Managing Privatization: The Tools, Skills, Goals and Ethics of Contracting

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Abstract

As contracting out of government services becomes more prevalent, public managers must develop the skills to work effectively with contractors. This paper is concerned with how public managers may deal with some of the difficulties in forging successful working relationships with private organizations. The paper identifies twenty common problems – including flawed Request for Proposal and or contract language, and poor communication between government and contractor management – and suggests solutions. These problems are inherent to the contracting relationship, which places public managers in the position of overseeing the work of leaders and staff in private organizations. The solutions involve establishing formal mechanisms, incentive systems, and informal communication networks.

Introduction

As the economic market place becomes a global one, the quality and cost of government services can substantially influence a nation's ability to compete. In response, innovative government managers are seeking to improve their performance and leverage public resources through partnerships, contracting out and incentives to private and nonprofit organizations to help deliver public goods and services. To some degree, these trends reflect an ideological preference for smaller government, but they are also connected to a search for managerial effectiveness. Public managers have correctly concluded that they will more successfully implement public policy if they learn to work with private organizations. The process of privatization sometimes includes moving a public function into the private sector where it develops a market and no longer needs government support. This paper focuses on the type of privatization that does not generate a purely private market for a current government function, but requires public support through a contracting process.

There is an emerging literature on the use of contracts by government and the private sector. Network management due to outsourcing is becoming a way of life throughout our public and private economy. A great deal of scholarship has been devoted to analyzing the decision to privatize and to providing advice to decision makers about how and when to contract out. (Avery: 2000) Murem Sharpe (1997) has written that contracting out has become a normal response to economic change in the private sector, and that workers have learned to adapt to this new world. George Boyne (1998) has analyzed the outsourcing decision by local governments in an effort understand the influence of fiscal stress, market structure and politics on the "make or buy" decision. Osborne and Gaebler noted the usefulness of contractor competition in improving the effectiveness and efficiency of government organizations, an argument also made by John Rehfuss (1991) when he compared contracting out in the United States and Great Britain.

A wide variety of scholars are skeptical about the benefits of contracting out (Harrison and Stanbury:1990, Hirsch: 1995, Sclar: 1994, 2000) Sclar questions the assumption that contracting leads to cost savings, citing transaction costs and the absence of competitive markets for most of the work performed by government. Others note that while contracting out can save money, it will only do so if a private market exists for the services being purchased (Rehfuss, 1991, Johnston and Romzek: 1999). Jonas Prager (1994), like Sclar, notes that contracting out should only take place after government analyzes the cost of: (1.) letting contracts, and: (2.) monitoring performance. Globerman and Vining (1996) also cite the importance of analyzing transaction costs. Prager considers it essential that direct government provision of service be carefully analyzed as an option when considering contracting programs.

Scholars have also analyzed the effect of contracting on government effectiveness and legitimacy. This literature has been best summarized and analyzed in Brinton Milward's path breaking work on what he terms "the hollow state". (Milward: 1994, 1996, Milward and Provan: 2000). Gilmour and Jensen (1998) have written of the need to redefine our formal concepts of government accountability to deal with the facts of increased privatization. Bardach and Lesser raise the issue of accountability to particular parties versus accountability for results. In their view, before developing accountability mechanisms one must decide who management is accountable to and/or what government is accountable for. While concerns about the hollowing out of government are important, and worrisome, increases in contracting activity are widely reported (McDavid, J. and Clemens. E: 1995, Green: 1996, Light: 1999). A number of observers have discussed the need for more sophistication in government contract management (Johnston and Romzek: 1999, Romzek and Johnston, 1999, Gordon: 1998). Whether one favors or opposes contracting out, its growth is indisputable. Those of us in the business of advising and training public managers must learn to understand this management tool and trach public managers how to use it more effectively. The focus of this paper is to begin to get specific about the obstacles that public managers must overcome to be better contract managers.

We have written elsewhere about a “functional matching” approach to privatization and the different attributes and motivational advantages of each sector for different tasks (Cohen: 2001). Simply put:

- Government organizations must be used when authority relationships are at the center of the task--such as police and regulatory functions.

