

**Chasing Competition:
Examining the Effects of Noncompetitive Public Service Markets**

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Abstract

When public managers contract out government services, they often confront challenges associated with low levels of provider competition. This research provides insights from the front lines of contract management on how and why public officials cope with inadequate competition for public service contracts. Through extensive qualitative research, we find that contract managers expend significant resources on “managing the market”. Furthermore, related opportunity costs can include diminished attention to other elements of contract management, and the accountability expected when public resources are used to acquire goods and services from nongovernmental actors. We also conclude that despite their efforts, public managers are often unsuccessful when trying to “grow the market,” and that they are often forced to manage with resignation in the face of limited competition and vendor monopoly.

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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 federalist 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 2007a). 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.

Meanwhile, states and local governments are moving larger 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 to nursing homes; 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, the distinction between public and contractual employees is often unobservable (Hedgpeth 2008), and citizens are not able to determine which sector is actually serving them (Van Slyke and Roche 2004).

More recently, the fundamental theoretical underpinning of contracting has also been challenged. Those who are skeptical about the “public choice” and market-failure rationales for contracting have devoted newly invigorated attention to contracting viewed through the lenses of

public values (Bozeman 2007; 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; Radin 2006). At the same time, those more focused on the design, implementation, and management of contracts increasingly find that government contracting often simply does not follow the logic of market theory (Johnston and Romzek 1999; Kettl 1993). That logic rests squarely on the power of competition to enhance the efficiency of government programs and services. Cost effectiveness is 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 relying on competition as the rationale for contracting. 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 for certain service types and levels of government. And perhaps more fundamentally, the benefits of competition have come under question because even in competitive provider markets, contracting operates with less success than theory might predict.

We will review these competition issues as we characterize the work of contract managers and their efforts to manage features of the markets they encounter. In addition to low levels of provider competition, managers may confront markets constrained by political and legal forces. In many markets that were originally competitive, managers face conditions of low competition due to provider consolidations and mergers. Managers can also manipulate both “sides” of the market, and many have strengthened their purchasing position by strategically shifting power to the government through cooperative purchasing systems or by pursuing

alternative contract structures such as mixed public-private delivery.

We also address both normative and empirical questions that have received relatively little attention in the contracting literature. First, we use qualitative data drawn from semi-structured interviews with federal, state, and local contract administrators to 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 the transaction costs associated with economic exchange (Coase 1937; Williamson 1981), the concept of “managing the market” remains quite general in nature (Warner and Hefetz 2008; Graddy and Chen 2006; Brown and Potoski 2004; Fossett et al. 2000). Our data provide insights from the front lines of contract management on how public officials cope with low levels of provider competition. We find that contract managers expend significant resources on managing the market, and that related opportunity costs can include 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 nongovernmental actors. We also conclude that despite their efforts, public managers are often unsuccessful when trying to “grow the market,” and that they end up managing with resignation in the face of limited competition and vendor monopoly.

Second, we raise the related normative questions. *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”? While we do not intend to answer these questions here, we do hope to shed light on some of the factors that shape these questions, and on 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 an organization “must compete for market share, functions and resources” (Cohen 2001, 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” (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. purchasers 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, 122). The 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 for public services. This may be especially true for specific program areas such as social services, for specific geographic regions such as rural areas, or under conditions requiring rapid response such as those experienced after the 9/11 attacks and Hurricane Katrina.

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. This expansion has taken place despite evidence that competition for government contracts is often insufficient. One report finds that the number of federal contracts awarded under full and open competition declined from 2000 to 2006, from 45% of the total to 34% (openthegovernment.org 2007 in Yost). This trend is especially troubling because over 25% of discretionary federal spending goes to contracts (GAO 2006).

