.\(^{202}\)

Some of a public agency's front-line employees also may not see the agency's success as being in their interests. Apart from whatever altruistic concerns may have driven them into human services work in the first place, employees' selfish motivation is to maximize their earnings. For many, that will mean continuing to work for the government, giving them an incentive to improve its performance. For some of the most talented, however, a private contractor might pay better and offer greater opportunities for advancement. Thus, they may not rally to help the agency win the competition.

As a result, private contractors will compete aggressively, while the public agency is likely to face severe constraints. Most competitions of this kind are established by policymakers who are ideologically committed to privatization. As such, policymakers are unlikely to give public agencies the flexibility and the access to capital required to compete effectively.\(^{203}\) They also may be

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199. See Street et al., supra note 177, at 48-63.
200. See Breaux et al., supra note 110, at 46.
201. Public choice theory addresses the usual situation in which bureaucrats' jobs are secure or, at least, their tenure security has no inverse relationship to the bureaucracy's budget.
202. Some also may feel they would enjoy a better quality of life working for a smaller entity, either public or private. See Coase, supra note 70, at 42.
203. To much the same effect, the agency may be saddled with pension and other costs that the government must bear no matter who wins the competition. Also, some of the agency's best
tempted to skew the competition overtly, requiring public contestants to meet higher standards than those applied to private bidders.  

The competition is unlikely to be any better if services are purchased on an as-needed basis. Finding ways to motivate the public agency to compete will be difficult. Thus, although both public and private administrative help are available in SSA’s disability determination process, no true public-private competition exists: when a claimant chooses to rely solely upon its assistance, the SSA incurs marginal costs but few if any marginal benefits. This is because agencies’ administrative budgets do not reliably expand in response to increased workloads.

C. Lessons from Antitrust Theory for the Privatization Debate

It is no small irony that demands for the privatization of government functions—in essence, demands for divestures by the governmental conglomerate—come in an era of aggressive mergers and acquisitions in the private sector. Some of the same groups that urge the government to accept the concentration of functions within single large, vertically-integrated private corporations criticize the government’s vertical integration in the operation of public benefit programs. Government administration of public benefit programs has characteristics of both horizontal and vertical combinations within an industry, as well as conglomerates across industry lines. Privatization can be seen as an attempt to disintegrate programs’ operations in each of these dimensions. Moreover, both public and private administration will affect other markets and, hence, implicate some of the concerns present in antitrust analyses of tying arrangements.

Scholars have warned that antitrust principles cannot usefully be applied to make government functions more competitive, and the Court has agreed. Thus, even if the government’s administration of public benefit programs violated antitrust principles, that would not, by itself, be grounds for

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204. For example, Wisconsin required county welfare departments to demonstrate substantial savings in order to get and keep contracts to administer its cash assistance programs; private entrants need only to submit the lowest bid.

205. SSA may benefit from winning the “competition” with a private representative only if that representative would complicate the process enough that SSA must expend more administrative resources than it would have providing all necessary assistance itself.

206. The Reagan Administration cut one-third of SSA’s front-line staff during the early 1980s, even as the quantity and rigor of its disability adjudications were rising dramatically.


208. See AREEDA & HOVENKAMP, supra note 32, ¶ 100c.

change. In fact, however, the lack of competition in public benefit programs springs not from anti-competitive actions of the government but rather from efficiencies achieved through the current method of operation. At the behest of conservative law and economics scholars, antitrust law no longer criticizes market dominance resulting from superior efficiencies.

This Section applies that precept to program administration, arguing that more efficient public administration should not be punished. Subsection 1 tests the current mode of administration against antitrust principles criticizing horizontal combinations. This Subsection also considers the possibility that privatization of public benefit programs' administrations may divert productive resources from activities that would otherwise compete with those programs. Subsection 2 notes that the same factors identified above that guide the government's "make-or-buy" decision with regard to public benefit program administrative services are accepted in antitrust law as justifications for vertical integration. Subsection 3 considers whether any antitrust concerns that still apply to conglomerates have any application to the privatization debate. Finally, Subsection 4 compares the tying likely to occur with public administration of benefit programs with that possible under private administration.

1. Horizontal Combinations

Like a horizontally-integrated company, the government has a near-monopoly on the provision of subsistence benefits to low-income people within its jurisdiction.\textsuperscript{210} If one defines the market for aid nationally, one can find some interstate competition as states offer parallel versions of federally-funded programs. State programs diverge from one another only modestly with respect to food stamps, but can have dramatic variances in Medicaid, SCHIP, and particularly cash assistance. Otherwise, private charities offer some aid, but the amount pales compared to that provided through public benefit programs.

Antitrust law has largely abandoned the approach of breaking up large firms merely because they are large.\textsuperscript{211} Those horizontal combinations that seek to improve efficiency, rather than market dominance, enhance consumer welfare.\textsuperscript{212} Moreover, the government's behavior could hardly depart more dramatically from that of the jealous near-monopolist.\textsuperscript{213} Far from trying to
exclude potential competitors, the government makes open-ended offers to subsidize them through tax deductions for charitable contributions. Recent devolutionary changes in all major public benefit programs have also expanded states’ ability to compete meaningfully with one another. The government’s near-monopoly in providing public benefits springs largely from its natural monopoly in operating the tax system and secondarily from the natural monopoly in administering these programs. Contemporary antitrust policy recognizes that some horizontal combinations, even those formed by mergers, can benefit consumers by improving efficiency.

The extent and value of competition among providers of subsistence benefits is contested. Somewhat ironically, conservatives, who advocate breaking up the government’s role in program administration through privatization and reliance on private charity, view the current system as more competitive than many liberals do. Conservatives contend that states with more generous programs will function as “welfare magnets,” drawing low-income people from less generous states. Many liberals ridicule the notion that people will leave their social support systems for a few extra dollars, although some contend that the fear of being a welfare magnet has contributed to a “race to the bottom” in which states compete to adopt ever-more draconian policies. On the other hand, liberals have been enthusiastic about competition cast as “pluralism.”

If one defines the relevant market for subsistence benefits as a state, or a part of a state, private charities and some local governments provide the only organized competition to federal and state public benefit programs. Although their scope pales in comparison, they have some limited capacity to assist

214. For a critical account of how the procedural themes of devolution and privatization together have undermined substantive policy goals, see Michaels, supra note 20.
215. To be sure, states operate tax systems parallel to the federal one. These are motivated by sovereignty, not efficiency, concerns. States seek to reduce the inefficiency of their systems by relying as much as possible on federal policies and determinations. See David A. Super, Rethinking Fiscal Federalism, 118 Harv. L. Rev. 2544, 2602-04 (2005) [hereinafter Super, Fiscal Federalism]. State tax systems are particularly ill suited to supporting means-tested benefits. Id. at 2568-80.
216. See Hughes et al., supra note 95, at 43-44; Bork, supra note 32, at 222.
218. Martin, Social Policy, supra note 137 at 233-34.
people that fall through the cracks of the larger programs. This is an important function, both for the low-income individuals involved and as a means of identifying systematic defects in federal and state programs. For example, state and local governments' advocacy, seeking to relieve demands on programs they operate without federal support, played a crucial part in persuading Congress to moderate the 1996 welfare law's rules disqualifying legal immigrants from public benefits.\footnote{220}{Sheri Steisel, Nat'l Conf. of State Legislatures, States May Bear the Costs of Helping Immigrants, State Legislatures (Jan. 1997), available at http://www.ncsl.org/statefed/WELFARE/HELPIMM.HTM; Robert Greene, County Officials Say They Have Made Headway in Effort to Obtain Federal Funds, Metropolitan News Enterprise, May 8, 1998, at 11.}