- Nonprofit organizations seem best suited to functions such as health care that have a strong mission-driven dimension.
- Private organizations are best when material incentives are needed to assure high quality task performance.

We foresee that public managers will continue to assign functions to non-governmental organizations. As we noted in an earlier paper (Cohen and Eimicke, 2000) the trend toward multi-sectoral public service delivery creates several critical and difficult operational problems that must be addressed, including:

- Finding out what contractors are doing;
- Developing and implementing systems of contractor incentives;
- Getting a fair price for services, and;
- Developing the skills needed to negotiate performance-based contracts and manage contractors.

The importance of performance measurement to managing contractors has received a great deal of attention, as scholars have sought to identify the conditions that lead to successful out-sourcing (Cohen and Eimicke: 2000(b),. Wulczyn et. al.: 2000, Campbell and McCarthy: 2000, Heinrich: 1999, Panet and Trebilock, 1998) In an earlier piece we discussed the reason that performance measurement is so critical to contract management :

> "Management of interorganizational networks and contracts means that leaders cannot depend on traditional hierarchical controls to influence the behavior of subordinates who are responsible for performing particular tasks. This means that management cannot use organizational culture, personnel promotion, demotion, termination, or authoritative command structures to influence behavior…In contrast, contractual relationships with private and nonprofit firms provide the surest way to punish poor-performance: contract termination. While there are limits to the use of this technique- it is difficult to terminate contracts in mid-term- they do provide incentives that are clearly understood by the people who work in the organizations holding the contract". (Cohen and Eimicke, 2000: pp. 101-102).

We have also written about the use of performance measurement techniques for learning about contractor inputs, work processes, outputs and outcomes. (Cohen and Eimicke, 2000):

> "The need for vertically integrated, hierarchically controlled organizations has been reduced as technology has made it easier to communicate ideas and information and transport goods and components of goods around the world. Satellite communication, cellular telephones, hand-held computers, containerized shipping and multinational organizational networks make it possible to create goods and services in a variety of locations. These goods and

> services can be assembled throughout the globe, from components made all over the world. They can be tailored for use in a particular location or market. The creation of a world-wide system of production means that organizations must constantly ask and then reexamine the "make or buy decision": should we do this task in-house or hire a consultant or another firm to do this work for us?" (Cohen and Eimicke: 2000, pp.99-100)

While we are optimistic about the ability of government to enter into productive and successful contractor relationships, but we think that the new era of privatization requires a substantial increase in the sophistication and managerial skills of government managers. Contracting not only solves problems,. it creates them as well. We must learn how to identify and solve the problems that contracting creates.

This paper will discuss the following problems created by government contracting :

1. Flawed Request for Proposal (RFP) and or contract language.
2. Overly bureaucratic contracting procedures resulting in delays and high transaction costs.
3. Too few bidders and/or contractor monopolies.
4. Poor communication between government and contractor management.
5. Poor communication between government and contractor staff.
6. Inadequate direction from government to contractors.
7. Contractors that give an agency's work a low priority.

8. Insufficient contractor staffing, training, equipment and facilities.
9. Poor contractor management.
10. Political opposition to contracting.
11. Political interference in contractor selection or management.
12. Underestimating or overestimating resource needs for contractor-performed tasks.
13. Insufficient or excessive profits.
14. Inappropriate or outmoded performance measures and insufficient systems for communicating performance data.
15. Incomplete methods for auditing performance reporting.
16. Inadequate methods for incorporating performance data into government and contractor decision making.
17. Misdirected or inadequate contract incentive provisions.
18. Conflict of interest issues.
19. Union opposition to contracting.
20. Media and political attention to contractor failures.

1. Flawed Request for Proposal (RFP) and or contract language.

When a service is being contracted for the first time it is difficult for the staff working on the Request for Proposal (or on the actual contract) to develop contract provisions that anticipate all the tasks involved in the work and all of the problems that may arise.

Sometimes the specifications in the RFP or the contract do not permit critical tasks to be performed. While contracts must provide a vendor with some predictability there are a number of techniques that government can use to retain discretion over contract provisions and contractor work. One very common technique is to use a task-order, mission contract. This large-scale, multi-purpose contract provides a general description of the contract's anticipated tasks, but does not release funding until a government client writes a specific task order directing the firm to perform particular tasks.

