

**Public Managers and “Managing the Market:”
Evidence from the Front Lines of Contracting**

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The expansion of government contracting has been underway for over two decades, prompted in part by market-based reforms that now permeate administrative practice across the globe and at all levels of government in the American federal system. At the federal level, spending on contracts has nearly doubled since 2000, with estimated growth from \$219 billion to \$415 billion in 2006 (Barr, 2007b). These developments have attracted relatively little mainstream attention, but recent developments related to the Iraq and Afghanistan conflicts have raised a host of new questions and intensified scrutiny of contracting strategies. Singer (2007) notes that in Iraq, in the realm of private military contractors alone, there are more contractual “soldiers” than uniformed soldiers. In addition, of course, there are many more contracted support workers (Merle, 2006).

Meanwhile, states and local governments are moving increasing numbers of public services into contractual arrangements. Government functions considered until recently to be too “inherently governmental” in nature are now performed under contract. These include the determination of eligibility for public assistance (Walters, 2004); client case management for publicly funded welfare, child welfare, and health programs (Romzek and Johnston, 2002; Choi et al, 2004; Fossett et al 2000); the ownership and management of state and local correctional facilities (Nicholson-Crotty, 2004; Price and Riccucci, 2005; Donahue, 1988); a wide variety of local services ranging from refuse collection to homeless shelters; and, most recently, a state’s entire information technology infrastructure (McDougall and Hoover, 2005; Pearlman, 2007). “Blended workforces” and “co-located” staff are no longer unusual; indeed, many view these new arrangements as partnerships. The distinction between public and contractual employees is often unobservable, and this holds true not only in Iraq, where the key identifier for Iraqis is simply whether the actor is an American, but also in domestic contractor arrangements when citizens are not able to determine which sector is actually serving them (Van Slyke and Roche, 2004).

The fundamental theoretical underpinning of contracting has also been questioned. Those who are skeptical about the “public choice” and market-failure rationales for contracting devote invigorated attention to public values (Bozeman, 2002; Jorgensen and Bozeman, 2007), constitutional and administrative law norms (Rosenbloom and Piotrowski, 2005; Moe, 1987; Gilmour and Jansen, 1998; Hansen, 2003), and social equity (Frederickson, 1996; Hefetz and Warner, 2002). At the same time, those more focused on the design, implementation, and management of contracts note increasingly that government contracting simply does not follow the logic of market theory. That logic rests squarely on the power of competition to enhance the efficiency of government programs and services. Savings are theorized to result not from the use of nongovernmental service delivery per se, but rather from the dynamics created by competition. (Boyne, 1998; Savas, 2000; Hefetz and Warner, 2004; Pack, 1987).

Two direct problems flow from the competition foundation. To begin with, as we will argue, competition for government contracts is often weak. “Thin” provider markets (Weimer and Vining, 2005) are an endemic problem, especially depending on service type and level of government. And perhaps even more fundamentally, the benefits of competition have come under question – even in competitive provider markets, contracting operates with greater difficulty than contracting theory might predict. We will review these competition issues as we characterize the work of contract managers and their efforts to manage many features of the markets they encounter. In addition to low levels of competition, managers must sometimes deal with markets constrained by political and legal forces. In many markets that were formerly competitive, managers now confront conditions of low competition due to consolidations and mergers. Managers can manipulate both “sides” of the market, and many have strengthened their purchasing position by strategically shifting power to the state through cooperative purchasing systems that establish oligopolies or monopsonies.

In this paper, we address both normative and empirical questions that have received relatively little attention. First, through a review of scholarship on the topic, supplemented with qualitative data drawn from semi-structured interviews with federal, state, and local contract administrators, we survey and assess strategies used by public managers to enhance competition in the markets from which they purchase goods and services.¹ While many of these strategies have been cited in contracting research, primarily in the context of transaction costs, the concept of “managing the market” (Graddy and Chen, 2006; Brown and Potoski, 2004; Fossett et al, 2000; Warner and Hefetz, forthcoming) remains general in nature. Our data provide insights from the front lines of contract management on whether, why, and how public

officials try to cope with low levels of provider competition. We find that contract managers expend significant resources on managing the market, and that opportunity costs can lead to diminished attention to other elements of contract management, and therefore to the accountability expected when public resources are used to acquire goods and services from private actors. We also conclude that despite their attempts, public managers are often unsuccessful when trying to “grow the market,” and that resignation in the face of limited competition and monopoly can result.

Second, we raise the related normative question. *Should* public officials manage markets? If so, why? How does “managing the market” comport with standard, classic notions of markets? What are the implications of “managing the market”? These latter questions, important as they are, flow directly from our research. While we do not intend to answer them here, we do hope to shed light on some of the factors that shape these questions, and why they are critically important.

Contracting and Competition

The dynamics associated with competition are fundamental to the rationale for government to contract with nongovernmental organizations. Competition, and the efficiency it fosters, exists when the organization “must compete for market share, functions and resources” (Cohen, 2001, p. 434). Donahue (1989) emphasizes the “cardinal importance of competition” in privatization, stating that “most of the kick in privatization comes from the greater scope for rivalry when functions are contracted out, not from private provision *per se*....Efforts to compensate by other means for the missing discipline of competition will seldom be fully successful” (p. 218).

According to this view, competition forces providers to keep costs under control and quality at a high level because there are consequences for inefficient behavior (i.e. consumers choose another supplier. Greene, 2002; Kettl, 2002; Pack, 1987). Accordingly, “the primary goal of any privatization effort is, or should be, to introduce competition and market forces in the delivery of public services” (Savas, 2000, p. 122). The ultimate underlying objectives include maximizing return on taxpayer investment, and improving government performance, customer service, and citizen well-being (Osborne and Gaebler, 1993).

Yet one of the complicating factors in public service provision is that thriving private markets with ample providers, a necessary condition for competition, often do not exist in traditional public service markets. This may be especially true for specific program areas such as social services or under conditions requiring rapid response such as those experienced after the 9/11 attacks and Hurricane Katrina. In addition, geographic and regional conditions influence levels of competition; rural areas may present especially low levels of provider competition for public services.