These charities and local governments can plausibly decide that they can obtain the greatest return for their limited resources by helping claimants apply for benefits that federal and state governments fund, rather than by administering and funding their own programs. This will be particularly true where they perceive a large number of people substantively eligible for federal or state benefits that are failing to qualify because of administrative problems. Any change in federal or state programs that increases the procedural demands on claimants or reduces the administrative resources available to help them meet those demands, therefore, is likely to reduce competition from private charities and local governments.\footnote{221}{This bears some resemblance to the practice of denying competitors access to inexpensive raw materials. See Thomas G. Krattenmaker & Steven C. Salop, Anticompetitive Exclusion: Raising Rivals' Costs To Achieve Power over Price, 96 Yale L.J. 209, 232-34 (1986) (finding this practice deserving antitrust criticism under some circumstances). Although volunteers' time and donors' money are nominally free to a non-profit, in fact the group's leadership must expend resources recruiting and tending to supporters. The marginal cost of additional volunteers and donors is likely to increase. A non-profit that has devoted its existing, relatively inexpensive, volunteers to helping low-income people qualify for federal and state benefits may be unable to find enough additional sustainable resources to mount a competing program of its own.}

Diminution in administrative assistance to claimants is not at all inevitable in privatization, but some current proposals clearly make less assistance available. In particular, Texas, Indiana, and other states' privatization plans involve closing many or most local assistance offices, turning their responsibilities over to "call centers" operated by contractors.\footnote{222}{See Letter from William Ludwig, Regional Administrator, U.S. Dep't of Agric., to William Hawkins, Tex. Health & Human Servs. Comm'n (Sept. 26, 2005).}

This would largely eliminate assistance to claimants that are unable to access call centers due to disability, illiteracy, or other impediments.\footnote{223}{See Letter from Tom Harkin, Senator, to Mike Johanns, Sec'y of Agric. (Aug. 23, 2005).} Texas acknowledged this deficit resulting from lay-offs of over four thousand state employees. Texas assumed the shortfall in assistance would be made up by one million hours per year of uncompensated labor from non-profit organizations. This brought protests from non-profit groups that the assumed labor is unlikely to be
available and that whatever resources they do provide will detract from their core missions.\textsuperscript{224} Thus, far from enhancing the role of private charities and local governments as competitors to large public programs, these plans actually deplete their capacity to play that role.\textsuperscript{225}

2. \textit{Vertical Combinations}

First and foremost, privatization is a challenge to the vertical integration of program operation: an attempt to separate financial support and whatever other functions the government retains from those proposed to be shifted to private concerns. Like a vertically-integrated company, the government takes responsibility for several stages of production of means-tested benefits.\textsuperscript{226} Although horizontal combinations typically result from desires either to wield monopoly power or to enjoy economies of scale, vertical combinations traditionally have been seen as efforts to reduce transaction costs.\textsuperscript{227} Having sequential steps in production take place within a single organization avoids the “transactional haggling, opportunism, and uncertainty that contaminates buyer-seller relationships.”\textsuperscript{228} Economists also have seen vertical combinations as efforts to reduce uncertainty and vulnerability to exercises of market power by those at other levels of the production process.\textsuperscript{229} Organizational theorists similarly see vertical integration as a means for an entity to manage uncertainty and risk.\textsuperscript{230}

Antitrust law rejects the view that an entity choosing to handle a step in the production process internally “is guilty of monopolizing because [it] is unnecessarily restricting competition” that would have occurred if bids had been taken.\textsuperscript{231} Accordingly, vertical combinations do not necessarily reduce competition, although they are more common where relatively little

\textsuperscript{224} See, e.g., Ferrell Foster, \textit{Agency Relies on Churches to Connect Poor to State Aid Programs} \textit{The Baptist Standard}, Sept. 3, 2004, available at http://www.baptiststandard.com/postnuke/index.php?module=htmlpages\&func=display\&pid=2244.\textsuperscript{225} See \textit{MICHAEL B. KATZ, THE PRICE OF CITIZENSHIP: REDEFINING THE AMERICAN WELFARE STATE} 163-65 (2001) [hereinafter \textit{KATZ, CITIZENSHIP}].\textsuperscript{226} See supra Part II.\textsuperscript{227} See \textit{WALTER H. GOLDBERG, MERGERS: MOTIVES, MODES, METHODS} 52 (1983). Conglomerates traditionally were said to seek to diversify their businesses and hence reduce risk. \textit{Id}. This rationale seems to fit governments well since different services will appeal to different segments of the electorate. A proposal that government discontinue a particular service effectively increases the government’s dependency on the constituencies for its remaining services and its risk of losing power should some of those groups become disgruntled.\textsuperscript{228} \textit{Id}. at 110.\textsuperscript{229} See \textit{id}. at 53; see generally \textit{F.M. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE} (1970); \textit{OLIVER E. WILLIAMSON, CORPORATE CONTROL AND BUSINESS BEHAVIOR: AN INQUIRY INTO THE EFFECTS OF ORGANIZATION FORM ON ENTERPRISE BEHAVIOR} (1970).\textsuperscript{230} See generally \textit{JAMES D. THOMPSON, ORGANIZATIONS IN ACTION: SOCIAL SCIENCE BASES OF ADMINISTRATIVE THEORY} (1967); Jeffrey Pfeffer, \textit{Merger as a Response to Organizational Interdependence}, 17 \textit{Admin. Sci. Q.} 382 (1972).\textsuperscript{231} Posner, \textit{ANTITRUST 2d ed., supra} note 38, at 201-02; \textit{BORK, supra} note 32, at 226-45.
competition exists at the stages of production before or after that in which a
given entity is engaged.\textsuperscript{232} Thus, a manufacturer that depends on obtaining
critical parts from a relatively uncompetitive market is more likely to seek to
produce its own parts to avoid the risks of sudden run-ups in prices.\textsuperscript{233} More
broadly, the efficiency of vertical integration depends on the factors identified
above as shaping the "make-or-buy" decision.\textsuperscript{234}

Applying this principle to public benefit programs, then, rational
managers might be expected to want to concentrate the activities required to
operate a program in the government's hands, unless those activities can be
turned over to a relatively competitive private market. Experience to date seems
to bear out this hypothesis. The major programs that have privatized application
preparation, EITC, SSDI, SSI, and GSL, rely on competitive markets in tax
preparation, legal services, and loans. No comparable market is available for
assistance in applying for food stamps, Medicaid, and other benefits,\textsuperscript{235} making
continued vertical integration logical. By contrast, those functions that have
been most privatized, such as the issuance and transaction of benefits, also
parallel activities in the private market that have spawned substantial competi-
tion. Issuing EBT and Medicaid cards is not very different from issuing credit
and debit cards, an activity several companies perform. Converting food stamps
into food, vouchers into housing, or Medicaid coverage into health care is what
supermarkets, landlords, and physicians do every day in cash transactions.