States also experience thin markets as they deliver increasing numbers of services through contracts. The trend toward state contracts for social welfare services accelerated with passage of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (Nathan and Gais 1998), and research indicates that competition is often insufficient for many, if not most, of these services (Johnston and Romzek 1999; Romzek and Johnston 2002; Van Slyke 2003; 2007; DeHoog 1990; Smith and Smythe 1996; Schlesinger et al. 1986). 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 that attract two or fewer managed care provider bids (Fossett et al. 2000). Competition for local contracts is also often weak (Johnston et al. 2004; Hirsch 1995; Kodrzycki 1994; Hefetz and Warner 2004). For local governments outsourcing social services or nursing homes, provider markets can be especially thin (Amirkhanyan 2007; Van Slyke 2003; 2007).²

Contracting scholars do not necessarily agree on the definition 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” (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). Former Indianapolis Mayor Stephen Goldsmith concluded that adequate competition was established when three or more vendors bid, and in that count he often included city departments authorized to compete for city contracts.

Questioning the Benefits of Competition

Many contracting scholars emphasize that even when vendor competition is adequate, competition does not deliver the benefits promised by theory (Boyne 1998; Donahue 1989; Brudney et al. 2004; Hirsch 1995; Sclar 2000). And while public choice theorists and other supporters of contracting stress that efficient production requires competition, efficiency is only one of several values fundamental to governance in the U.S. Constitutional and political values are of equal or perhaps greater 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 2007; Milward and Provan 2000; Rosenbloom and Piotrowski 2005; Moe 1987; Frederickson 1996). Recent emphasis on “best value” contracts reflects, in part, renewed attention to these alternate values. Best value contracts consider lowest cost as one of several criteria to be evaluated, thus balancing competing values of importance to the specific program or service.

Competition can also undermine other government objectives related to service quality and program performance. 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 2008; Milward and Provan 1995; 1998; Agranoff and McGuire 2004; 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).

When contracts change hands, costs are imposed on the entire service delivery systems. For instance, in interviews with state child welfare administrators, officials reveal that these costs – which include staffing and other service delivery disruptions – affect not only program clients but also the managers of other child welfare contracting organizations. These contract disruptions can create cascading effects that destabilize other contractors’ financial positions and their capacity to serve child-clients (Romzek and Johnston 2005). The impacts of instability may help explain why we see evidence that more monopolistic, less competitive markets may be preferable from a performance point of view, at least in certain components of a service delivery network (Milward and Provan 1998; 2000; Romzek and Johnston 2005). While some “optimal” level of competition may exist, it appears that increasing levels of competition for some government contracts may be associated with diminishing returns.

The incentives created by competition can also give rise to serious complications among contracting organizations. Competition can draw nonprofit organizational 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 organizations, and can undercut the characteristics that made the organization attractive to government in the first place (Romzek and Johnston 1999; Smith and Smyth 1996). And when organizations compete for government contracts, their pre-contract collaborative relationships on

behalf of the public with other nonprofits may be sacrificed, and their advocacy roles diminished (Romzek and Johnston 2005; Graddy and Chen 2006).

Another problematic side-effect of competition concerns the seepage of expertise from government to contract organizations, many of which offer higher rates of compensation 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, 1).

Despite the shortcomings of competition, it seems clear that an absence of competition is also highly problematic and 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 Noncompetitive Markets

Our interviews reveal that public managers engage in a variety of behaviors and adopt numerous strategies to ameliorate the shortcomings of a thin provider market, to maintain competition after contracts take effect, to ensure adequate competition for future purchases, and to otherwise strengthen vendor markets. The notion of “managing the market” may appear paradoxical; nonetheless, public managers do indeed create, shape, nurture, and expand provider markets (Warner and Hefetz 2008; Graddy and Chen 2006; Brown and Potoski 2004; Fossett et al. 2000; Allen and Walker 2007). Yet there is little detailed research on the practice or its implications. Our analysis supports the notion that public managers have a keen understanding of the importance of competition and its impact on costs and other performance objectives, and that they intervene when competition is weak.

The reality is that when contracting decisions are made, projections of cost reductions through contracted production and service delivery often fail to mention transaction costs – the resources required to develop, maintain, and monitor contracts (Sclar 2000; Van Slyke 2003). These transaction costs may consume up to 25 percent of the amount of the contract, according to some estimates (Prager 1994; DeHoog 1990; Pack 1989). 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.”