How Competitive Are Public Service Markets?

One of the challenges associated with the current wave of government contracting results from expansions in the scale and scope of contracting. While provider markets for traditionally contracted goods have functioned fairly well, there is some evidence that levels of competition are insufficient for many current government contracts. Increasing reliance on contracts for delivering services, in addition to tangible goods, is associated to some extent with insufficient provider supply. Recent congressional testimony indicates that roughly sixty percent of federal government procurement spending in recent years has gone to contracts for services (Barr, 2007b). A recent report from opengovernment.org finds that the number of government contracts awarded under full and open competition has declined from 2000 to 2006, noting only 34 percent of contracts were awarded under full and open competition as compared to 45 percent just six years earlier. Furthermore, some estimates suggest that during the period of time, over 25 percent of contracts, totaling 559.9 billion, were awarded in instances of no competition (openthegovernment.org 2007 in Yost 2007)

Inadequate competition for federal contracts is not new news. The Government Accountability Office (GAO) recently reported that “competition is a fundamental principle underlying the federal acquisition process. Nevertheless, we have reported on the lack of competition in the Department of

Defense's (DOD) acquisition of services since 1998. We have reported that DOD has, at times, sacrificed the benefits of competition for expediency." (GAO, January 2007b, p. 7). The implications of low levels of competition are serious. According to U.S. Comptroller General David Walker, "acquisition of goods and services from contractors consumes over one-fourth of discretionary spending government wide and is a key function in many federal agencies (GAO, October 2006, p. 1).²

The problems associated with low levels of provider competition for government contracts are not limited to federal procurement. States, increasingly delivering services through contracts, also experience thin markets. The trend toward state contracts for social welfare services accelerated with passage of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (PRWORA) (Nathan and Gais, 1998), and research indicates that competition is often insufficient for many, if not most, of these services (Schlesinger et al, 1986; some of our stuff; Van Slyke, 2003, 2007; DeHoog, 1990; Smith and Smythe, 1996). In the area of Medicaid Managed Care, which comprises the largest portion of state general fund budgets aside from K-12 education, many states operate contracts with two or fewer HMO providers (Fossett et al, 2000.) The ideal conditions for Medicaid Managed Care, enjoyed in only a few states, require not only competition among potential providers, but also the requisite political support that translates into sophisticated contract management systems and buffering against the political influence of health care providers (Weissert and Goggin, 2002; Johnston, 2003). But like many of these services, Medicaid Managed Care is contracted out with the expectation of cost savings, and many political and administrative actors are not interested in enhancing the capacity of a contract management "bureaucracy" (Fossett et al, 2000).

In addition to social welfare services, low levels of competition have been documented in the areas of corrections and education contracting. Corrections Corporation of America (CCA) and Wackenhut (now GEO), control 74 percent of the for-profit prison market and are often the only providers even with the resources to bid on contracts. State prison contracts typically attract bids from up to 15 firms, but two firms hold over three-quarters of all state contracts. Donahue (1989) predicts that competition for state corrections contracts is unlikely to increase because there is very little efficiency to be gained. Yet despite the dearth of competition, estimates suggest that up to 160 corrections facilities in the US – either state prisons or county jails – are currently operated under contract (Nicholson-Crotty, 2004). Similarly, in just one area of state education contracting, recent press coverage of costly errors in the grading of new state standardized public education tests reveal that most of these exams are typically graded by one of two companies that hold most state contracts for this service (Associated Press, 2007).

Government contracting is a long-standing practice among local governments. Nonetheless, competition for local contracts is also often weak. While rural areas, not surprisingly, often lack multiple providers for local contracts, urban areas also experience thin provider markets (Johnston et al, 2004; Hirsch 1995; Kodrzycki 1994). Hefetz and Warner (2004) report survey results indicating that nearly 25% of respondents in city governments, where competition should be strongest, report low levels of vendor supply. For local governments contracting out social services, similar problems exist (Van Slyke, 2003, 2007). Data compiled by Savas (2002) indicates that even in New York City, where contracts for homeless services might be expected to attract several bidders, three or fewer bids were typical. Of a total of 36 homeless service contracts, 17 attracted only one or two bids (although there was interest from organizations that lacked the requisite qualifications). While other social services might fare better, the fact remains that for many programs, providers are scarce.

Of course, one valid question concerns the characteristics of a truly competitive market. Brown, Potoski and Van Slyke (2006) remind us that "strong and effective markets . . . require some fairly strict conditions. They need large numbers of buyers and sellers, participants need to be well informed about products and each others' preferences, and actors must be able to enter and exit the market and exchange resources at low [transaction] costs" (p. 325). Such conditions, they suggest, mitigate the principal-agent problems that can put government purchasers at a disadvantage. By contrast, The Reason Foundation suggests that competition exists when at least two providers compete in a bidding process (Van Slyke, 2007, fn19, p. 167). Former Indianapolis Mayor Stephen Goldsmith advised that three bidders provided adequate competition, and in that count he often included city departments authorized to enter bids for government contracts.

Regardless of the optimal level of provider competition, public managers involved with government contracts deal directly and continuously with issues related to competition. They engage in a variety of behaviors and adopt numerous strategies to ameliorate the shortcomings in a thin provide market, to maintain competition after contracts take effect, and to ensure adequate competition for future purchases. The notion of “managing the market” may appear paradoxical. Nonetheless, evidence from other scholarship on this topic, and from the data reported in this analysis, indicate that public managers are indeed creating, nurturing, and expanding provider markets.

Questioning the benefits of competition

Although many contracting scholars emphasize that competition is fundamental to effective government contracting, many others believe that competition is not a panacea. The purported benefits of competition have been questioned both by critics of excessive focus on efficiency, and by researchers who find that, due to a variety of factors, competition often fails to deliver expected efficiencies.