3. Government as a Conglomerate

Little imagination is required to see the government as a conglomerate,
operating a host of relatively unrelated activities. To the extent that antitrust
traditionally has been concerned with conglomerates or conglomerate mergers,
those concerns have reflected fears that the conglomerate could mobilize
resources from its other, unrelated, lines of business for a short-term effort to
 crush competition in a particular market.\textsuperscript{236} In effect, the argument is that
enterprises within the conglomerate have access to short-term capital at below-
market costs and thus can sustain losses while selling at prices other firms
cannot afford to match. Conservative law and economics scholars have argued

\textsuperscript{232} See \textsc{Goldberg}, supra note 227, at 110-11.
\textsuperscript{233} For example, an automobile manufacturer may feel the need to make many of its own
model-specific parts because it could not continue to make cars without them, and it would take
some time for another firm to begin making those parts if the company's regular supplier were to
fail. By contrast, a coffee shop is less likely to enter the donut-making business since the latter is
likely to be competitive already and, if the coffee shop's supply of donuts ever were threatened, it
could switch to pastries or muffins.
\textsuperscript{234} See supra Part III.A.1.
\textsuperscript{235} See supra Part III.A.2.c.
\textsuperscript{236} See Alan Hughes & Ajit Singh, \textit{Mergers, Concentration, and Competition in
Advanced Capitalist Economies: An International Perspective}, in \textsc{The Determinants and
that the proper focus is not size, but actual anti-competitive behavior. They have largely prevailed in that argument.

This suggests that antitrust doctrine and prevailing economic theory offer scant support for privatization of public benefit programs merely to reduce the size of the government. Even a more populist antitrust policy lends little support to privatization as an anti-conglomerate measure. To be sure, public benefit programs are expensive undertakings that could benefit from greater access to funds. That need for funds, however, is chronic and is not related to any anti-competitive efforts. More importantly, the need for those resources is in program financing, an aspect of the program that privatizers would leave in government hands.

4. Tying Public Benefits Administration with Other Services

Another antitrust concern, which can arise in connection with vertical integration or conglomerates, is the relationship between markets for distinct products. Even if a firm is prevailing in one market legitimately due to superior product design, it may still be guilty of anti-competitive behavior if it leverages that advantage to enhance the market for one of its other products. For example, the Justice Department accused Microsoft of selling its Windows operating system, which had won market dominance, as a package with other products that would not have done as well had they competed on their individual merits. Tying applies monopoly power held in one market to improve a seller’s position in another.

Under either public administration or sole-source contracting, one entity will have a clear monopoly on access to the public benefit in question. Even where application assistance is purchased on an as-needed basis from a number of vendors, those vendors are likely to develop a trust relationship with claimants, giving them the opportunity to sell an additional, unrelated service as a credence good. Accordingly, assessing the respective competitive consequences of public and private entities’ administration of public benefit programs requires examining the impact on the markets for other services that each of them provides. Subsection a examines the likely increase in consumption of other public benefits when a public agency administers a given program. Subsection b then identifies some services that private firms may be able to sell to claimants if they administer public benefit programs.


238. These arguments also suffer from ambiguity as to what the “size of government” means. Exponents of this view commonly cite tax burdens as a reason for wanting to shrink government, see supra notes 41-42, yet only the elimination of government functions, not their assignment to private contractors, reduces the government’s need for revenues.

a. The Advantages of Tying with Other Public Functions

Many of the steps required to obtain one public benefit closely parallel those required to obtain another. The claimant must learn of the program, learn of the entity administering the program, and contact that entity. The claimant must provide and verify her or his identity, residence, family composition, income, and other personal circumstances. An interview is commonly required. To reduce burdens on both claimants and the government, programs increasingly provide for "one-stop shopping" or "no wrong door" policies allowing claimants to apply for multiple programs at a single location. Some programs also confer adjunctive eligibility, deferring to determinations made by other programs.

Antitrust policy would not criticize the relationship among publicly administered programs, although they could technically be termed tie-ins, because the relationships are the product of economies of joint production and sale. Efficiency, rather than efforts to marginalize competing providers, drives the relationships. For similar reasons, consumers typically buy tires with their cars even though it would technically be possible to buy a tireless car and separately purchase tires and fit them to the car.

The loss of tying among public benefit programs would increase the government's cost of administration and reduce the net value of the benefits to claimants. In theory, privatization need not disrupt common application arrangements if all programs involved employ the same contractor at the same time. In practice, however, states that have privatized application processing in SCHIP have been effectively unable to comply with the statutory requirement that they "screen and enroll" in Medicaid any SCHIP applicants meeting Medicaid's eligibility requirements.

b. The Problems with Tying with Other Private Functions

Privatization of the administration of public benefit programs presents an opportunity for contractors to tie the programs' operations to other private activities. In fact, this has been a major motivation for ideological advocates of privatization: tying the receipt of public benefits to the provision of particular moral messages. Commercial tying presents the greatest risk to vulnerable


243. Although some conservatives applaud these barriers as laudable incentives, they are in fact highly inefficient. See Super, Invisible Hand, supra note 28, at 825-30.

populations served by social welfare programs.\textsuperscript{245} Examples of tying the privatized administration of public benefits programs to particular moral messages and commercial services are discussed below.

Efforts to engage religious organizations in the administration of these programs have sought to tie the distribution of aid to those groups' moral messages.\textsuperscript{246} A much-debated feature of the 1996 welfare law sought to facilitate this contracting as "charitable choice."\textsuperscript{247} Both political and constitutional concerns have encouraged proponents of "charitable choice" to remain coy about the extent of tying they envision. In practice, the legislation appears to have done little: most religious organizations reported little difficulty in competing with secular groups for available contracts before PRWORA.\textsuperscript{248} On the other hand, the law's limits on tying also seem to have proven ineffectual, with some religious contractors imposing requirements, such as attendance at worship services, that PRWORA did not authorize.\textsuperscript{249} This tying may become an even more serious issue if charities are tasked to distribute more valuable benefits, such as Medicaid and food stamps.

Tying in the commercial context is even more worrisome. Privatized administration of EITC has allowed tax preparation firms to tie it to their other services. Most obviously, someone using a tax preparation firm to claim the federal EITC may pay more to have her state income tax prepared as well, even if she is under the threshold at which such returns must be filed. Much more troublingly, tax preparers have aggressively promoted "refund anticipation loans" (RALs). Although many taxpayers appear to believe that a RAL is an expedited refund from the IRS, in fact it is a loan for which an anticipated refund is collateral. Financially unsophisticated EITC claimants overestimate the likely delay in receiving refunds and underestimate the effective interest rates represented by RAL fees—from an annual rate of 97\% in low cases to 222\% in typical cases to more than 2000\% in high cases.\textsuperscript{250} Because the IRS provides markers to preparation firms indicating when a taxpayer's refund is due to be intercepted, these loans entail extraordinarily low risk to the lenders. The conjunction of private EITC administration and RAL marketing apparently has gutted competition in loan rates: a study found those rates higher in areas with large numbers of tax preparers and loan offices. Nonetheless, in some areas two-thirds of EITC claimants take out RALs.

\textsuperscript{245} It is no answer to say that the additional services are given rather than sold to low-income people seeking public benefits through non-profit providers. Bundling and tying are functionally equivalent. POSNER, ECONOMIC ANALYSIS, supra note 213, § 10.10, at 321-22.