Figure 1 provides a schematic representation of the multiple management challenges related to competition, drawing on data from interviews with contracting officials, combined with analyses of relevant public documents. In weak vendor markets, public managers must contend with markets that range from conditions of low vendor supply, to provider markets constrained by legal and political forces, to post-contract provider consolidation (and, in some cases, vendor monopoly). Competition is not static. Considerable attention must be paid to markets after a contract takes effect because government contracting may in fact encourage provider consolidation and thereby reduce competition. In other cases, contract managers expend resources in attempts to retain and nurture contracted providers who threaten to leave the market (often because these providers did not fully understand the costs related to the contract), and they also endeavor to strengthen those that are vulnerable to failure.

[Insert figure 1 about here]

The fundamental problem revealed in Figure 1 is that thin markets require significant administrative resources. “Managing the market” moves contract transaction costs beyond

contract oversight. At the same time, opportunity costs are created because administrative resources are diverted from the monitoring of performance and accountability. These costs further reduce the justification for outsourcing because they lower the net benefit of the contract to the government purchaser. In the following sections, we use the results of our interview data to detail some of these transaction and opportunity costs.

Confronting Markets Constrained by Legal and Political Forces

Public contract managers frequently confront provider markets that have been constrained by legal and political forces. 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 designed to diversify the provider market and ensure the awarding of federal contracts to businesses that face competitive disadvantage with larger firms, or to businesses owned by women, minorities, and others who have suffered discrimination in past contract awards (Public Law 95-507). Nearly every federal official we interviewed reported that finding adequate numbers of qualified small disadvantaged businesses is a major challenge – and one which requires significant time investments. This dynamic existed regardless of the level of provider competition for their contracts.³

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 providers in order to internalize any resulting economic benefits. Recent revelations that British companies were the only finalists for selected U.S. contracts in Iraq have generated congressional attention and calls for American taxpayer dollars to be directed to American contractors (Klein 2007). Constraints are sometimes created to shut out

bidders with efficiency advantages but little knowledge of the local market, or to limit contract awards to those with a record of success, such as in Massachusetts, where state mental health administrators encouraged bids only from providers with proven track records, thereby erecting barriers to full competition (Schlesinger et al. 1986, 252).

More sinister political considerations can also constrain provider competition. One former Department of Defense (DOD) contracting official told us that she often felt pressured to minimize competition in order to allow contracts to be awarded to associates of current DOD staff. In her view, there are way too many project managers roaming the halls of the Pentagon who “used to be in uniform who joined private firms” and come to her “want[ing] to help my buddy startup his business.” Charges of old-fashioned cronyism have emerged around contracts for services for the Iraq war and the Hurricane Katrina recovery. One salient example was provided in recent congressional testimony by Bunnatine Greenhouse, an SES principal assistant responsible for contracting who alleged that DOD awarded long-term no-bid contracts to Halliburton for Iraq war services, despite her insistence that a competitive market of providers existed and that standard emergency bidding procedures would meet DOD’s needs (Tucker 2005).

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 most of 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 (Allen and Walker 2007). As these examples illustrate, in addition to their other efforts to stimulate competition, contract managers must also surmount

barriers to competition created by legal and political forces.

Managing Markets by Stimulating – or “Chasing” – Competition⁴

Government contracting officials use a wide array of approaches designed to stimulate provider competition. Some of these strategies are required by law. The federal government’s procurement process, for example, is heavily formalized to conform to legal requirements, with competition stimulation embedded in the procedures used by contracting officers and other purchasing staff. In essence, many federal agencies follow the “any willing provider” method, under which 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 then rotated through the providers in the database, based on elaborate algorithms. This strategy awards contracts to many providers, thereby serving to sustain a large number of providers. It does not, however, foster competition in the classical sense (e.g., competition that theoretically produces a winner based on relatively high performance and low price). Its success in maximizing value is therefore questionable and is indeed questioned by some of the federal contracting officials we interviewed.