Public choice theorists and other supporters of contracting stress that efficiency of production requires competition. Yet efficiency is only one of several values fundamental to governance in the U.S. Constitutional and political values are of equal, or perhaps higher importance to many who study government service delivery. Among these competing ideals are effectiveness, equity, responsiveness, responsibility, accountability, due process, transparency, and other public values (Cooper, 2003; Bozeman, 2002; Milward and Provan, 2000; Rosenbloom and Piotrowski, 2005). Recent emphasis on “best value” contracts reflects, in part, renewed attention to these alternate values. The general idea with best value contracts is that lowest cost production is only one of several criteria to be evaluated when deciding whether and with whom to contract, and that cost must be balanced against competing values of importance to the specific program or service.

In addition to the value conflict, the concept of competition has gained new scrutiny from policy analysts, economists, and others who note that competition may not always generate the levels of efficiency and/or quality promised by market theories, and that the market failure analytic framework used to justify contracting may be flawed (Zerbe and McCurdy, 1999). Whether efficiencies are gained, and if so, at what expense, is of great debate in the literature (Boyne, 1998; Donahue, 1989; Brudney et al 2004; Hirsch 1995).

Competition can also undermine other government objectives. In the area of social welfare policy, for example, continuity of care is highly valued (Schlesinger et al, 1986). Certain features of competitive contracting inflict significant instability on clients, administrators in government and contracting organizations, and on other members of complex service delivery networks (Johnston and Romzek, forthcoming; Milward and Provan, 1995, 1998; Agranoff and McGuire, 1998). In addition, the administrative coherence associated with a more stable, monopolistic system is often sacrificed when competitive contracting is used (Romzek and Johnston, 2002; Milward and Provan, 2000). Put simply, competition does not guarantee improved government or policy (John and Ward, 2005).

The incentives created by competition can also give rise to serious complications among contracting organizations. Competition can draw nonprofit focus away from service by increasing the salience of financial performance (Smith and Lipsky, 1993). The contracting dynamic can fundamentally alter the culture and mission of nongovernmental contracting organizations, and can undercut the characteristics that made the organization attractive to government in the first place (Romzek and Johnston 1999; Smith and Smythe, 1996) And when organizations compete for government contracts, their pre-contract collaboration with their competitors on behalf of the public may be sacrificed, and their advocacy roles diminished (Romzek and Johnston, 2005).

Another problematic side-effect of competition concerns the seepage of expertise from government to contract organizations, many of which offer higher rates of competition and are eager to attract individuals with program experience and institutional history. This difficulty has become visible recently in military circles, and Defense Secretary Gates is reportedly “troubled by security contractors’

practice of luring soldiers out of uniform by offering them higher salaries...[and is] looking for ways to put legal limits on that practice. (Burns, 2007, p. 1).

In short, while the benefits of competition are emphasized by proponents of government contracting, competition will not ensure successful service delivery – whether carried out by public or nongovernmental actors. Competition should be one of several objectives and values considered by those working to improve government performance. But all else equal, it seems clear that an absence of competition has the potential to diminish performance in government contracting. Public managers, acutely aware of this, do what they can to be sure they are dealing with healthy levels of provider competition when they design and implement contracts.

Managing the Market

In the absence of a healthy provider market, public managers seek to intervene by creating, maintaining, and enhancing provider competition. While some scholars note that public managers are “managing the market” to increase competition for government contracts (Graddy and Chen, 2006; Brown and Potoski, 2004; Fossett et al, 2000; Warner and Hefetz, forthcoming), there is little detailed research on the practice or its implications. This analysis, which draws from interviews with contract managers, administrators in contracting organizations, and reviews of relevant documents, press reports, and scholarship on the topic, indicates that contract officials engage a wide variety of practices in pursuit of competition. They understand the importance of competition and its impact on costs and other performance objectives, and they adopt a wide variety of strategies designed to foster competition.

Public managers confront multiple challenges related to competition ranging from the typical thin markets that characterize conditions of low vendor supply to provider markets constrained by legal and political forces, provider consolidation, and monopoly. Competition is not static, and considerable attention must be paid to markets after the contract is in effect; indeed, government contracting may encourage provider consolidation. In other cases, contract managers expend resources in attempts to retain contracted providers that threaten to leave the market, perhaps because they did not fully understand the costs related to the contract, and they may also work to strengthen those that are vulnerable to failure. Ironically, there is evidence that excess competition also creates oversight difficulties for contract managers. And finally, the elimination of competition, or “contracting back in” (Hefetz and Warner, 2004) may be required. In addition to managing provider markets, public managers may also modify the purchaser side of the market by strengthening their position through consolidated purchasing systems such as those operated by the federal General Services Administration (GSA), and by several states and local governments.

Stimulating Competition

Government contracting officials use a wide array of approaches designed to stimulate provider competition, some of which are statutorily required. The federal government procurement process is heavily formalized, and competition stimulation is embedded throughout the procedures used by contracting officers and other purchasing staff. In essence, many federal agencies follow the “any willing provider” method, which also characterizes the work of some state social welfare purchasers (Johnston, 2003). Parties interested in bidding on a given contract are reviewed for required qualifications and invited to submit proposals or bids. When sufficient numbers of qualified providers exist, databases are created and maintained. Contract work is rotated through the database, often through elaborate algorithms. Or, where the number of providers is smaller, as is often the case for social welfare contracts, all qualified parties may share in the contract, depending on the service and how it is apportioned by state administrators. By maximizing the number of organizations involved in delivering the service, managers hope to enhance program capacity (Graddy and Chen, 2006).

As Cooper (2003) notes, “market analysis does not have to be a purely passive activity” (p. 78). Government administrators may use “multiaward contracting, deliberately awarding contracts to more than one service provider” (p. 78; see also Brown et al, 2006; Brown and Potoski, 2005; Hansen, 2003), or they may rely on “partial contracting and public-private competition” (p. 79), also referred to as managed

competition or joint contracting (Warner and Hefetz, 2007; Johnston et al, 2004; Brown et al 2006). The presence of a public alternative to the private services creates a competitive environment and improves government oversight as public managers use their own experiences to better monitor contractor performance. Warner and Hefetz (2007) find that this form of “mixed delivery,” (i.e. public and private provision of public services) has become an alternative to competitive bidding. In their study of local government contracting they observed that “experienced managers were more likely to use mixed delivery rather than trust the market to ensure cost efficiency and failsafe service” (p. 10). For instance, when officials in Kansas City began to recognize the weakness of the provider market for their contracted refuse collection service, they adjusted service delivery by resuming public collection in one portion of the city, retaining contracted providers in the remaining areas. In contrast, long-standing contracts with one dominant provider in most suburban Kansas City communities were subject to minimal monitoring, oversight, or competition (Johnston et al, 2004).