Another technique for dealing with this problem is to let a short-term "trial " contract with explicit provisions for early and rapid renewal. Both of these techniques are useful as the organization learns more about the work being contracted out. As this learning occurs the contract can get more specific. In the long run, it is best to translate these learning experiences into standard operating procedures and clearly delineated tasks, incentives and expected outputs and outcomes.

Other techniques for improving an RFP or contract include a request for qualifications or request for information from perspective vendors. These requests to firms to either provide a demonstration of capability or evidence of qualifications can be used to narrow the field or develop the additional information needed in order to draft an appropriate RFP. Another strategy is to find one organization to work with and use a sole source procurement to pay that firm. Through this method the government can obtain some of the firm's time to learn more about how to define and measure the service being contracted.

2. **Overly bureaucratic contracting procedures resulting in delays and high transaction costs.**

The rules governing contracting can be quite cumbersome and time consuming. Some of the procedures are designed to combat waste and fraud, others are needed to allow for public comment and governmental transparency and accountability. Still other procedures are designed to enhance the power and leverage of senior administrators. Some of these procedures have a basis in law, some in regulation, and others are internal practices and standard operating procedures.

There are several approaches that one can use to overcome this particular obstacle. The most common is to bundle a number of RFPs under a single more general heading. A second is to find a colleague with a large contract vehicle that is not fully funded and add your contract dollars to your colleague's contract vehicle in return for access to the contractor or to subcontractors you are hoping to work with. This is not a cost-free option. The subcontractors must be qualified to work on the contract, the assignment must be related to the contract's purpose, and frequently your colleague who manages the contract will ask for funding for his or her own tasks in return for contract access.

Another approach is to go over the head of the procurement office staff and either ask to use emergency contracting procedures (if they are applicable) or put pressure on the procurement staff to move quickly. These strategies are also not cost free, since they lead to resentment and often retaliation.

A final option is to advocate reforms in contracting procedures. This is a long-term strategy with some promise, although it will not help you get this contract out the door. The details of contracting are not simple and not cost-free. The amount of time and effort expended in letting a contract must be factored into the overall cost of privatizing a function.

3. **Too few bidders and/or contractor monopolies.**

Some of the work that government performs is not performed by the private sector. It may be that there is no private market for the service or product. It may be that it is not a product or service that governments have typically purchased from external sources. The contract may be seeking to purchase something that is available in some regions of the country, but not in others. If privatization is critical or mandated, and there are not enough bidders to generate competition, the agency must develop methods to entice private organizations into the bidding.

Private participation can be stimulated by providing grants or contracts for capacity building. Such participation can also be encouraged by permitting generous payment schedules, profits, and even payment of up-front capital and/ or facilities. The absence of bidders in a contract competition is a strong indication that the approach to privatization must be restructured. It is dangerous and foolish to proceed with a contracting process in the absence of competition. A monopoly will permit a vendor to raise prices unilaterally, and even more damaging a contractor can withhold service, after government has come to depend on it. If the service or product is essential, government simply cannot allow a vendor to hold a monopoly on its delivery.

There is a simple, common sense method for determining whether a service can be purchased in a particular jurisdiction. This is the "Yellow Pages Test". Simply look in the commercial phone directory in your area and see if there are any vendors who sell the goods or services you are hoping to buy. If you can't find it in the phone book, you probably need to make it or do it yourself.

4. **Poor communication between government and contractor management.**

Some government officials think of contracting as a "turn-key operation". You set it up, turn the key, and it starts working. Unfortunately, most contracts do not work that way. Once a contract is in place and a vendor is providing a service, the work of government managers is ready to begin. A working relationship must be developed between the contract’s managers and the vendor’s management. This includes relationships with the program’s substantive managers and their counterparts in the private firm and also with the government’s contract and financial management staff and their private sector counterparts.

Poor communication can result in late payments that save government no money, but require the vendor to pass along the increased cost of working capital in the contract’s cost structure. Poor communication can result in poorly defined tasks and can lead to unacceptable performance. It can also result in conflict between government and contractor when projects fail. Management must set the tone for a cooperative and productive relationship.

