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**Privatization of Welfare
Services: A Review of
the Literature**

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CHAPTER I

INTRODUCTION

The private provision of government-funded services has a long history in the United States. In recent years, however, the use of private organizations—both for-profit and not-for-profit—to perform social service functions has increased substantially, and this increase is expected to continue. The privatization of welfare services, in particular, grew substantially after passage of the 1996 Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA). PRWORA signaled a major shift in the federal government's philosophy regarding welfare by ending the cash assistance entitlement. Just as importantly, it gave states much more autonomy to formulate their own policies under the new Temporary Assistance for Needy Families (TANF) program. Many states have used this newfound flexibility not only to change the types of services they provide, but also to rethink the mechanisms by which these services are delivered. This legislation, together with an increasing skepticism about government and an interest in performance-based management techniques, provided an impetus for the growing use of private providers.

Not much is known about the privatization of welfare services, however, especially of those services traditionally performed by public agencies, such as eligibility determination, intake and assessment, and other case-management functions. For this reason, the Office of the Assistant Secretary for Planning and Evaluation (ASPE) of the Department of Health and Human Services (DHHS) asked Mathematica Policy Research, Inc., (MPR) to conduct a study of privatization with a special emphasis on case management of TANF. The study will describe the experiences of, and lessons learned by, six TANF agencies that have privatized case management.

To set the stage for the case studies, this report provides a review of the literature on the privatization of welfare and related services. The empirical literature is fairly limited. The U.S. General Accounting Office has conducted studies on the privatization of government services in general (GAO 1997b, 1998). Others have conducted studies of the privatization of particular services, such as child support enforcement (GAO 1996) or JTPA employment services (Heinrich 2000), although few focus on welfare services. Still others have conducted case studies of government privatization in specific states (Kornfeld 2001;

Sanger 2001; Roper 1998; Yates 1997a). Given the significant changes in welfare policy that have occurred over the past five years, a clear need exists for more current and more detailed information on privatization of TANF programs.

The MPR case studies of the privatization of TANF case management as well as a forthcoming GAO study will partly meet this need for further research. The GAO will report on a survey of TANF administrators in the 50 states and the District of Columbia, as well as some counties. The survey collects information on the extent and nature of contracting out for TANF services. That study also includes six case studies of the procurement and monitoring of TANF contracts.

In the rest of this introductory chapter, we define what we mean by privatization and describe the reasons for the recent increase in privatization. Chapter II describes the current extent of privatized social services and describes the organizations that are providing services. Chapter III discusses the arguments for contracting out, while Chapter IV discusses the challenges that contracting out presents. Finally, Chapter V outlines research needs that will be met by the MPR/ASPE case studies.

A. DEFINITION OF PRIVATIZATION

The term “privatization” can mean several things. For the purposes of this study, we focus on the most common form of privatization—contracting out services to private organizations. However, privatization can also refer to the complete government withdrawal from the function, including the sale of government assets such as rail systems or banks to private companies. In addition, it can include the use of vouchers to allow customers to “shop around” for services, as used, for example, in providing training services under the Workforce Investment Act (WIA) (GAO 1997b; Nightingale and Pindus 1997).¹

In this study, we focus on the contracting out of services that are funded by public agencies, irrespective of whether the services are provided by nonprofit or for-profit private organizations. Some observers make a distinction between government contracts with not-for-profit organizations and those with for-profit companies, arguing that the differences in their missions and incentives will lead to different strengths and weaknesses in service provision (Cohen 1998; Nightingale and Pindus 1997; Sanger 2001; Osborne and Gaebler 1992). However, others argue that making a sharp distinction between for-profit and nonprofit privatization is not particularly useful because, in many jurisdictions, for-profit and nonprofit organizations subcontract with each other, making it difficult, if not impossible, to draw clean operational or contractual lines between them.

¹ Some policymakers and scholars emphasize the extent of competition rather than whether the public or private sector provides the service. In an effort to increase competition and still include the public sector, a number of states and localities are requiring public-sector organizations to compete with each other and/or with private organizations.