Many public managers are also continually engaged in seeking new providers through a variety of means including contacts in professional networks and other governments advertising (Brown and Potoski, 2004, 2003), and in simple recruitment through phone calls, written and electronic correspondence, and extensive. In the case of especially large contracts, managers may arrange information sessions/conferences and invite organizations whose work is related, or who may be of assistance in finding vendors. When the State of Kansas renews contracts for its child welfare case management system, state officials typically advertise and conduct informational forums, inviting organizations known to be involved in child welfare to participate in shaping the program (Romzek and Johnston, 2005; Johnston and Romzek, forthcoming). Similarly, when trying to establish its managed care program, the state’s Medicaid officials regularly contacted local, regional, and national HMOs to assess and encourage their interest in the state’s contracts.

Government managers may also be involved in the establishment of the alternative service provider organization – that is, in the creation of a new entity that will secure the contract. This has been observed in state Medicaid Managed Care programs (Fossett et al, 2000), the federal Employee Stock Ownership Plans (GAO, 1997), and other services. Such cases often result from legislative action requiring the “privatization” of a selected good or service when there is in fact no existing provider market.

These activities consume substantial resources. In the federal government, where contracting has become ubiquitous, many staff devote significant amounts of time to market research. Our interview data demonstrate that contract support staff are regularly engaged in electronic, phone, and other types of research designed to find vendors. Indeed, contract specialists may in fact devote more time to the competition issue than any other. A DOD contract official’s work is illustrative. He reported to us that he spends “one-third of my time on market research,” simply seeking vendors for his small program. Then the vendors must be contacted and solicited. Competition rarely exists, he notes, and for the most part, “two big firms bid on all contracts.” These two firms – which, in essence represent his provider market – were recently purchased by Middle Eastern companies and their future position in the market is not clear. Much of the remaining portions of his time are devoted to cost analysis and other contract preparation tasks. When asked whether his position was considered in calculating the costs of contracting out the service, he noted that “the procurement process is not considered,” and that the decision to contract “never took contract administration costs into account.” A Department of Energy (DOE) contract manager reported devoting 50% of her time to finding vendors, and noted that it’s typical to have three or less vendors” bidding on contracts.

One federal SES official devotes all of his time to “trying to grow national capacity” for a function that was outsourced as a result of the National Performance Review (1993). He is one of several staff devoted solely to “growing the competition.” He emphasizes that “it’s not like these guys [providers] grow on trees,” and that he and his staff are essentially “trying to build an industry.” While this situation might be expected for a highly specialized service, or one characterized by “asset specificity” (Brown and Potoski, 2006, p. 326), this particular federal program, which is related to security, is one that might be expected to generate healthy levels of competition. But success has been limited. As is often the case, the regulations associated with the program, combined with high startup costs required to set up the requisite information and reporting systems, overwhelm organizations qualified to bid on the contracts (Romzek and

Johnston, 2002). “They all saw dollars, then realized that this is hard, complicated work,” according to the SES official, and he stresses that, at least in his program area, “contractors are *not* more flexible than government. They’re *less* flexible.” For this program, the cadre of six contractors nationwide was recently reduced to four as the result of two withdrawals during the current contract cycle. The program managers believe firmly that a market of four firms does not constitute adequate competition, and leaves the federal government at a disadvantage.

Another professional associated with this program, with over 15 years experience in procurement of federal goods and services, including weapons systems and defense infrastructure, observed that when it comes to competition and contract management there is “no big distinction between services and hard weapons. Often, the simple is the most difficult – even janitorial work” can create contract management problems related to competition and other forces. Throughout her career, she has devoted substantial time to “look for more vendors.” Her experience has led her to believe that “the federal government willfully underestimates the resources needed for contract administration to protect taxpayer interests,” and this is especially true under conditions of low vendor supply. Similar dynamics characterize the management of some state Medicaid Managed Care programs. State officials report working to “keep providers in the game,” and devoting scarce staff resources to continual solicitation of HMOs (Johnston and Romzek, 1999; Fossett et al, 2000).

These experiences reveal the comparatively high costs associated with creating and stimulating competition. And because lower levels of competition can reduce the power of the government purchaser, still more resources will be needed for more conventional contract management such as performance monitoring (Brown and Potoski, 2006), and the ongoing negotiation and bargaining that characterizes the administration of incomplete contracts (us, DeHoog, 1990; Sclar, 2000; Van Slyke, 2007).

Managing markets constrained by legal and political forces

Public managers may also confront legally constrained provider markets. Statutes may include requirements to target certain portions of the provider market for contracts. This is an especially salient constraint for federal contracting officials, who must adhere to Small Business Administration guidelines. Regardless of the level of provider competition for their contracts, nearly every federal official we interviewed reported that finding adequate numbers of qualified small disadvantaged businesses is a major challenge. The imbalance between the “too many vendors” in the Washington DC metro area eager for federal contracts, and available qualified small disadvantaged vendors, has led to the creation of a “mentor/protégé” solution (GAO, January 2007a) which arguably undermines the original small disadvantaged business objective. Under this initiative, larger, more experienced federal contractors establish a legal relationship with a qualified small disadvantaged business vendor. While the small disadvantaged business vendor holds the actual federal contract, one or more larger firms end up doing most of the work as sub-contractors. Federal contract managers, accustomed to dealing with what one federal manager calls “the usual suspects” that bid on most of their contracts, are therefore unable to truly diversify the provider market.