Frequent formal and informal meetings, clear milestones, and mutual respect are fundamental requirements for effective interorganizational relations. Government managers need to make an effort to understand the constraints and forces driving the behavior of private sector managers. The relationship should be seen as a partnership and an exchange relationship.

However, sometimes, all the goodwill in the world does not result in effective management. Where private or nonprofit contractors exploit the relationship and fail to produce or act unethically, government managers need to utilize contract penalty and termination clauses and end the working relationship. The possibility of such failure is reduced, but not eliminated by frequent communication. A formal performance measurement system, backed up by frequent communication, can provide government managers with early warning of performance problems. While a sound working relationship requires informal communication and interaction, the government manager must be careful not to be "taken in" by friendliness, and must be certain to ensure that no gifts or free meals are provided. Contract managers should ***never*** accept any thing of monetary value from a vendor.

5. Poor communication between government and contractor staff.

Senior management communication and relationships are important, and so too are staff-level relationships between government and contractors. Very often, poor communication at the staff level reflects similar problems at higher levels of the organization. Sometimes staff, seeing these problems, work together to problem solve at the operational level. Other times they develop strategies for getting their bosses to talk to each other. Without regular communication at the staff level it is difficult for contractor staff to determine the definition and requirements of the assignment they have been given. When problems develop or choices must be made, contractors must make the choices themselves without the benefit of input from their government customers.

The solution here is to write frequent contact into the contract's requirements and to assign senior staff to work with contractors. The conversations should take place in formal meetings and in informal settings as well. For government to truly benefit from the communication process, contractors must be encouraged to be honest and they must be made to feel free to identify problems. Most businesses are reluctant to share operational problems with their customers, so eliciting such honesty is not easy or simple. Off-the-record conversations in informal settings can often uncover crucial information that would not surface through formal channels of communication.

6. **Inadequate direction from government to contractors.**

Inadequate communication is one cause of inadequate direction. It's hard to know what to do if no one bothers to tell you. Inadequate direction also has several other causes:

- Conflicting or inconsistent goals—This can lead to multiple directions and deep confusion at the operational level.
- Inadequate knowledge—Sometimes a contractor is being asked to perform a task that no one in the government (or possibly anywhere else) knows how to do.
- Political gamesmanship, secrecy and other obstacles to communicating direction. Sometimes the government staff or management has a political reason to be vague about what a contractor is being asked to do. They may not want to leave a paper trail, or they are worried that by asking for

"A" they implicitly or explicitly reject "B", causing anger and political retribution from those advocating course "B".

One solution to this problem is for contractors to recognize the danger from inadequate direction and actively seek direction when none is offered. The reality is that many contractors are content to bill hours if they can and make money while government tries to decide what to do. This strategy may work for firms holding contracts for analysis and other less tangible services. When a facility's construction or its management is being contracted it's a little more difficult to hide behind vague and inconsistent direction. Another solution is for government to delay the contracting decision until fundamental choices about direction are in place. Unfortunately, some bureaucratic players use the action-forcing characteristics of contracting as a tactic to facilitate decision making. Policy is made implicitly because the contractor is obligated to act in order to get paid, and therefore may act without clear direction from the government client.

7. **Contractors that give an agency's work a low priority.**

Small local governments sometimes find when contracting that the only time the huge national engineering or consulting firm paid attention to them was when the company was trying to win the contract. Sometimes a poorly managed firm simply decides to "punt" on a piece of work and tries to get by with an inadequate effort. A company may know that a contract is not going to be renewed, and decides to assign weak, or at least inexpensive, personnel to staff it. There are a variety of methods that government can use to encourage a private firm to put more time and effort into a job.

Meeting with the firm informally and formally can alert senior management to problems and elicit attention for your concerns. Incentives and threats of punishment can be used to motivate the desired behavior. A particularly potent threat can be to publicize inadequate performance. Even small jurisdictions can play this card. The problem is that it forces you to admit that something you are responsible for is not working.