Contract managers also indicated that despite these procedural safeguards - put in place in part to maximize vendor competition - contract support staff nonetheless spend substantial amounts of time on market research in order to find suitable vendors. Indeed, some contract specialists devote more time to “chasing” competition than to other components of contract management. One 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 a relatively small-scale program related to privatizing defense utility facilities. After he identifies vendors, they must be

contacted and solicited. Yet despite his efforts, true competition rarely materializes and for the most part, “two big firms bid on all contracts” for this specific DOD initiative. (Middle Eastern companies recently purchased the two companies and their future position in the U.S. market is not clear.) The remaining portions of this contract manager’s time are devoted to cost analysis and other standard contract preparation tasks. Similarly, a Department of Energy (DOE) contract manager reported devoting 50% of her time to finding vendors to provide information services, and that despite her efforts, it is “typical to have three or less vendors” bidding on contracts for this relatively routine service.

In the case of a federal security function that was outsourced as a result of the National Performance Review (1993), a federal senior executive service (SES) official devotes *all of his time* to “trying to grow national capacity” for the service, and is one of over a dozen staff dedicated 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 predicted for a highly specialized service, this particular federal security task is quite routine and should generate relatively healthy levels of competition (thus, the original decision to “privatize”). But success has been limited. As is often the case in the contracting arena, 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. The security contractors “all saw dollars, then realized that this is hard, complicated work,” according to the SES official. He also stresses that contrary to common perceptions, “contractors are *not* more flexible than government . . . They’re *less* flexible,” at least in this service area. Another administrator newly associated with this program, with over 15 years of experience in the purchase of federal goods and services, (including weapons systems,

defense infrastructure components, and other less technical security services) 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, and consistently requires substantial time and energy to “look for more vendors.”

Similar dynamics characterize the management of state contracts. In some states, Medicaid managed care officials have reported that they devoted scarce staff resources to continual efforts to “keep [HMO] providers in the game” (Fossett et al. 2000; Johnston and Romzek 1999). On the other hand, in Pennsylvania and Michigan, where comparatively robust HMO competition exists, Medicaid administrators preserve competition by awarding contracts to more than one provider (Weissert and Goggin 2002; Johnston 2003), primarily by carving up the state into regions, or by otherwise ensuring that all qualified parties share in the contract. In effect, the strategy of maximizing the number of organizations involved in delivering the service enables managers to protect and enhance program capacity (Allen and Walker 2007; Graddy and Chen 2006), as in the case of federal purchasing procedures described above.

In other cases, government administrators create competition in thin markets by requiring public organizations to bid on public contracts. For instance, when officials in Kansas City, Missouri began to recognize the weakness of the provider market for their contracted refuse collection service, they adjusted service delivery through a “mixed delivery” strategy by resuming public collection in one portion of the city and retaining contracted providers in the remaining areas (Johnston et al. 2004). (By contrast, in most suburban governments in the Kansas City metro region, competition was essentially non-existent, and long-standing contracts with one dominant provider were subject to minimal monitoring or oversight.) Warner and

Hefetz (2008) find that this combination of public and private service provision has become a common alternative to competitive bidding in local governments because “experienced managers were more likely to use mixed delivery rather than trust the market to ensure cost efficiency and failsafe service” (10).⁵

Government managers may also help to establish alternative service provider organizations – that is, to create a new entity that will secure the contract. This has been observed in state Medicaid managed care programs where states create “Medicaid-only” HMOs to cater exclusively to Medicaid patients (Fossett et al. 2000), in the federal Employee Stock Ownership Plans (GAO 1997), and in other service areas. 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.

Finally, it may be the case that the healthiest levels of competition are not among the primary 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.⁶ Despite the competition they bring to the service delivery system, such subcontracts – and their removal from proximate state oversight – impose opportunity costs associated with diversion of resources from direct program monitoring and a focus on improving program performance.

In short, interviews with federal, state, and local contract administrators reveal strategies and activities designed to create, sustain, and stimulate provider competition, and demonstrate that they generate high costs in terms of staff time and energy. Contract managers’ detailed insights into competition enhancement strategies put a face on the “transaction costs” associated

with contracting.