Less surprising are markets constrained by political considerations. It is not unusual for executive or legislative actors to stipulate or otherwise encourage that contracts be designed to favor local, regional, or state participation in order to internalize any resulting economic benefits. Recent revelations that British companies are the only finalists for U.S. contracts in Iraq have generated congressional attention and calls for American taxpayer dollars to be directed to American contractors (Klein, 2007). Constraints may be designed to shut out bidders with efficiency advantages but little knowledge of the local market. In Massachusetts, state mental health administrators ultimately encouraged bids only from provider with proven track record, thereby erecting barriers to full competition (Schlesinger et al, 1986, p. 252).

The accommodation of political interests in contracting through targeting is one of many ways that the market, or competition model, is adjusted to reflect competing values. Although completely legitimate – perhaps even laudable – motives may drive these adjustments, the fact remains that their impact on efficiency and cost-effectiveness is real. Whether any net cost or quality contracting benefits are sustained under such conditions, compared to public service delivery, is open to question.

Managing post-contract markets

Contracting is a dynamic process, and management of the market does not cease when a government contract takes effect. Sclar (2000) warns policy makers that healthy, competitive provider markets can quickly change.

Even when a market initially appears to be competitive, policy makers must remain wary. Public-contract markets, like most markets, change quickly and continually. Often, the very act of creating a public-contracting process sets anticompetitive forces in motion. What begins as apparent competition quickly transforms itself by the second or third round of contracting into monopoly or, more typically, oligopoly (p. 70).

Public managers often expend resources trying to retain existing contractors that, for a variety of reasons, may wish to withdraw from their contracts. A federal SES official described the intense efforts undertaken by his staff to preserve – indeed nurture – two contractors over a long period of time. They ultimately terminated their contracts, leaving a less competitive provider market, costly “holes” in service delivery, and lost staff resources diverted from other objectives such as contract monitoring and performance enhancement. Another federal official offered a similar scenario, describing the agency’s efforts to counsel contractors for poor performance. After receiving a poor quality product the government helps with a “get well plan” to bring their work up to par and keep the provider in the fold.

Throughout a contract cycle, managers may also be engaged in seeking new vendors for the next cycle, if only to create some purchasing advantage over existing contractors who correctly assume that they can use incumbency to enhance their position for the next contract. When Kansas Medicaid managed care contractors resigned themselves to the reality that only one organization would bid on the state’s contract, they nonetheless tried to encourage – almost “begging” – other HMOs to at least bid on the next contract, knowing that they would almost certainly not accept the state’s reimbursement rates. They acted in part to improve their bargaining position with the sole contractor (Romzek and Johnston, 1999)

Despite public managers’ efforts, market dynamics may, over time, drain provider supply through consolidation. Schlesinger et al (1986) describe the multiple forces encouraging consolidation among contractors for mental health services in Massachusetts. These forces include economies of scale in both provision and bidding and asymmetries between providers and government. In addition, government preference for familiar contractors, driven by motives to reduce the transaction costs and risks associated with the uncertainty of the production process, contributed further to provider consolidation (p. 253).

Managing consolidation

Consolidation plagues provider markets at all levels of government. A recent study reports that while mid-size companies won 44 percent of federal contracts in 1995, they now hold only 33 percent compared to 46 percent held by large firms, up from 37% in 1995 (Goldfarb, 2007). The consolidation rate has doubled in the last seven years. For federal contract managers, the reality is that while “for many years, the middle tier of companies in the \$200 billion federal services industry was regarded as a source of innovation and productivity,” they must increasingly deal with companies that are likely to become less innovative, more powerful in the procurement relationship, and more dominant in the market (Goldfarb, 2007, p. D01). This dynamic is likely to require contract managers to devote more resources to monitoring and stimulating provider markets.

State managers responsible for purchasing corrections management and services observe that consolidation is a fact of life. One state procurement official noted that despite the fact that a small, regional, high-quality company won a preliminary bid for a prison privatization initiative, one of the two dominant private prison companies bought it out and won the final contract. Consolidation and large organization dominance characterize other markets for state services, including mental health services (Schlesinger et al, 1986) and welfare (Sanger, 2003), as well as for several local services (Johnston et al,

2004; Brown and Potoski, 2004; Graddy and Chen, 2006). Graddy and Chen (2006) observe that “most lead agencies have been successful in renewing their contracts” for local family preservation programs in Los Angeles, “some for several cycles. Thus, just as we find in franchise arrangements, this structure could create long-term contracts that begin to look like monopolies” (pp.548-9). Similarly, managers in organizations contracting to deliver child welfare services in Kansas reported that “vertical integration” was increasingly attractive as cost pressures made sub-contracting less feasible. Small, precariously financed subcontracting organizations fully recognize their vulnerability under these conditions (Romzek and Johnston, 2005, forthcoming).

Managing with resignation – or – giving up?

Public managers clearly expend consequential amounts of staff resources on managing markets. Yet despite their best efforts to create, stimulate, and enhance provider markets for government contracts, many must, in effect, resign themselves to the reality of a flawed market. In some cases, that means living with at most two viable providers, and in others, with perhaps only one. Sole-source contracting has received critical attention in recent months, but it is nothing new, and not uncommon. According to one Department of Energy contracting official, roughly 40 percent of all the contracts in her portfolio were sole-source contracts – many related to proprietary information systems contracts. Luckily, the percentage is about half that level – in the range of 20% - in terms of dollar value. The fact that she spends nearly half of her time seeking vendors is therefore hardly surprising.

There is little doubt that in states that have contracted out for corrections, state administrators have resigned themselves to a market that, in essence, consists of two dominant providers with a handful of others who are likely acquisition targets, and despite continued growth in state and county inmate populations. One state corrections official put it bluntly: States are “throwing money at the problem.” In his view, there is a “bidding war, in effect, going on in the private prison industry. It’s a seller’s market. Demand is too high, and there are too many inmates chasing too few beds.” As a result, states are at a real disadvantage when contracting out for corrections, despite its political appeal. California’s recent decision to house inmates in private out of state facilities further complicated the picture, creating even more competition among state buyers. The situation, in fact, is one in which “the main problem is inadequate capacity in the market – there are not enough beds available for national needs.” Recent media reports of abuse in a privately operated Texas youth corrections facility provide salient reminders that when a contractor fails to deliver, and the state purchaser has few (or no) alternatives to call on to fill the gap, the results can be catastrophic (Solomon, 2007).