Contract mechanisms should be designed to include frequent reviews with specific sanctions for poor performance. Where you sense that your work is not getting the effort it deserves, you should make your views known to the firm and (if necessary) to its senior management as soon as possible. While it is not in your interest to be seen as a poor or whining client, it is also important that you signal your dissatisfaction as clearly as possible. If you are a small client, but work in a large organization, you may want to call your problem to the attention of the contract management staff in your organization. They can threaten the contractor with being frozen out of the agency or even jurisdiction’s contracts.

8. Insufficient Contractor staffing, training, equipment and facilities.

If the RFP was not specific enough, or if the firm allocates its resources to other contracts, one result of being a low priority is that you find yourself with inadequate numbers of staff, poorly trained staff, inadequate facilities and/or outmoded equipment. Sometimes the contract itself can be used to require specific resources. These requirements can then be subject to contract-mandated audits. Most contracts have cancellation clauses that allow the government to cancel or defund the contract if performance is deficient.

Contractors can experience start-up problems and growing pains that are typical of new or quickly growing organizations. The government client must determine if the problem is one of poor management, inadequate resources, or simply an early place on the learning curve. Each issue calls for different strategies. It is vital that the government not ignore the problem, and have detailed information on specific shortfalls.

9. Poor contractor management.

Some contractors are better at winning contracts than managing them. The incentives in many firms are often directed toward the rainmakers, the people who bring in business. While a well-managed firm will understand the need to execute as well as win contracts, the problem we are discussing is not characteristic of a well-managed firm. A consultant friend of ours once divided consultants into three categories: finders (rainmakers), minders (project managers) and grinders (workers). Contract RFPs can be designed to elicit the management experience of the senior people in the firm that the contractor plans to use if they win the contract. However, there is no guarantee that these people will actually work on the contract, or devote sufficient energy and attention to it. This may well be the most fundamental and difficult to solve problem in privatization.

The absence of competent contractor management makes it difficult to address other issues. If the government manager has no capable counterpart to communicate with in the firm, then it is unlikely that the contract has any chance of succeeding. When faced with this type of situation, the best strategy is contract termination, as soon as possible.

10. Political opposition to contracting.

Political opposition to the idea of contracting out or privatizing a function is a problem that agencies often face. Some of this opposition is simply fear of change. Some of it comes from people who benefit or receive privileged access with the current arrangement. Some political opposition is ideological, and based on a belief that a certain function should not be performed by a private organization. The potency of the political opposition is a critical issue for a manager seeking to privatize. If the opposition is intense, privatization might be discouraged or even prohibited by elected officials or political appointees. In these cases, a strategic retreat may be necessary.

More typically, political opposition is not as clear-cut and may be counterbalanced by political support. There may be some approaches to contracting that can be used to address political issues. A fear of lay-offs, for example, can be countered by a requirement that the contractor hire some or all of the current employees. It is also possible to initially contract on a pilot project basis and only gradually expand if the experiment works.

As part of an overall management strategy a manager may decide to produce certain goods and services and buy others. Sometimes these decisions are interconnected and being forced to contract one program or function may make it more difficult to privatize a function you consider more appropriate for out-sourcing. Anti-government ideology may lead to pressures to privatize functions that managers would rather retain direct control over, and might even need control over in order to effectively privatize other functions.

In general, public managers must understand and seek to accommodate political factors. First, by paying attention to political issues and players and treating political input seriously. Second, by developing a strategy for accommodating political input with the least possible damage to operations management. Where opposition to contracting is deep, ideological and uncompromising, the manager will need to determine if the force of opposition can be overcome and if the cost of doing so is worth the benefit.

11. Political interference in contractor selection or management.

While political opposition to the concept of contracting is a legitimate policy dispute, political involvement in contractor selection or contract management tends to be unsavory and should be resisted. This is easier said than done. Political influence will be expressed by elected officials through political appointees. Career employees must decide whether to disregard the advice (if not the commands) of their boss. Appointed officials must decide if they can afford to resist the demands of their elected mentors.