\textsuperscript{247} See PRWORA, supra note 8, § 104.

\textsuperscript{248} See Chaves, supra note 246, at 121-22.

\textsuperscript{249} See id.

\textsuperscript{250} Id. at 142.
Adding insult to injury, some tax preparation firms installed check-cashing machines in their offices charging an average of 2.2% of the amount of the RAL check.251 Here again, the transaction has a spectacularly low risk, with checks all coming from tax preparation firms the check-cashing company considered solvent enough to merit placing its machine in their offices. The net effect of these fees is that recipients of typical EITCs can pay 11 percent of their benefits for administration and delivery costs. This is, of course, in addition to the amounts the IRS pays for information, processing, audit and enforcement functions that it retains as well as the time claimants must spend compiling records and working with the preparation firm.

None of this likely rises to the level of tying that antitrust law forbids: a self-confident, assertive, well-informed consumer could easily select the services she or he wants to purchase and reject the rest. These practices are nonetheless troubling because they target a population that disproportionately includes people with little self-confidence or assertiveness in commercial matters and with limited information about programs’ administration and the value of related services.

Similar commercial tying would be possible if administration of Medicaid and food stamps were privatized. H&R Block, a large commercial tax preparation firm, is preparing to offer food stamp eligibility determinations as part of its services. The value of these determinations is questionable because tax returns report annual information from a prior period while food stamp eligibility depends on monthly information from the current period; and, of course, Block’s conclusions will carry no weight with the food stamp office.252 Nonetheless, Block appears to have determined that offering this service will attract additional customers. Privatization that replaces local food stamp offices with distant call centers is likely to increase demand for advisory opinions and help completing applications among claimants with limited telephone access and those uncomfortable with or unable to use technology. Block would then be well-positioned to sell food stamp claimants its tax preparation services. Should Block obtain an official role in food stamp administration, these opportunities would multiply.

The same analysis applies to commercial tying with Medicaid. Indeed, as a more valuable benefit, Medicaid has greater susceptibility to tying with other products. Most obviously, managed care companies will be well-positioned to enroll any beneficiaries they help to apply for Medicaid; even under the current system, managed care companies conduct Medicaid and SCHIP outreach for this purpose. Reductions in government-funded application assistance would offer these companies even greater opportunities to guide new beneficiaries to select them. The focus of competition among managed care companies thus

251. Id.
252. See Determining Household Eligibility and Benefit Levels, 7 C.F.R. § 273.10(c) (2007).
would shift from quality and accessibility of care to the aggressiveness of application assistance; this distortion presumably would be have a deleterious effect on the value, though not the cost, of Medicaid benefits. A more in-depth interaction with prospective beneficiaries also might yield information to facilitate adverse selection, helping companies avoid enrolling persons likely to have costly medical needs.

Companies offering supplemental insurance policies of dubious value, nursing homes, firms seeking volunteers for medical testing, home health services, and even funeral homes might find it advantageous to help claimants apply for Medicaid and steer successful ones toward their services. To be sure, these incentives already exist, and some service providers already provide application assistance. Reductions in the availability of public application assistance, however, could vastly expand the pool of claimants seeking application assistance and hence the return to resources invested in building the capacity to provide it. Tying the markets for administrative services and health care services likely would result in reduced quality in each. In some instances, it also could result in increased consumption of health care services, imposing additional hidden burdens on the public fisc.

IV
PRIVATIZATION'S IMPACT ON PUBLIC BENEFIT PROGRAMS' EFFICIENCY IN PROVIDING VALUE TO THE ELECTORATE

Although public benefit programs provide direct material aid to their recipients, they owe their existence to the support of the electorate. If these programs did not convey to the electorate utility that exceeds their cost, they would cease to exist absent some failure of the political process. This value could come in a wide range of forms. Some voters may feel satisfaction for helping those in need, others may find a more egalitarian income distribution appealing, still others may have instrumental motives, perhaps anticipating expanded markets for particular goods or services, a more productive future workforce, reduced risk of social disturbances, or a better image for this

253. Politicians commonly discuss this problem in terms of taxpayers, rather than the electorate. This seems erroneous and likely to produce inaccurate utility calculations. Taxpayers may provide the funding for government, which in turn provides the funding for public programs, but the programs' existence depends on the support of the electorate. Although the two groups overlap substantially, voters, not taxpayers, make voluntary decisions that make programs possible.

254. Political failures of this kind, through which elected officials or their appointees create or continue a program lacking significant popular support, are considered below. It should be noted, however, that support need not extend to a majority of the electorate in order to sustain a program. A minority that feels strongly enough about a particular program can trade its backing for other groups' priorities for their support for the program in question. In these cases, the program may be directly increasing the utility only of its core supporters; to be politically sustainable, the program must provide them enough utility to win not only their support but their willingness to make side deals to cobble together a majority for the program.
country abroad.

Whatever individual voters' preferences, the electorate is the "owner" of the "firms" that are public benefit programs. And just as the efficiency of firms in the private sector can be measured by the returns they produce on their owners' capital, the efficiency of a public benefit program can be measured by how much utility it produces for the electorate relative to the tax dollars expended and the public capital used to carry it out.

Over time, the electorate's expectations for program function and design change. For example, as concerns about inefficient cost-shifting in the health care system increase, spending to reduce the ranks of the uninsured may produce more utility than a comparable amount of money spent on another social welfare program. At the same time, the relative costs of various possible programs changes over time: for example, health care inflation has made Medicaid more and more expensive every year relative to the Food Stamp Program. Thus, to provide maximum value to the electorate, a program must respond both to variations in the costs of producing this or that benefit and to variations in which benefits the electorate values having produced.

This Part considers the ways in which transferring additional aspects of program operations to private entities could reduce the electorate's ability to obtain maximum satisfaction from the programs it authorizes. Section A examines the reduction in flexibility policymakers have to respond to changing public preferences when important aspects of program administration are locked into long-term contracts with private vendors. In effect, a long-term contract raises the transaction costs of implementing policy changes. Section B explores the increase in information costs that policymakers and the electorate are likely to suffer as a result of privatization. Finally, section C considers the ways in which the electorate may experience reduced agency as a result of privatization. The cumulative effect of these distortions is likely to be a serious divergence between the actual architecture of public benefit programs and the one that would produce the greatest utility for the electorate.

A. Loss of Policymaking Flexibility

Quite apart from the shortages of information about the program's operation discussed below, contracting out administration is likely to result in some significant policy paralysis. Many important policies will be set by way of the contract between the vendor and the government. Defining quality in terms concrete enough to be included in a contract is exceedingly difficult.\textsuperscript{255} It is a concept that is inherently political;\textsuperscript{256} thus, by signing a long-term contract


\textsuperscript{256} \textit{Id.} at 93-96.
with a particular definition of quality, a political administration can extend its reach far beyond the term for which it was elected. During the life of those contracts, changes in policy may be difficult or impossible. Contractors can demand a huge premium to change requirements during the term of the contract. Flaws in the program thus will be allowed to persist months or years after they are recognized, impairing its effectiveness and bringing public criticism.

For example, after the Food Stamp Program converted to electronic benefit delivery, contractors imposed heavy charges for changes made during the term of their contracts. This had many ramifications, one of which was to delay the implementation of interoperability, which allows claimants with cards from one state to buy groceries in another. Similarly, some states postponed their adoption of transitional food stamps and other options under the 2002 Farm Bill to help low-income working families because they could not afford to pay automation contractors to make the required changes to their systems.