A corrections procurement specialist in another state notes that even in a two-vendor world, “the incumbent has a tremendous advantage” but at least there is some recourse. He reported being careful to reassure the competitor that the incumbent did not “have a lock on our contract.” In fact, he was able to accept the competitor’s bid on the state’s most recent contract because although the proposals were deemed equal in terms of quality, the competitor’s price carried a slightly lower price. He reported that he was relieved, and that the state was able to maintain some power in the purchasing relationship as a result of the change in contract; retaining the original vendor would have sent a very different message.

While this procurement specialist sees the flaws in the market serving his state, he is particularly concerned about some developments in other states. For instance, he was asked to testify to the Tennessee legislature about Corrections Corporation of America (CCA), which is headquartered in Nashville. In his view, CCA is putting lots of pressure on Tennessee to privatize all corrections,” and the state has considered selling its prison assets to CCA through a trust arrangement. In his testimony, the procurement specialist stressed that such a move was ill-advised because there is simply “not enough competition. The sale would eliminate the residual expertise to monitor” by the state. He also described developments in Colorado, where prisons are needed but there are countervailing pressures against increasing bond indebtedness. So the state has contracted with counties to hold state inmates with the understanding that they will do so through contracts. He reports that “the counties get a cut, and they are not required to use competitive bidding. The state determines who the county would use” to deliver the service privately.

Price and Riccucci (2005) note that private prison firms “organize lobbying efforts not only to

encourage prison privatization, but also to lobby for mandatory sentencing and other legislation that works to keep people incarcerated and is ultimately favorable to their bottom line . . . The lion's share of contributions has been to politicians in the South" (p .227). While lobbying is nothing new for contractors, prison contracting and the relative advantage enjoyed by the dominant providers illustrates the potential for contractors to shape policy to a greater extent than might be expected under more competitive conditions, where transparency is more likely and governments are less dependent on contractors.

As noted earlier, Kansas Medicaid managed care officials became resigned to living with one bid on their periodic requests for proposals for HMO care. Ultimately, the HMO disengaged and the state was able to help a nonprofit HMO from a neighboring state to create a subsidiary that bid on and won the contract (without any competitors). For several years, Kansas managers in essence had to accept the reality that they were highly dependent on one organization for a critical – and very expensive – service (Johnston, 2000). The state's resources were diverted from managing the market to engaging closely with the contracting HMO to both ensure its survival and to enhance performance. And in the Kansas City metro area, most cities seem unconcerned by the fact that one dominant trash hauler has held most city contracts for years, with virtually no scrutiny.

Managing when the benefits of competition are questionable

As noted above, even in what appears to be a competitive market, the expected efficiency payoffs may be elusive. Whitford (2007) reminds us that the strategic interactions of bidders and bid-takers can undermine the expected benefits of competition. The information required to properly set incentives for contractors is highly complex and often simply unavailable.

Public managers recognize the weaknesses that underlie the competition model. A fully competitive model increases instability in the service delivery system, and instability can impose high costs on clients and organizations (Johnston and Romzek, forthcoming). And there is evidence that less competition may be preferable from a performance point of view, at least in certain components of a service delivery network (Milward and Provan, 1998, 2000). While the "optimal" level of competition may be identifiable, it is at least possible that increasing levels of competition for some government contracts may be associated with diminishing returns.

According to one state education procurement specialist, "more competition may not be good. It is difficult to weed out those that don't have the wherewithal to do a good job. We rely on proxies" such as trying to "limit our work to firms with some minimum number of years in business. I want more firms, but I also want quality and expertise." Limited competition is a fact of life, so "why bounce the ball back and forth" when stability may improve service overall?

The benefits of competition are also questioned by administrators dealing with frequent changes in providers and the attendant disruptions to clients (Johnston and Romzek, forthcoming; Schlesinger, 1986). Especially in the service delivery networks that increasingly typify contractual arrangements, the continual adjustments required when multiple organizations enter and exit the system exact a high toll on network participants, including the government purchaser, the nongovernmental contracting organizations, subcontractors, interest groups, and citizens and clients. Because networks are less resilient in the face of external disturbances, compared to traditional, hierarchical governmental delivery systems, unanticipated organizational costs are common in competitively contracted systems (O'Toole and Meier, 1999, 2003)

Related management strategies

In addition to managing vendor markets characterized by monopoly, consolidation, and weak competition, contract administrators also "reverse contract" (Hefetz and Warner, 2004), returning production or service delivery in-house in order to address market shortcomings that give rise to performance problems, excessive costs, or a relatively weak position in the purchaser/vendor relationship. Reverse contracting may be adopted as part of a managed –competition, mixed-delivery system, as described in the Kansas City refuse collection system described earlier, or may entirely replace contracted production or delivery. Although probably more typical at the local level, recent developments may

portend reverse contracting at the state and federal level as well. The recently elected Democratic House voted to repeal an IRS program that uses private sector debt collectors (Barr, 2007a) and the Food and Drug Administration just awarded first four of thirteen programs under study to FDA workers, based on evidence that outsourcing would not generate savings (Associated Press, 2007)

Regardless of the level of provider competition, some contract managers strengthen the purchaser side of the market through consolidated purchasing systems such as those operated by the federal GSA, and by numerous states and local governments. (The GSA has recently come under increasing criticism for alleged abuses in its “assisted buy” program, through which the agency’s procurement expertise and scale is contracted out to other federal agencies. Because the agency recoups a percentage of each contract administered for other federal agencies, an incentive exists for contract managers to award higher priced contracts). One GSA contract manager described the new system adopted in the wake of Hurricane Katrina that authorizes crisis-stricken state and local governments to purchase needed goods and services through the federal procurement system. In the city of Charlottesville, Virginia, purchasing officials take advantage of state-authorized cooperative purchasing agreements with other local governments including the heavily populated, service-intensive northern Virginia counties, or with state departments, including the University of Virginia which is located in the city limits. In addition to cooperative contracting, one Michigan county provides services otherwise procured from private sector vendors at significant cost savings to within county communities.