Typically, this interference comes from efforts to reward campaign contributors and former government officials now working in private firms. Sometimes the pressure helps a firm that is well qualified and might receive the contract without political influence. At other times it is used to help firms that are not capable of doing the work. If a political person simply “calls the firm to the attention of the contracting official” such pressure is subtle and probably not illegal. But if pressure is exerted, the contracting official is placed in an ethically and possibly legally compromising situation. In those cases political pressure must be resisted for ethical reasons, regardless of the practical or managerial issues involved. Moreover, even the appearance of impropriety can taint the contracting out process and make it appear that privatization is being pursued for personal or political gain, rather than as a method of improving public services. In extreme cases, reporting to the official ethics organization, resigning, or leaking the situation to the media might be necessary.

12. Underestimating or over estimating resource needs for contractor performed tasks.

When a function or program is being contracted out for the first time it is difficult to project costs precisely. As a program moves from government to the private sector the costs of capital, and a variety of legal, administrative, reporting and other costs must be included in cost estimates. Governments do not pay taxes on their supplies and facilities, private for profit organizations typically pay these taxes. There are often free and in-kind services that government agencies receive when delivering a service. These hidden savings become costs when a private firm assumes responsibility for performing a task. On the other hand, private firms do not have to deal with civil service protections and can motivate workers through both financial incentives and fear of unemployment. Private organizations are still subject to legal restrictions on hiring and firing and often must deal with unions just as government must.

Moreover, the work being contracted out often involves tasks that the private organization has not performed before. They may have performed similar tasks, but possibly not at the scale required by the contract or to the same group of customers they now serve. All of these factors can contribute to underestimating or overestimating the costs of performing a function. When a firm bids too low, it may cause them to cut corners and do a poor job on a contract. When they bid too high, it can create a problem if the media discovers they are “gouging” the public. In either case, the contract mechanism for a newly contracted out function needs to permit renegotiation of price based on experience. A change in the pricing structure of a contract may be seen by an agency’s critics as a method of “getting around” a sealed competitive bidding process. This is, of course, less of a problem if the contractor overestimated costs when bidding. Nevertheless, a well-structured mechanism for price adjustment is often needed to remedy this problem.

13. Insufficient or excessive profits.

A related problem when contracting with a for-profit firm is the amount of profit generated by the contract. In some contracts, profit is a fixed fee that is figured as a percentage of the contract’s costs. Through accounting manipulation firms manage to increase real profits by charging overhead or other costs to a contract that are not generated by that contract. Still, if a private firm holding a contract does not generate an adequate return on the equity invested in it, investors will turn to other firms and the contractor may become starved for capital.

Even if the profit to be made on the contract is sizable, but lower than profits generated in other parts of the firm, government contract work will not be able to attract the firm's best and brightest staff. These talented staff will gravitate to more profitable work leaving government contract work to mediocre staff. While such a tendency can be countered by effective government management of a contract, it is a factor that should be understood and addressed by government managers using contractors to get work done.

The problem of excessive profits is essentially one of perception. If a private firm can figure out a way to get the work done more efficiently and at a lower cost, shouldn't their ingenuity be rewarded with increased profits? The answer might be yes in some cases, but if the media learns that a contractor is profiting "at the public's expense" the reaction against the firm and the government agency involved in the contract can be severe. The issues around profit are an outgrowth of the fact that government and for- profit firms operate with very different organizational cultures, and often relate to different cues from their organizational environment. While all organizations are concerned about their public image, government organizations are more frequent subjects of media scrutiny. Private firms can pick up and operate in another jurisdiction and can drop unprofitable services, governments do not have the advantage of that flexibility.

An open and truly competitive process and a true market environment should work to prevent these problems. If profits are excessive, a lower-cost bidder should emerge when the contract is open to re-bid. If profits are inadequate, a more efficient firm may develop a less expensive way to deliver the service and increase profit levels.

14. Inappropriate or outmoded performance measures and insufficient systems for communicating performance data.

When some of the functions of a government program are contracted out, government managers become coordinators of interorganizational networks. To do this job effectively, government managers must have accurate and timely information about contractor performance. These performance measures must be carefully designed to provide information about the processes, outputs and outcomes that matter the most to the government and its program. Since the program's activities are being implemented by another organization acting under contract, the performance measurement system must be explicitly designed into the contract's structure.