Policymakers may lose further flexibility as private contractors become active lobbyists on public benefit policy. Service providers and vendors in Medicaid, WIC, and other programs have already done so. These providers and vendors naturally pursue the interests of their shareholders. Adopting policies that improve a program’s effectiveness or integrity therefore may become difficult politically if those policies might undermine contractors’ profitability. Winning approval of such policies may require that the contractors be “bought off,” diverting funds that could otherwise expand benefits. Some states have had to reduce Medicaid coverage for families with children severely in part because of the hospital, nursing home, and managed care industries’ ability to resist proposals to share the pain of budget shortfalls more broadly.

B. Information Problems: Reduced Access to Program Data

The electorate requires reliable information about the operation of public benefit programs so that it can both take pleasure in those programs’ past work—the direct benefit it receives from its investment—and decide how much of those programs it wants to “buy” in the future. Public officials, in turn, require fairly detailed information about programs’ operations to make the ongoing adjustments required to make those programs deliver the most utility for their master, the electorate. Making sound policy in public benefit programs depends on having adequate information.

For several reasons, the quality of program data is likely to decline if administration is turned over to a private contractor. As Subsection 1 discusses, contractors may seek to withhold much of this information as proprietary. Subsection 2 explains that contracting also is likely to reduce both the quantity and the value of data collected on programs’ operations, data that is vital to making appropriate policy changes. Subsection 3 describes how the separation of policymaking from operations is likely to further constrict the flow of vital
information despite the best intentions of all concerned. Finally, and perhaps most seriously, Subsection 4 demonstrates that privatization is likely to mislead the electorate about both programs' costs and their benefits.

1. Proprietary Information and Government Openness

Public benefit programs represent important moral decisions by society to expend resources to aid low-income people. With taxpayers' dollars funding such programs, the public has an obvious need and right to know how those dollars are being distributed. With these needs in mind, federal regulations contain numerous provisions allowing both claimants and members of the general public access to information about public benefit program operations. The federal Freedom of Information Act (FOIA) and similar state laws provide further access to program information. Both federal and state administrative agencies supplement this supply of information through websites and other means.

Turning over crucial components of a public benefit program's operations to a private contractor would significantly reduce the availability of information for several reasons. First, since the contractor's obligation to its stockholders is to maximize its profitability, it will be unlikely to devote resources to providing public information that is not specifically required by its contract. Second, many of the laws and rules that currently require program information to be made public will not apply to contractors. FOIA and similar state laws apply only to the government, not its contractors. Some federal rules requiring information to be made available to the public describe specific documents that state agencies prepare but that contractors might not.

Third, and most important, contractors are likely to regard much of the most important information about their policies and operations as proprietary. The Coca-Cola Company works diligently to protect information about how it manufactures soft drinks. Pharmaceutical companies fight mightily to keep confidential its processes for formulating drugs. Microsoft is highly protective of the source code for its programs. In the public benefits context, a contractor's "product" will be the administration of the program. It creates that "product" with its policies and procedures. Having access to those policies and procedures presumably would give other prospective bidders a distinct

258. See Demsetz, supra note 76, at 43-44 (noting that retaining secrets is essential to businesses' ability to compete).
259. See, e.g., 7 C.F.R. §§ 271.3, 271.4, 272.4(c), 273.15(p) (2007) (requiring state food stamp agencies to make various kinds of information public). Florida's privatization proposal declined to specify which current requirements it seeks to waive; Texas did not release the details of the bid that it accepted from Accenture. Thus, in neither case is it clear how many of the documents USDA's regulations require to be made public would continue to be prepared and released by the state agency, how many would be prepared and held confidential by the contractor, and how many would cease to exist altogether.
competitive advantage: they will not have to expend the resources to design these procedures from scratch and can concentrate on finding ways to improve on the first contractor’s approach. Contractors therefore are likely to refuse to release many of the kinds of information that state agencies routinely make available to the public. Although the state can try to negotiate a contract that requires release of some of this information, the contractor can be expected to resist vigorously and to insist on a premium price for exposing itself to this very real competitive disadvantage. At best, any likely compromise will leave low-income households and the public at large with far less access to information about program operations than they have today.

The potential consequences of this loss of access to program information are troubling. If program participation begins to drop sharply at a time of rising poverty, it may be difficult or impossible to determine the cause. Determining whether corrective action is needed, much less what kind, will be exceedingly difficult.

Applicants and recipients, in turn, may have no way to determine why an eligibility worker is imposing onerous verification requirements. Is that the contractor’s policy for all applicants? Is it the policy for all applicants of a particular category into which the eligibility worker believes, perhaps erroneously, that the applicant falls? Does it mean that the eligibility worker distrusts this particular applicant, perhaps for reasons that the applicant could readily clear up? Or do the requirements reflect personal hostility, or even racism? Each of these possibilities may call for a different course of action. Yet the applicant may be left with nothing more than speculation if the contractor keeps its policies secret. Having these kinds of doubts linger is unhealthy for the program in particular and society in general. The experiences of applicants like this may persuade other eligible people, incorrectly, that it would be futile for them to apply.

2. Reduced and Misdirected Data Collection Activities

Even if contractors do not actively withhold data, they may nonetheless choose not to collect the amount and type of information required to adjust programs’ operations to maximize desired outcomes. Contractors can be expected to undertake only those data collection activities that their contracts specifically require. Contracts require contractors to produce some specific types of data about the program’s operation. After the contract is signed, the government can offer to pay its contractor to collect additional data that had not initially seemed important, but the contractor’s monopoly position is likely to result in a very high price.

Policymaking in public benefit programs depends heavily on data produced by the research staffs of administering agencies. Time and again, important questions about program policy have been decided on the basis of an obscure table or chart providing valuable insights into how the program was
operating. Had a state entered into a long-term contract to operate its Aid to Families with Dependent Children (AFDC) program prior to the Family Support Act of 1988, it might not have thought to require collection of detailed information about recipients' efforts to secure employment. Such a state would have been ill-equipped to plan a major welfare-to-work program or to monitor the effectiveness of any program it did launch without paying a premium for new data collection or waiting for the expiration of its contract.

Similarly, had the Food Stamp Program's operation been contracted out prior to the mid-1990s, it seems unlikely anyone would have thought to specify collection of data on how the frequency with which working poor households are required to visit food stamp offices affects their participation. Without this information, policymakers likely would not have appreciated the need for the set of policy initiatives that became centerpieces of both the Democratic and the Republican policy agendas in that program from 1999 to 2002.

Moreover, even if a contractor chooses to collect some additional data, it likely will lack the experience with the program required to identify what information is most likely to have future value to policymakers. This can be a significant problem when data analysis is contracted out. For example, the debate on immigrants' eligibility for public benefits that took place in 1994-96 suffered from the lack of meaningful analysis of immigrants' patterns of participation by the major programs' data contractors. The information shortage would have been far worse if the public agencies had failed to require that the contractors collect samples that could later be reanalyzed with new policy questions in mind.