Finally, contract management strategies must also be tailored to meet the challenges posed by subcontracting. It may be the case that the healthiest levels of competition are not among the organizations with which the government contracts, but instead among the multiple vendors with sub-contracts. This subcontractor market, in most instances, cannot be directly managed, raising critical accountability and responsiveness issues, not to mention cost questions. The GAO reports that in an interagency contract for construction services, DOD paid 7 percent to the Department of Treasury to award a contract to a staffing company, which then subcontracted to a construction firm. In combination, Army paid 17 percent more than subcontractor's proposed price" (GAO, September 2006, p. 12).

Subcontracting in Iraq has attracted recent attention as well. Walter Pincus reports that “it costs the U.S. government a lot more to hire contract employees as security guards in Iraq than to use American troops,” and “it comes down to the simple business equation of every transaction requiring a profit,” (2007, p. A7). The now-famous Blackwater “was a subcontractor to Regency, which was a subcontractor to ESS, which was a subcontractor to Halliburton's KBR subsidiary, the prime contractor for the Pentagon.” Data indicates that daily Blackwater personnel costs were \$600 per guard. The rate, supply and service schedule indicated that Blackwater charged at least \$200 more per day to Regency, which in turn billed others in the subcontractor chain, “and each company along the way was in business to make a profit” (p. A7).³

Even in relatively mundane social service subcontract systems, the subcontracting dynamic can be problematic. The State of Kansas department responsible for child welfare contracts arranged a \$500,000 payment to one financially troubled subcontractor struggling in part because the prime contractor had not been sending reimbursements. The state made the payment by diverting the money from the regularly scheduled monthly payment to the prime contractor. In doing so the state agency violated its own policy against getting involved in payment disputes between contractors and subcontractors. Ultimately, the nonprofit contractor revealed that it had exhausted its \$20 million endowment, and it subsequently declared bankruptcy. The subcontractor payment resulted in part from the fact that a state legislator sat on its board of directors.

As Milward and Provan (2000) point out in their discussion of the “hollow state,” multiple links can seriously complicate management and accountability. The growing use of contracts dependent on multiple subcontracts, which can also create numerous layers in the contract network, requires managers to scan an increasingly complex environment with boundaries that extend far beyond traditional inter-organizational structures.

Revisiting Competition, Contract Management and other Transaction Costs

Despite its promise of cost-savings, government contracting is hardly cost free. Estimates of cost reductions through contracted production and service delivery often fail to mention the resources required to develop, maintain, and monitor contracts (Sclar, 2000; Van Slyke, 2003). These transaction costs may consume up to 25% of the amount of the contract, according to some estimates (DeHoog, 1990; Pack 1989). In interviews with officials throughout federal, state, and local agencies, many contract managers indicated to us that administrative costs are nearly always ignored when the contracting decision is made. These managers, closely familiar with the costly endeavors required by contracting, and frequently operating in strained resource environments, find their capacity to provide adequate oversight further challenged when they must also “manage the market.”

Ironically, however, low levels of competition put the government purchaser at a disadvantage and require contract management that is more direct and intense in order to minimize “vendor opportunism” (B&P, 2006). But if public managers are resource-challenged in competitive environments, then utilizing resources to create competition in thin markets further stresses the organizational capacity needed for more intense oversight. “Because contracting and privatization initiatives remain so centrally driven by cost savings considerations, contract supervision and contractor performance assessment functions are often grossly understaffed and under-budgeted by state agencies” (Auger 1999, p. 449). In addition to cost constraints, Van Slyke (2007) asserts “...ideological motives to contract can also contribute to a lack of administrative capacity in government agencies...limiting the ability of public managers to develop competition...and monitor and hold contractors accountable” (p. 160).

Based on interviews with public managers in the New York social service market, Van Slyke (2003) found that while governments would prefer increased competition, overly stimulating the market proves too costly. Managers also felt constrained in developing competition “because of their own capacity limitations and the political disincentives associated with adding staff or encroaching on private markets” (p. 301). In a later study of county managers, Van Slyke (2007) observed differences in managerial approaches to contracting due to the effects of limited capacity and competition in the marketplace, concluding that managers are least risk-averse in urban counties and at the state level because of more competition in the market. Suburban managers were most risk averse because although competition can often be developed, administrative capacity is limited thus constraining county managers in terms of market development and contract oversight.

Problems with both contract oversight and increased reliance on contractors are illustrated in a recent report from GAO chastising DOD for failing to correct persistent shortcomings in contract oversight given consistent recommendations to do so for the past 10 years (GAO 2007). The GAO found that nearly one-third of the Defense contracts they reviewed suffered from inadequate monitoring resulting in increased costs, underperformance, and poor outcomes, citing an over-reliance on contractors providing operational services. While inadequate contracting oversight is a significant issue, systemic problems with the contracting process manifest at contract inception. Comptroller General David Walker highlights the failure on the part of the federal government to effectively contract for goods and services, as demonstrated by his recent testimony before the Senate Committee on Homeland Security and Governmental Affairs.

Once the decision to contract has been made, we have observed challenges in setting contract requirements, using the appropriate contract with the right incentives given the circumstances, and ensuring proper oversight of these arrangements - especially considering the evolving and enlarging role of contractors in federal acquisitions. The failure to adequately address these challenges explains, in part, why agencies continue to experience poor acquisition outcomes in buying major systems, goods, and services (GAO – 17 July, p. 8).

Yet throughout government we observe management capacity decreasing as the magnitude and complexity of contracting is increasing (Van Slyke 2003, Milward and Provan 2000, Auger 1999). Despite

the drastic increase in acquisition spending by the federal government (from 219 billion in 2000 to 347 billion in 2006), the size of the acquisitions workforce has remained constant since 2000 (GAO 2006 – Oct). Capacity issues are not limited to the federal government – state and local governments alike are reducing staff as they increasingly contract out, “thus creating capacity shortages in critical areas such as contract management” (Van Slyke 2003, p. 305).