The performance measurement system must be allowed to evolve, but should include specific indicators, reporting processes and deadlines, along with mandatory periodic briefings and discussions. The data must be collected and reported, but the government client must have the opportunity to question the data and its analysis. If these systems are not developed and maintained it is impossible to monitor and manage the contract. You cannot manage something if you can not measure its performance. Without measurement you cannot tell whether management decisions and actions are improving or impairing a service. The performance measurement system must be flexible and should be regularly revised to reflect new conditions, processes, outputs or outcomes.

Related to the issue of measures is the compatibility and reliability of the computer hardware, software and communication system used to transmit performance measures. For measures to be utilized they must be easily accessible and frequently updated. Contracts must include specific provisions for adequate performance measures but must also ensure that those inputting data and those receiving the data are capable of simple and rapid two-way communication.

15. Incomplete methods for auditing performance reporting.

One of the fundamental problems with performance measurement systems in most organizations is that the people being measured also do the measuring. While we believe that most people are honest most of the time, performance measurement seems to bring out the creativity in some government managers. The best way to keep a reporting system honest is not-so-coincidentally the same way that the IRS keeps us honest when filing our taxes—a real and credible threat that someone may go back and check the numbers and see if they were real. Most government performance measurement systems have no provision for audits. It may be that performance measurement is still quite new and some managers are happy to have any performance data they can get hold of.

Unless information is checked and a credible audit system is in place, it is difficult to know if the performance data is real. This is not simply a matter of reporting nonperformance, credible data is also needed to demonstrate that management innovations have succeeded and that new initiatives are paying off. The cost of auditing such data is typically not factored into the cost of contracting, but should be seen as a standard and necessary interorganizational transaction cost.

16. Inadequate methods for incorporating performance data into government and contractor decision making.

Collecting and verifying performance data is interesting and potentially meaningful work, but it only makes a difference in the real world if performance data is used to influence management and organizational activities. In the case of contract relationships, performance measures need to be used to influence changes in contractor behavior and contract provisions.

There are a variety of techniques that can be used to bring performance data into program management. However, to use these techniques the contract must allow for a change in activity based on an assessment of current performance. One method that can be used to increase the use of performance data in management decision making is to have a periodic meeting where managers are asked to explain current levels of performance, and when necessary, to identify the steps that are planned to improve performance. A related technique is to have managers demonstrate how they use performance data in day-to-day management as part of the process during which management performance is appraised. Periodic release of performance data to the public can also help focus attention on public management and government performance.

17. Misdirected or inadequate contract incentive provisions.

Contractors, like everyone else, do better work when there are rewards associated with superior performance. Some government contracts reward performance with cash bonuses, others provide firms with advantages during contract renewal competitions. Since many government managers have not worked as private sector managers they do not always understand the type of incentives that are most effective with private firms. Nonprofit organizations may be a bit closer to the government manager's field of understanding, due to the shared mission orientation of many government and nonprofit organizations. However, the entire matter of financial incentives for organizational performance can be difficult for government managers to fully understand unless they have excellent communication with their contractors.

We strongly advocate incentive clauses in contracts. These work best when they are the result of the accomplishment of specific, *verified* performance measures. For example, when a firm that is installing subway track completes the work a month ahead of time and is given a bonus for every day the project comes in ahead of schedule. In fact, an even better technique links a similar penalty clause to late completion. The point of an incentive is that it is only useful if it inspires the specific changes in behavior that improves organizational performance. If it doesn’t motivate change or motivates the wrong change, it fails.

Managers should experiment with different forms of incentives, and attempt to determine the independent impact of the incentive on performance. One problem with bonuses is that if they are given too easily, they are soon seen as a type of base pay and people come to rely on them and expect them. When that happens their impact on performance is significantly reduced.

18. Conflict of interest issues.

Another obstacle to contracting is that people who work in government organizations may have a history of work relations with counterparts in private firms. People in the private organizations may also have been political supporters of elected officials whose administrations are now seeking contractor assistance that they are capable of providing. It is critical that government officials avoid both the reality and appearance of conflicts of interest. Government officials must bend over backwards to recuse themselves from any contract situation where such a conflict is possible. Moreover, government officials must be proactive in these situations and seek to anticipate any potential problems. It is not enough to respond to an investigation or attack. Government officials must think through their past interactions and those of people they are close to, and anticipate potential conflicts of interest.