Post-Contract Markets: Managing Weak Vendors and Consolidation

Vendor Retention. In some cases, public managers must devote energy to the retention of existing contractors that, for a variety of reasons, may wish to withdraw from their current contracts. A federal SES official described to us the intense efforts undertaken by his staff to preserve – indeed nurture – two contractors over a long period of time, including training the vendors “to think like business.” These organizations ultimately terminated their contracts, thereby reducing the number of available service providers from six to four, creating costly “holes” in service delivery, and diverting staff resources from contract monitoring and performance enhancement. Another federal official offered a similar scenario, describing an agency’s efforts to counsel contractors for poor performance. After receiving a poor quality product the government helped with a “get well plan” to bring the contractor’s work up to par and keep the organization in the fold of providers. Vendors, according to another federal official, “will say yes to everything – they do not have the ability to manage their own workload” and therefore become vulnerable and more likely to abandon their contracts.

Throughout contract periods, 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 competitive position. When Kansas Medicaid administrators resigned themselves to the reality that only one organization would bid on the state’s managed care contract, they nonetheless tried to encourage other HMOs – almost “begging” – for at least a 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).

Vendor Consolidation. Over time, provider consolidation creates additional management challenges. Sclar (2000) warns policy makers that:

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 (70).

A recent study reports that among federal contractors, the vendor consolidation rate has doubled in the last seven years. Mid-size companies hold 33 percent of federal contracts in 1995, down from 44 percent in 1995. (Goldfarb 2007). 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 standardized, more bureaucratized, more powerful in the procurement relationship, and more dominant in the market (Goldfarb 2007, D01; see also Schlesinger et al. 1986). There is also evidence that over time, the strength of performance incentives built into contracts diminishes (Marvel and Marvel 2007); as a result, more staff resources are required for fine-tuning incentives, and less remains for conventional contract oversight.

Interviews with contract managers reveal that for some, consolidation is a constant concern. One state corrections contract manager told us that he was especially gratified when he was able to award a preliminary prison construction and management contract to a small, regional, high-quality company. He was hopeful that the state could temper the market power of the two dominant prison contracting firms. However, one of those two companies bought out the

small firm and won the final contract. Consolidation and large organization dominance characterize other markets for state services, including welfare services (Sanger, 2003). For example, administrators of primary child welfare contract organizations reported that “vertical integration” was increasingly attractive as cost pressures made sub-contracting less feasible. Small, precariously financed contract and subcontract organizations fully recognize their vulnerability under these conditions (Romzek and Johnston 2005) as they compete increasingly with large, dominant contractors. Similarly, 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” (548-9). Schlesinger et al. (1986) described the multiple forces encouraging consolidation among contractors for mental health services in Massachusetts. These forces included economies of scale in both provision and bidding. In addition, governments aware of the transaction costs and risks associated with the uncertainty of the production process or with the dearth of high-quality providers, establish preferences for “familiar” contractors, contributing further to provider consolidation (253). 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. She noted that “I ended up where I wanted to be, working with the firm that I was familiar with.”

These consolidation dynamics push contract managers to devote more resources to monitoring and stimulating provider markets. While managers strive to expand and enhance competition, they are swimming upstream against forces that lead some contractors to leave the

market, others to consolidate, and still others to fail in the face of competition from large, entrenched organizations.

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 thin, flawed market. In some cases, that means living with at most two viable providers, and in others, with perhaps only one, through sole-source contracts. Sole-source contracting has received critical attention in recent months, but it is nothing new, and not uncommon. An interview with a DOE contracting official revealed that roughly 40 percent of all the contracts in her portfolio were sole-source contracts, many related to proprietary information systems contracts. (Luckily, this represents a lower portion - in the range of 20 percent - of the total dollar value of her portfolio.) The fact that she spends nearly half of her time seeking additional vendors to stimulate competition is therefore hardly surprising. Yet her outlook is realistic – for a good portion of her portfolio, she is resigned to inadequate competition.