3. Problems with Obtaining Operational Information

One of the most valuable sources of information about a program is that obtained in the course of administering it. Numerous policy changes, large and small, have sprung from the experiences of state and local administrators. For example, eligibility workers may notice that policies are having an unintentionally harsh impact on the homeless, domestic violence survivors, or other particularly vulnerable groups and complain up the ranks of their agencies to

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261. Many of the options for food stamp program simplification in the 2002 Farm Bill, such as semi-annual reporting, were motivated by data that showed that virtually all of the decline in nationwide program participation occurred in states that had increased their reliance on short certification periods for working families with children. Data on the length of certification periods had rarely taken on policy significance in previous years, and the USDA staff that decided to start compiling it long before the surge in short certification periods had no reason to believe it would eventually become pivotal. That staff, however, works closely with program administrators and therefore had a sense that certification periods were a sufficiently important aspect of program administration to be worth monitoring.

262. See Super, Quiet Revolution, supra note 9, at 1305-08 (describing regulatory initiatives of the Clinton Administration and legislative initiatives of both the Bush Administration and Senate Republicans to reduce the administrative burden of food stamp participation).
their senior managers. Those managers, in turn, may either change the policy or inform elected officials of the reasons why they should consider doing so.

Once administration has been turned over to private contractors, information obtained during program administration likely will become unavailable to policymakers. Once a program's administration is privatized, state and federal officials making program policy no longer have direct involvement with the people carrying out that policy. Although contractors' eligibility workers may see problems developing, the contractors will have incentives not to pass those concerns along to state or federal officials if changing the policies would adversely affect their profitability. For example, eligibility workers might see many apparently eligible working families abandoning their applications when told about the contractor's policy of requiring applicants' employers to submit frequent earnings statements. This could raise questions about whether these verification practices are disadvantaging the working poor and undermining the program's emphasis on work. If the contractor's performance is judged in part based on the error rate it achieves, however, the contractor may feel it unwise to alert state officials to this problem because working families' eligibility is more difficult to determine. The contractor also may fear that the state will prohibit these requests of employers, preventing the contractor from achieving as low an error rate.

Alternative sources of information about program operations may also prove ineffective, in part because contractors' policies are so opaque. In past years, Congress and federal administrators often learned about problems in states' administration of a program from lawsuits filed by legal services offices. In 1995, however, Congress prohibited federally-funded legal services programs from filing class action lawsuits. Some states have legal services programs that do not receive federal funds and therefore could bring suit, but most of these are small, overworked, and unable to muster the resources required for litigation. More broadly, because contractors may not be required to make their policies publicly available, legal services advocates may have difficulty discerning the difference between isolated misapplications of policy and deliberate denials of service.

The news media also may have difficulty identifying problems with contractors' administration because contractors are not subject to state open records laws. As noted above, contractors may regard their policies and procedures as proprietary and refuse to release them to the public. Reporters may still hear that a contractor is inexplicably denying benefits to eligible people. But without access to the contractor's policy materials and instructions for eligibility workers, they may be unable to determine whether the denials are the kind of isolated problems that are inevitable in any large program or part of a broader pattern.
4. Misattribution of Costs and Benefits

Privatization further fragments the delivery of public services. As such, it can be expected to increase the frequency of the public's attribution errors, namely beliefs that the government is performing functions actually entrusted to private contractors or vice versa. These errors commonly distort the public's opinions about government performance.²⁶³

Where a private company takes applications for a publicly-funded program, some members of the electorate may believe that the benefits dispensed are partially or wholly corporate philanthropy.²⁶⁴ Even if they understand that government funds are involved, they may not understand the terms on which those funds were provided, e.g., whether the government is reimbursing all valid claims (providing a "responsive entitlement" as in Medicaid)²⁶⁵ or has provided the vendor a lump sum and discretion about how to allocate it. This confusion will prevent voters from formulating an informed response to perceived denials of needy claimants. Similarly, the public may misunderstand which level of the government is funding the program a contractor operates. If the electorate believes a federally-funded program is in fact operating with state and local tax dollars, it may overestimate the efficiency of those levels of the government—and the merit of maintaining or increasing state and local taxes—while making opposite errors with respect to the federal government.²⁶⁶

Just as a highly visible private vendor may inappropriately prevent the government from receiving credit for benefits it funds, the public is likely to blame governmental incompetence when a low-profile vendor errs. Although badly selecting or supervising vendors is indeed a failure of the agency, it is a different kind of failure that may be subject to a different kind of solution. Believing that the government is operating a program incompetently, voters may conclude that the problem is incurable and the program is best dismantled; if they understood that a contractor was making the errors in question, they might prefer to maintain the program but to change its method of administration.

C. Agency Problems

When applied to the private sector, the theory of the firm typically

²⁶⁴. Already, states' renaming of their public benefit programs has confused recipients sufficiently to cause major government surveys to undercount participants in those programs. See Evaluating Welfare Reform in an Era of Transition 113-14 (Robert A. Moffitt & Michele Ver Ploeg eds., 2001).
²⁶⁵. See Super, Political Economy, supra note 6, at 654-55 (distinguishing between responsive entitlements and capped programs).
²⁶⁶. See Super, Fiscal Federalism, supra note 215, at 2584 (noting the tendency for state and local governments to receive credit for the full output of federal-state programs rather than only for the share that they finance).
identifies agency problems as a cost of internal production. Privatization can reduce public benefit programs' efficiency in producing utility for the electorate by exacerbating agency problems. Elected and appointed officials inevitably have their own agendas that diverge in significant respects from that of the electorate. Subsection 1, however, demonstrates that privatization can significantly increase the intensity of self-interested lobbying that seeks both to expand the total budgets of these programs beyond the level required to satisfy the electorate and to increase the share of that budget devoted to administration. Subsection 2 explores the incentives officials may have to take more risks in privatization contracts than the electorate likely would prefer because of the likelihood that negative impacts will fall on their successors or on the federal government. Finally, Subsection 3 considers the risk of the most direct assault on public officials' reliability as agents of the electorate: corruption.

1. Lobbying by Public Employees and Private Contractors

Whoever is performing important functions in a public benefit program will have a focused interest in the continuation and expansion of that program. Thus, for example, the Food Marketing Institute, representing the major supermarket chains, supports the Food Stamp Program. Likewise, the trade associations representing children's hospitals, public hospitals, and community health centers champion the Medicaid program that covers many of their patients. By the same token, whoever administers these programs will become a natural, self-interested proponent of them.

The advocacy of non-recipients deriving financial benefit from these programs, while legitimate, threatens to skew public policymaking. As Anthony Downs and Mancur Olson demonstrated, a small group with a focused interest in a particular issue can easily dominate a popular majority that disagrees but feels less motivation to participate. The result may be programs larger than those the electorate would prefer. In addition, whatever these programs' budgets, those administering them are likely to lobby for allocating a larger share of funds to administration and a correspondingly smaller share to benefits. They also may oppose policy changes in whatever direction if

267. See Demsetz, supra note 76, at 25-28 (terming this problem managerial "shirking").

268. See Mancur Olson, The Logic of Collective Action: Public Goods and the Theory of Groups 60-65 (1971) (describing the dynamic that allows small groups with focused interest to dominate majorities with contrary views); Anthony Downs, An Economic Theory of Democracy 265-74 (1957) (explaining why majorities may rationally abstain from voting and allow a narrow economic minority to impose policies the majority opposes).