B. RECENT INTEREST IN PRIVATIZATION

Private provision of publicly funded services, including social services, is not new. Before the New Deal era, most social services were delivered by private religious or secular organizations that sometimes received public subsidies to pay for the care of needy people, though the level of public funding varied widely (Smith and Lipsky 1993). After the Great Depression, the government's role in funding private social services began to increase, though it remained fairly limited. During the 1960s and 1970s, however, federal expenditures for social welfare services escalated, and a large proportion of this growth was due to spending on services provided by private agencies. State spending increased as well--one study found that in 1971, 25 percent of state spending on social services was for "purchased services." By 1976, the percentage had risen to 49 percent (Smith and Lipsky 1993). A national 1993 study by the Council of State Governments found that almost 80 percent of the states surveyed reported that in the previous five years they had increased their use of privatized social services (GAO 1997b).

In recent years, both the scale and the nature of the relationship between the government and the private sector have changed. The government is contracting for a wider variety of services, and government contracts are purchasing whole programs, rather than simply limited services (Smith and Lipsky 1993). Interest has grown in bringing for-profit companies into new areas, such as welfare services. In addition, as we discuss in the next chapter, the number of social service agencies who contract out services has increased.

Increased interest in contracting out welfare services in recent years has occurred for several reasons: frustration with the welfare system under Aid to Families with Dependent Children (AFDC), the passage of PRWORA, skepticism about the ability of government to provide services effectively, and a growth in the desire for performance-based management.

1. Desire for System Change

Before PRWORA, a widespread belief existed that the old AFDC system and the agencies that administered it were fundamentally flawed, and geared more toward ensuring eligibility and compliance with rules than toward helping recipients work and become self-sufficient (Bane and Ellwood 1994; Walters 1997). The sense of frustration with the old welfare system seemed to increase interest in using private organizations to provide welfare services. Many states articulated the goal of "changing the culture of the welfare office," and contractors were seen as less entrenched in the old ways than public welfare agencies were (Diller 2000). One journalist commented that the effective replacement of AFDC with TANF would require "nothing less than the reinvention of human services delivery at the state level" (Walters 1997). Privatization was one way to accomplish this reinvention.

2. Passage of PRWORA

Welfare reform provided an impetus to privatization in several ways. Its work requirements spurred states and localities to find new ways to deliver employment services. By dropping the requirement that eligibility for cash assistance be determined by public

employees, it encouraged contracting out of a broader set of services. And the change to funding through block grants gave new incentives for privatization.²

a. Need to Emphasize Work

In response to growing frustration over the lack of focus on work in the AFDC program, the new welfare system shifted to an emphasis on “work first” rather than the verification of eligibility. Initiatives were developed to divert applicants into jobs before they reached the rolls, to move welfare recipients into employment as quickly as possible, and to support their efforts while in work. Although many states had begun such efforts under waivers before the passage of PRWORA, their efforts accelerated after the law’s passage. While all states had provided some employment programs for welfare recipients through the Job Opportunities for Basic Skills (JOBS) program under AFDC, the new requirements for work programs far exceeded the old. PRWORA mandated sharp increases in recipient work participation, requiring that states rapidly gear up their employment programs. The new law mandated that states place at least 25 percent of household heads in all families in work activities by 1997, increasing to 50 percent by 2002. For two-parent families, the required rate reached 90 percent in 1999.³ In addition, as welfare caseloads declined, many believed that a larger proportion of those still on the rolls were “hard-to-employ” clients who would require more intensive assistance to leave welfare for work.

Public officials in many states believed that they lacked the capacity to meet these demands and to meet them quickly enough, without contracting with private organizations. Contracting out allowed them to “buy” new capacity and come up to speed quickly, while giving them the flexibility to get rid of this additional capacity if needs changed (Sanger 2001).

² Through its “charitable choice” provision, PRWORA expanded states’ ability to contract with faith-based organizations, allowing these organizations to provide TANF-funded services without requiring that they remove religious symbols from their facilities or religious content from their services (Title I, Section 104). The privatization literature thus far has not focused on this as a significant reason for increased contracting out.