As noted above, some state corrections managers indicate that they have essentially resigned themselves to a market that, in essence, consists of two dominant providers with a handful of others that are likely acquisition targets. The absence of competition exists despite continued growth in state and county inmate populations that must be housed. This puts states at a disadvantage as purchasers of corrections services. One state corrections official put it bluntly: 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....States are “throwing money at the problem.” 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, described by a prison official in Arizona, is a familiar one – new public service demands confront unprepared provider markets. In the prison case, “the main problem is inadequate capacity in the market – there are not enough beds available for national needs.”⁷

Another corrections procurement specialist stressed that even in a two-vendor world, “the incumbent has a tremendous advantage” but at least there is some recourse. He reported that in a recent bid cycle, he was careful to reassure the one viable competitor that the incumbent did not “have a lock on our contract.” In fact, he was able to accept the competitor’s bid because although the proposals were deemed equal in terms of quality, the competitor’s bid carried a slightly lower price. He was relieved because 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. Nonetheless, this result was due in large part to good luck. The manager would have had little recourse if the original contractor had won the bid, and that contractor would have become even more powerful in the contract relationship. Regardless, this manager is resigned to the reality that his state must purchase from a market with only two viable vendors.

While this corrections official is busy dealing with the flaws in the market serving his own state, developments in some other states concern him even more. He was recently 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. He stressed in his testimony that such a move was ill-advised because there is simply “not enough competition. And the sale would eliminate the residual expertise to monitor”

by the state.⁸

In Kansas, and in other states, Medicaid officials became resigned to living with one bid in their periodic requests for proposals for HMO managed care. Ultimately, the sole HMO bidder terminated its contract and the state scrambled to help a nonprofit HMO from a neighboring state create a subsidiary that bid on and won the contract (without any competitors). For several years, Kansas managers in essence have 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 oversight to engaging closely with the contracting HMO to ensure its survival. Similarly, officials in several Kansas City suburbs are resigned to the fact that one dominant trash hauler has held most city contracts for years, with virtually no oversight. Many of these administrators acquiesced long ago to the non-competitive market for refuse collection.

Managing the Market, Resource Diversion, and Opportunity Costs

Managing the market aims to reduce the low levels of competition that put the government purchaser at a disadvantage. Yet ironically, market management creates opportunity costs by diverting contract oversight resources in those very situations that require more intense contract monitoring. Thin markets therefore deliver a double contract management whammy. They require more intense contract management, yet they also drive contracting officials to manage the market in order to increase competition, thereby reducing resources available for those intense contract management needs. Many contract administrators emphasize that under such conditions, they are hard pressed to deliver the best return to citizens, in terms of service quality and cost.

Yet at all levels of government, contract capacity is eroding even as the magnitude and complexity of contracting is increasing (Brown, Potoski and Van Slyke 2007; Van Slyke 2003

Milward and Provan 2000; Auger 1999; GAO 2006). One result of this squeeze is increased outsourcing of contract oversight and monitoring. Contractors are now overseeing other contractors with growing frequency, and the role of government in public service provision is shrinking. The GAO has issued countless reports about the declining management strength of the federal government, and increasing vulnerability in the fact of contracting our policy design, program implementation, service assessment, and contract oversight. In a 2008 report, they critique DOD dependence on contractors for procurement planning and contract negotiations, and the consequent risks of fraud and abuse. When markets are noncompetitive, all of these problems proliferate, increasingly scarce administrative resources are stretched even thinner, and diversion from the few remaining government oversight functions can lead to highly problematic results. The loss of in-house expertise and institutional history is high in cost but very difficult to quantify.

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 analysis indicates that provider competition may be difficult to achieve and sustain. 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, scarce administrative resources may be stretched, pitting market management objectives against contract design, implementation, oversight, and accountability.