269. Lest anyone doubt the effectiveness of this lobbying, it should be noted that even with increases in the number of people living in poverty during each of the last four years, states have devoted an ever-increasing share of the TANF block grant to payments to contractors of all kinds, with barely a quarter of those funds now going to sustain low-income families. See Mark Greenberg, Dir. of Policy, Ctr. for Law & Soc. Policy, Presentation at the National Association of State Budget Officers Eastern/Southern Regional Meeting: The TANF Fiscal Structure: Trends, Implications of Reauthorization and Katrina 15 (Sept. 19, 2005), available at

HeinOnline -- 96 Cal. L. Rev. 462 2008
those changes are likely to increase administrative workloads more than they increase administrative compensation. To the extent that contractors succeed in blocking change, programs' designs will gradually drift apart from the electorate's preferences. This lobbying therefore makes public officials less efficient and accurate agents for the public. The administrative arrangement that results in the least effective lobbying therefore will improve the political process's efficiency in meeting the electorate's goals for the design of these programs.

By this standard, public administration of public benefit programs is likely to be the most desirable option, with the award of large sole-source operating contracts the least. To be sure, public employees' unions often maintain active legislative arms that lobby for increased spending on administration. They are limited, however, in their use of members' dues for political purposes. The unions also face free-rider problems in seeking voluntary political contributions from their members. Moreover, in many areas, the public employees that administer means-tested programs are not organized. In addition, some states follow the federal government in restricting the political activity of their employees. Finally, public employees' unions' lobbyists have a number of other ways of advancing the interests of front-line eligibility workers, such as mandating improvements in the pay and benefits of all state employees; the extent to which they will focus on programmatic policy issues is uncertain.

Large contractors, on the other hand, are likely to be more effective at lobbying because they can organize their lobbying efforts surrounding programs much more efficiently. For most activities, contractors can spend corporate profits directly. Even where individual contributions are required (e.g., for donations to the campaigns of influential legislators), those can be secured from a relatively small, cohesive group of owners and executives whose future employment will be jeopardized should they fail to help. Contractors also lack other obvious means of advancing their interests in their relationships with the government besides policy advocacy, so their incentives

Sources:

[270] Some of these programs' supporters might disagree, preferring to give more politically powerful interests a stake in the programs' continuation and expansion. This view is shortsighted. First, a program that has grown over time not because of broader public appreciation of its value but because of the quiet lobbying of special interests will be particularly vulnerable when a recession or changing fiscal agenda calls for budget cuts. Second, lobbying that bloats a program's administrative budget will cause the program to develop a reputation for inefficiency, again increasing its long-term political vulnerability. Third, it is unclear whether administrators' lobbying to increase the share of total spending devoted to administration will reduce spending on benefits more or less than their efforts to increase the program's total spending will expand benefits.

[271] Programs' rules may not permit direct reimbursement of lobbying costs. See, e.g., Principles for Determining Costs Applicable to Administration of the Food Stamp Program by State Agencies, 7 C.F.R. § 277 app. A (2007). Nonetheless, they do allow contractors to make profits, and contractors can elect to spend some of those profits lobbying for policies that will lead to more profitable contracts in the future.
to lobby are strong: there are no generic benefit packages for contractors, and most politically plausible changes in contracting requirements are unlikely to produce significant gains.

Vendors hired as needed to assist claimants likely represent an intermediate case. On the one hand, they can marshal the profits from their administrative work to support lobbying, resembling sole-source contractors more than public administrative agencies. On the other hand, if a relatively large number of vendors are involved, free riders may hamper efforts to organize lobbying.

2. Excessive Risk-Taking

Supporters often present privatization as a means of saving the public money. As discussed above, however, contracting for complex, difficult-to-specify activities such as application preparation and eligibility determination could subject a program to massive financial losses if the contractor is unable to perform as required or if it authorizes benefits to large numbers of ineligible claimants. These losses would damage the program directly and undermine public confidence in its stewardship of taxpayer funds. Because the losses often will be realized during a different political administration than the one that initiated the privatization, these risks pose serious agency problems: public officials may be far less risk-averse in deciding to privatize programs than the electorate that "owns" the program.272

The costs of this excessive risk-taking are likely to be born by the electorate. No contractor will be able to afford to cover the costs of additional benefits conferred because of serious administration problems. Contractors, unlike states, can declare bankruptcy. The burden of any significant losses therefore will almost certainly accrue to either state or federal governments.

In practice, the federal government will likely bear the brunt of the cost because turnover among state and federal officials and other limitations on the federal-state relationship make it difficult to protect the federal government from severe financial losses if an experiment goes wrong. For example, in the early 1990s, Florida moved to implement an ambitious new system for automating many aspects of the eligibility determination process for the state's Food Stamp Program. Florida rapidly implemented the system statewide and

272. Indiana's privatization contract, for example, spans ten years, with the promised savings heavily backloaded. See Theodore Kim, $1.16B Deal is Sealed: Welfare Goes Private, INDIANAPOLIS STAR, Dec. 28, 2006, at 1. Even if he is reelected, Governor Daniels will have been out of office almost four years before the contract ends. Ordinarily, one might expect politicians to want to reap quick savings and leave their successors to foot the bill. If, however, the goal is ideological—to eliminate the programs' public infrastructure—concealing the adverse consequences of the change until the bureaucracy has been disbanded prevents opposition from coalescing in time, as it did in Texas. Legislators not subject to time limits may have longer-term perspectives, but they may lack the analytical resources to identify hidden risks in plans governors are promoting.
ran into severe difficulties. The automated system mishandled numerous cases, and the state’s food stamp error rate spiked. In 1992 alone, Florida over-issued more than $200 million in food stamps. Although the federal food stamp quality control (QC) system assessed a correspondingly large penalty, by that time the Republican governor who had rushed through the implementation of the flawed automation system had left office. His Democratic successor struggled to correct the problem but argued that imposing such a large penalty for something his predecessor had done would hobble his new administration. In the end, the Clinton Administration required Florida to spend some unmatched state funds to correct its system but did not collect any of the assessed QC penalty. The federal government absorbed all of the $200 million loss caused by Florida’s hasty experiment with automation. Similarly, in 2003, the Bush Administration forgave a nine-figure QC penalty against California when Governor Schwarzenegger argued that he should not have to pay for errors resulting from a deficient automation system mismanaged by his Democratic predecessor.

These examples show that the federal government, under either party’s leadership, is likely to incur substantial losses rather than extract payment from states whose former leaders presided over catastrophic failures of state administration. Similarly, both Republican and Democratic administrations have declined to require subsequent governors to make good on their predecessors’ commitments that demonstration projects would be cost-neutral to the federal government. The same thing could happen again if the current privatization proposals go awry.

These problems lack obvious solutions. Requiring state officials to bear severe fiscal burdens for their predecessors’ blunders does nothing to deter future incompetence. Indeed, depleting a program’s current funding to pay for past losses is likely to hamper the costly business of rebuilding a sound administrative structure. Federal financial participation in these programs typically reflects states’ lack of fiscal capacity to bear the costs themselves.273 The choices for absorbing these losses therefore often will be federal and state administrations, neither of which were implicated in the mismanagement that caused the losses. However those losses are divided, the electorate is likely to become dissatisfied with the program once substantial losses come to light. The program’s future funding may be reduced as a result, even though, with the administrative misadventure terminated, it will again be capable of providing the relief the electorate sought at a politically acceptable cost.