A number of techniques have been developed to reduce the possibility of conflicts of interest. Sealed, competitive bidding is one such technique. So, too, is the use of panels of officials to review proposals and select winning bids. Panels can include people from outside the agency to ensure greater independence and objectivity. Still, the best technique is vigilance and sensitivity on the part of government officials involved in contracting. From the point of view of managers seeking to privatize a function, the issue of conflict of interest makes the contracting process more complicated and cumbersome. It is simply another constraint on the “make-or-buy” decision that makes contracting more difficult.

19. Union opposition to contracting.

Public employee unions can be a significant source of opposition to contracting. It’s quite simple—why should they support a practice that reduces employment or opportunities for its members? If the firms or nonprofits bidding on the contract are unionized, such opposition may be muted, or even nullified. However, sometimes the issue is simply the economic survival of the union’s elected and administrative staff. They need the money generated from members’ dues for their own salaries, and oppose contracting because it reduces union revenues and their own pay.

Powerful unions can oppose contracting successfully through political influence and media campaigns as well as through the electoral power of their members. Unions opposing such contracts typically do not place concerns with the effectiveness or efficiency of public organizations ahead of their member’s self interest. Nor should they be expected to. Some of the more sophisticated unions will argue that government operations will be harmed by contracting out, and will maintain that they are also concerned with public service.

Union opposition to contracting can be addressed politically through deals negotiated between elected officials and union leaders. It can also be a subject of collective bargaining. In return for union support of contracting, the government provides increased pay, job security, or other benefits. Alternatively the contract could include severance pay, job placement and other resources that minimize the effect of contracting out on current job holders. Where public employee unions are powerful, those interested in contracting functions must take unions seriously and see them as significant and legitimate stakeholders in the decision making process. Unions cannot be ignored, and if they are not accommodated, can generate substantial and costly conflict. A key step in the privatization process is to analyze and assess the position and influence of organized labor.

20. Media and political attention to contractor failures.

When a government function has been privatized, it often generates a level of media scrutiny that government managers are often familiar with, but private managers have rarely seen. Nongovernmental organizations often find press inquiries, legislative oversight, audits and all manner of citizen participation as unexpected and unwelcome additions to their lives and cost structures. Government officials are responsible for any failures and may find themselves blind-sided by an unexpected expose of a contractor failure.

Both government and contractors should act at all times as if their activities will be the lead story on the evening news. If things are not going well, it is better to proactively bring the information to oversight bodies than wait for an investigation to identify a problem. By anticipating issues, the contracting agency has the opportunity to define the way the problem is presented and can control and communicate a plan for solving the problem.

Nevertheless, the extra level of scrutiny that a newly contracted function faces must be seen as an obstacle to privatization. Most organizations make mistakes early in the process of taking on a new task, and making mistakes in public does not always speed up the process of organizational learning. Attention is paid to blame and presentation and appearances, instead of improving operational performance. This can make it difficult to successfully bring in a non-governmental player and may impede success.

Conclusions

The process of contracting out a function is not easy or automatic. It brings significant transaction costs along with significant benefits. The procurement process requires skills and determination, and yet simply letting a contract may very well be the easiest part of the procurement process. The more difficult challenge for government involves managing leaders and staff who work in a separate and private organization. To address this challenge, government must establish the formal mechanisms, incentive systems and informal communication processes that stimulate appropriate contractor behaviors.

In many instances contracting leads to superior results and the work and expense of establishing these complicated interorganizational relations is worth incurring. In other cases, contracting is a political or ideological decision that will bring more cost than benefit. The “make or buy” decision must be an integrated element of an organization’s overall strategy. It must relate to the organization’s definition of its own distinctive competence. It must be built on an understanding of private sector capacities and incentives.

The government is getting better at working with nongovernmental organizations, but a great deal more must be learned. One next step would be to refine the list of obstacles to contracting developed in this paper and conduct systematic empirical research on how government overcomes these and other problems.

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