Our interviews are not necessarily representative, nor are they meant to be. Instead, they

provide a sense of how weak competition affects contract management. While the “managing the market” phenomenon emerges to some extent in prior research on contracting and transaction costs, this research is designed to provide a more detailed contextual understanding of how managers attempt to correct noncompetitive conditions and whether their strategies are successful, as well as to better comprehend 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. 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. Attention to accountability is necessarily compromised because market management creates opportunity costs manifested in reduced attention to service quality.

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 related democratic values such as equity, transparency, and other public values and norms (Rosenbloom and Piotrowski 2005, 103; Moe 1987; Frederickson 1996; Bozeman 2007; Jorgensen and Bozeman 2007; Radin 2006). 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.

Lobbying is nothing new for contractors (Kelleher and Yackee 2007; Johnston and Romzek 1999), but the relative advantage enjoyed by the dominant private firms for state and county prisons and jails 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 individual contractors. 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” where private prisons and jails are more common (227).

We should also note here that service type does not necessarily determine the degree of competition in provider markets. While relatively low provider competition has been documented in the area of contracting for social welfare and other “soft” services, our data indicate that contract managers purchasing a variety of other services are impelled to engage in significant levels of “market management” activity.

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? Should contract managers be in a position to intervene in provider markets by nurturing existing contractors, creating new entities to bid on contracts, or otherwise influence

the composition and trajectory of relevant 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 definitive 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, often with often limited success, and at a high cost.

¹ Data were drawn from over 125 elite semi-structured interviews conducted for previous and current research on government contracting. Interviews were conducted in waves beginning in 1996 through 2007. We use the term contract manager to describe a government administrator who is generally a subject-matter-expert with responsibility to select, manage, and oversee contracting relationships under their purview. Respondents were guaranteed anonymity, which constrains our ability to provide identifying information in some cases.

² 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.

³ Federal contract managers noted that the imbalance between the “too many vendors” in the Washington DC metro area eager for federal contracts, and available qualified small disadvantaged vendors, led to the creation of a “mentor/protégé” solution (GAO 2007). Under the mentor/protege initiative, larger 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 large firms end up doing most of the work through sub-contracts. This strategy, we were told by some federal contract officers, only serves to undermine the original small disadvantaged business policy objective. Federal contract managers, often frustrated at dealing with what one calls “the usual suspects” (that is, large, experienced federal contractors that bid on most of their contracts), are therefore unable to truly diversify the provider market and thereby stimulate the levels of competition they feel are

necessary to create maximum value for citizens.

⁴ We are grateful to a colleague for suggesting that we use the phrase “chasing competition” to describe efforts to develop and sustain provider markets.

⁵ In some situations, “contracting back in,” which eliminates competition altogether (Hefetz and Warner 2004) may be required to best ensure quality service delivery and accountability. Contracting back may be most likely in thin provider markets.

⁶ Subcontracting in Iraq has attracted recent attention as well. Writing in the Washington Post, 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. A17). For instance, 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 reveal that Blackwater charged at least \$800 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. A17)

But managing subcontractors can have far more serious consequences. Singer (2007) explains a more ominous consequence of the long chain of accountability related to Blackwater. The famous Fallujah incident, in which four contract (actually, subcontract) workers were killed and suspended from a bridge, completely undermined a counterinsurgency strategy underway by the U.S. military in the city. This incident proved to be a turning point in the war because as the city was ultimately abandoned by the military and “devolved into a base of operations for Al Qaeda in Iraq” (p. 14). In effect, contractor errors triggered significant destabilization and may

have contributed to the downward spiral that ensued. Ironically, the military in the vicinity were not even aware of the Blackwater subcontractor convoy's presence when it ventured out on its mission with minimal preparation, for the purpose of "escorting some kitchen equipment" (p. 14).

⁷ 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).

⁸ This official also described developments in Colorado, where prisons are needed but there are countervailing pressures against increasing state bond indebtedness. So the state has contracted with counties to hold state inmates with the implicit understanding that they should do so through contracts. He reports that "the counties get a cut, and they are not required to use competitive bidding. The state [is able to avoid the required state bidding process and therefore] determines who the county would use" to deliver the service privately.

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Figure 1: The Public Manager's Paradox: Managing Noncompetitive Markets