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273. See Super, Fiscal Federalism, supra note 215, at 2574-77 (identifying the federal government’s superior fiscal capacity as a prime cause of federal-state cooperation on spending programs).
3. Corruption

Corrupt officials are the least effective agents for the electorate. Some firms seeking administrative contracts have immense resources; others are smaller but exceedingly well-connected. Several of the most prominent and audacious efforts to privatize operation of public benefit programs have collapsed in bidding scandals. Most prominently, Florida’s relentless lobbying had secured tentative federal approval for waivers to allow wholesale privatization of application assistance and eligibility determinations for food stamps and Medicaid when the state inspector general reported that the head of the Department of Children and Families had been deciding competitions involving a firm where his former boss, who had recommended the Department head for his current job, was on the board of directors. Other top officials involved in the privatization effort stayed in the beach house of an officer of a bidder and had a range of questionable contacts with competitors. Ethical problems also plagued New York City’s welfare privatization plans.

Neither the number of attempts at privatization nor the number of documented instances of corruption are sufficient to support any meaningful empirical conclusions regarding connections between the two. As a theoretical matter, however, privatization of program operations seems to pose significant risks not present in state-administered models. In sole-source privatization, a single decision made by one person or a small group of people will convey a large financial benefit on the successful bidder. Although senior officials in human services agencies routinely make decisions affecting large sums of money, the winners and losers from those decisions are much more diffuse: even changes in Medicaid’s reimbursement rates for hospital care affect institutions spread across the state. Therefore, structures that may suffice to keep officials loyal to their principal, the electorate, when making policy may fail to guard against illicit influences in the award and oversight of large contracts.

Systems built on the as-needed purchase of administrative services are subject to several risks of corruption, although even cumulatively they are probably less severe than those surrounding large contracts. Where the program’s structure puts claimants in the position of purchasing the services, the claimants may be ill-equipped to assess the effectiveness or value of the services they receive. To keep unscrupulous or simply lazy vendors from siphoning off excessive shares of benefit dollars—thereby undermining the electorate’s goal in establishing the program—officials may wish to establish some audit mechanism for the fees charged. Because its place in the program may seem relatively esoteric, however, the audit system is unlikely to be well-

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274. See Katz, Citizenship, supra note 225, at 152-54.
funded. In addition, the potential for providers illicitly to induce auditors to look elsewhere cannot be discounted. At the other extreme, auditors may seek more business by corrupting individual decision-makers within the public agency to increase their success rates. Low-level bribery, of course, is always a risk when agencies dispense money. Creating repeated interactions between officials and private vendors of administrative services may increase that risk by allowing more cases to be covered by a single corrupt transaction. Vendors marketing to the public also may be tempted to employ corrupt means to get included on lists of recommended providers.

**CONCLUSION**

The narrow lesson from this analysis is that neither economic theory nor experience to date justifies the current movement to expand the private sector's already substantial role in public benefit programs. Moreover, we should be suspicious of the head-long rush to implement these radical changes without pilot projects subject to rigorous, in-depth evaluation. This haste prevents the government from negotiating broader contracts from a position of strength (i.e., while it is still free to decline to work with contractors) rather than seeking modifications to an extant contract after it has disbanded its own infrastructure. To the extent contractors' role in program administration expands, the government should impose strict limits on their ability to protect as proprietary information, or to destroy, the policies under which they administer the program and the files and data they compile in doing so.

The implications of the public benefits contracting experience, however, are much broader. The privatization movement still seeks legitimacy through references to needless government operation of activities well-handled by business, just as antitrust populists invoke the misdeeds of long-dead robber barons. In fact, the movement's efforts reach far beyond the areas where economic theory offers any plausible basis for expecting efficiency gains. For example, President Bush and others want to purchase investment services on the private market to replace Social Security.

276. In other contexts, conservatives have advocated rigorous evaluation of programs before expanding their implementation. See Robert Rector & Michael McLaughlin, *A Conservative's Guide to State-Level Welfare Reform*, in *Making Government Work: A Conservative Agenda for the States* 137, 154 (Tex Lezar ed., 1992) (finding reports of job training programs' success "pseudo-scientific"). Careful evaluation should continue after any roll-out, both to identify corrections needed within the states affected and to help develop expertise to guide any future contracting ventures. This is particularly true because of the reduced availability of programmatic data that is otherwise likely when the state agency is displaced.

277. See, e.g.,*Goldsmith*, supra note 122.

278. See *Bork*, supra note 32, at 197.

279. The President and his allies have been ambiguous about whether these services would be purchased with a few multi-year contracts—a government-selected oligopoly—or with purchases of these services as needed. They also have been unclear how purchasing authority would be divided between the government and claimants.
increasingly relied on private contractors to provide combat forces for missions to which it is unwilling to commit its uniformed services.280

Like yesteryear's most heedless populist champions of applying antitrust to atomize large corporations, the privatizers hover between practical and ideological arguments. They assert, often as if it were a proven fact, that privatization will save the government money. They thus cast their opponents as irrationally holding onto obscure values of dubious worth. An increasing body of empirical research, however, suggests that privatization of many public functions costs rather than saves the public money.281 The economic theory presented here suggests that, far from being flukes, these results are entirely predictable and are likely to be repeated in subsequent attempts.

The next question presented is how to convince privatizers of the problems with widespread privatization. Appeals to public values alone seem unlikely to prevail. Reflexive hostility to the government is too widespread, and any meaningful consensus on many of the key values wielded against privatization is, sadly, a distant dream in our angry and polarized society. Just as the Chicago School tamed antitrust law by framing its arguments in terms of consumer welfare that could appeal to liberals, critics of privatization must focus more on efficiency.

A good place to start is to treat the privatizers as advocating a change in the government's "make-or-buy" decisions and to analyze them under the theory of the firm. Approached in this manner, the defects of Social Security privatization become readily apparent.282 Investing has formidable economies of scale. A considerable body of expertise and information is required for savvy investing, but once amassed is available to guide as many investments as are required. In addition, many advantageous opportunities are wholly unavailable to individual investors. Moreover, small investors have difficulty diversifying their portfolios to reduce risk. Other factors identified by theory also militate against shifting from internal investment to the market: the high transaction costs (commissions) of organizing individual investments, many retirees' aversion to risk, and the lack of any serious agency problems preventing the electorate from guiding SSA.

Judge Posner argues that antitrust enforcement is appropriate when, but only when, it increases business efficiency.283 A sound principle to guide privatization decisions is that the government should obtain services on the private market when, but only when, doing so would increase a program's efficiency in satisfying the electorate. This measure is not pure economic

281. See supra notes 119 and 133 and accompanying text.
efficiency because the electorate does not authorize governmental programs purely to achieve a financial bottom line. On the other hand, the electorate has made clear that its intolerance for waste in public programs goes far beyond anything that cost-benefit analysis could explain. Thus, economic efficiency should guide the government's "make-or-buy" decisions unless the most efficient arrangement is likely to distort policymaking or offend strongly-held values sufficiently to decrease the satisfaction the electorate can derive from the program.

This standard would require liberals to abandon some sentimental attachments to public provision when the private sector demonstrably can do better. On the other hand, it also would preserve the basic infrastructure that makes a humane society administratively feasible. With that infrastructure facing the gravest threats since the New Deal, that is a trade well worth making.