In resource constrained organizations, managers increasingly use proxies for managing contracts to partially alleviate the burden of rigorous contract monitoring as reduced government management capacity and the lack of expertise to manage contracts compromise the effectiveness of contract oversight (Van Slyke 2007, Brown and Potoski 2006, GAO 2007). In addition to relying on contractor status reports, managers rely on relationships and informal networks to minimize information asymmetries between contractors and governments (Brown and Potoski 2004, 2003). Furthermore, Van Slyke (2007) finds that trust and reputation are highly influential in contracting relationships at the local level. Although federal acquisition law attempts to limit personal influence in procurements, managers we interviewed rely on reputation and past experience with contractors as determinants of contracting decisions. One federal manager with 25 years of experience recently let a small value contract for support staff. Realizing that she would get little interest (because of the size of the contract), she contacted a vendor she had previously worked with requesting the firm to bid on the request for proposal. The only bidder was the firm she contacted. “I ended up where I wanted to be, working with the firm that I was familiar with.”

When provider markets are thin and governments fail to maintain capacity, they become dependent on contractors (Cooper 2003). “There has been a tendency to argue that indeed it is the institutions of government that stand in the way of effective governance...these were among the arguments in favor of increased contracting out...However, government contracting by weak institutions is hardly likely to obtain a good deal for the public” (p. 161). Democratic government relies on the “capacity for ‘good’ administration” (Terry 2006, p. 122); yet as public managers continue to face pressure to do more with less while management resources are simultaneously diverted, public interest is compromised by ineffective and inefficient service delivery.

Conclusion

Advocates of privatization and contracting stress that competition is the chief driver of improved efficiency and performance in government production and service delivery, yet our interviews with federal, state, and local officials, and our review of research on the topic, indicate otherwise. For many public managers, competition is an elusive goal, and they find themselves purchasing goods and services from markets characterized by low levels of competition. We find that significant levels of administrative resources are devoted to “managing the market” by creating, stimulating, and maintaining competition. As a result, administrative resources may be stretched between managing the market and contract design, implementation, and oversight. Our interviews are not necessarily representative, nor are they meant to be. Instead, our interest is to get a sense of how weak competition affects contract management. While the “managing the market” phenomenon emerges in prior research on contracting and transaction costs, our research is designed to provide a more detailed, contextual understanding of how managers attempt to correct noncompetitive conditions, whether their strategies are successful, and also to better understand the implications of this activity.

In essence, our research demonstrates that managing the market entails real costs – costs that comprise part of the transaction cost picture, and that are often not considered when decisions are made to outsource public goods and services. Attention to accountability is necessarily compromised because the administrative resources devoted to managing the market are diverted from contract management. Because contract management and market management costs may not be factored into contracting decisions, staff remaining in the newly hollowed government organizations may then be diverted away from program and performance management in order to work on contract management and market management.

One implication is that the unanticipated costs of contracting, including the need to manage the market, can stretch organizational capacity and threaten not only contract accountability but also other

democratic values such as equity, transparency, and other public values and “norms embodied in constitutional and administrative law” (Rosenbloom and Piotrowski, 2005, p.103; Moe, 1987; Frederickson, 1996; Bozeman, 2002; Jorgensen and Bozeman, 2007). Terry (2006) warns that market-based management results in weak institutions lacking the management “...capacity for “good” administration...a necessary requirement for maintaining public trust in democratic government” (p. 122). Contract oversight and accountability are difficult objectives under the best of conditions. But increasingly, as the scope of government contracting expands beyond traditional bounds, contract managers confront conditions created by low competition and the consequent information asymmetries and related transaction costs. Reductions in the ranks of government administrators with institutional and program knowledge result not only in less accountability, but also in the contracting out of increasingly fundamental government functions such as policy design.

It may seem ill-advised to contract out when vendor competition is insufficient. Yet of the managers we interviewed who deal with weak competition, most reported that the competition problem is not seen by policymakers as a reason to reconsider the contracting decision. So in order to maximize “taxpayer value” and service quality, they resort to “managing the market.” This raises an important normative question. *Should* public officials manage markets?? If so, why? Doesn’t “managing the market” conflict with standard, classic notions of markets? In view of the opportunity costs associated with managing the market, what are the impacts on the efficiency objective driving government contracting?

While this paper does not offer answers to those questions, it does attempt to shed light on the increasingly common and costly practice of “managing the market,” and on the implications for management, accountability and democratic governance. Whether managing the market should fall under the purview of public managers is a legitimate question. But regardless of whether public managers should manage the market, they clearly do so in a variety of ways, and often with often limited success at a high cost.

Endnotes

¹ Data were drawn from over 100 elite interviews conducted for previous research on social welfare contracting, as well as recently conducted semi-structured interviews with 24 federal, state, and local contract managers. We use the term contract manager to describe a government manager who is generally a subject-matter-expert with responsibility to select, manage, and oversee contracting relationships under their purview. At the federal level, these would include contract officer representatives (CORs) or contract officer technical representatives (COTRs) for one or more projects, programs, or service areas.

² In an earlier report (September 2006: Contracting for Better Outcomes), the GAO notes that “The impact of not using full and open competition is reflected in one recent example involving the Army’s award of sole-source contracts for security guards. In this case, we found that the Army devoted twice as many contract dollars - nearly \$495 million - to sole-source contracts for security guards at 46 of 57 Army installations, despite the Army’s recognition that it was paying about 25 percent more for its sole-source contracts than for those it previously awarded competitively” (p. 6).

³ Managing subcontractors can have far more serious consequences. Singer (2007) explains a more sinister consequence of the long chain of accountability related to Blackwater. The famous Fallujah incident, in which four contract workers were killed and suspended from a bridge, completely undermined a counterinsurgency strategy underway by the U.S. military in the city, and proved to be a turning point as the city was ultimately abandoned by the military and “devolved into a base of operations for Al Qaeda in Iraq” (p. 14). Ironically, the Blackwater subcontractor convoy, which the military were not even aware were in the vicinity, ventured out on their mission unprepared for the purpose of “escorting some kitchen equipment” (p. 14).

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