³ A federal “caseload reduction credit” in PRWORA mandated that a state’s participation requirements be dropped by a percentage point for every percentage point drop in caseloads after 1995, as long as the decline was not due to state policy changes (U.S. House of Representatives 2000). Due to the sharp, and unexpected, caseload decline experienced by many states, this credit eased the work mandates during the first five years following passage of PRWORA.

b. Requirement That Welfare Eligibility Be Determined by Public Personnel Only Dropped

Unlike AFDC, TANF no longer prohibited states from using personnel from private organizations to perform eligibility determination for cash assistance (Title I, Section 104). This opened the possibility of contracting out welfare services broadly and created a potential new market for private providers (Nightingale and Pindus 1997; Sanger 2001). Possibilities for wide-scale privatization of welfare services were limited, however, by the continued requirement that only public workers determine eligibility for Medicaid and Food Stamps. States that wanted to privatize TANF eligibility determination but also wanted to preserve or increase integration of services either would have to receive waivers from the Medicaid and Food Stamp Program requirements (which to date have not been granted) or would have to choose between privatization and service integration for eligibility determination.

In a widely publicized effort at broad privatization of welfare services, Texas attempted to privatize its entire welfare system statewide, including the determination of eligibility for TANF, Medicaid, and Food Stamps. In 1997, however, the federal DHHS denied the state the necessary waivers. Instead, Texas opted to pursue integration of eligibility determination across programs, while keeping that function in the state Department of Human Services (Center for Public Policy Priorities 1997). At the same time, it moved to privatize other functions, such as job search and placement, through a system of decentralized workforce development boards that contracted with a range of private providers (Policy Research Project on Workforce Reform in Texas 1997; Pavetti et al. 2000). In contrast, Arizona elected to privatize eligibility determination of TANF on a pilot basis in one county, but left eligibility determination for the other programs under the auspices of the state welfare agency (Kornfeld 2001). Wisconsin began pursuing wide-scale privatization efforts under federal waivers that allowed the privatization of eligibility determination for cash assistance before passage of PRWORA. The state did not, however, also privatize eligibility determination for Medicaid and Food Stamps.

c. Change to a Block Grant

Under AFDC, the federal government provided unlimited matching funds to states, while under TANF, each state is given a fixed block grant. This has given states broad new discretion and new incentives and opportunities to change their service approaches. Under the TANF block grant, states have a new incentive to pursue cost-saving methods of service delivery. The block grant allows them to transfer limited amounts of their TANF surpluses to other social services, and state funds that have been spent on those services can be freed up for other priorities, including service enhancements or tax cuts. Because a common goal of privatization is cost savings, the chance to reap some of their TANF savings and use the funds for other purposes might have contributed to states' interest in contracting out. States' discretion has also freed them from the federal oversight entailed in the AFDC quality

control (QC) system, and allowed them greater flexibility to set their own rules and measures of program success.⁴

3. Declining Popular Confidence in Government's Ability to Provide Effective Services

During the last several decades, general public skepticism has grown about the capabilities of government, especially the federal government, and there has been a commensurate interest in harnessing market forces to perform a wide range of functions in a more “business-like” and efficient manner (Sclar 2000). One 1997 nationwide survey found that 41 percent of respondents said they had a “mostly unfavorable” view of the federal government, while 34 percent had a “mostly favorable” view (Pew Research Center for the People and the Press [undated]). In contrast, only 23 percent said they had a “mostly unfavorable” opinion of business corporations, while 55 percent expressed a “mostly favorable” opinion. This kind of ideological preference for private organizations has been reflected in an increasing reluctance to fund expansion of government services.

4. Growth in Performance-Based Management Techniques

Related to the increased skepticism about the performance of government, policymakers, practitioners, and scholars increasingly have advocated applying performance-based management and accountability techniques, used successfully in the private sector, to the public sector. On the federal level, legislation such as the Government Performance and Results Act of 1993 and the Government Management and Results Act of 1994, as well as the National Performance Review's “reinventing government” initiative of the mid-1990s, reflected the growing interest in using performance-based measurement and bringing entrepreneurial approaches into public-sector service delivery (Osborne and Gaebler 1992; National Performance Review 1994). The goal of federal deficit reduction and general cost cutting gave particular impetus to these efforts to find new ways to make government more efficient. These “re-engineering” efforts took hold in many states and localities as well. Privatization was seen as one way to bring performance-based management to the public sector.

⁴ However, the federal government uses measures of state success in meeting the TANF goals to allocate its high-performance bonuses and bonuses for reductions in out-of-wedlock births.

CHAPTER II

THE CURRENT STATE OF SOCIAL SERVICE PRIVATIZATION

State and local governments have turned to private providers for a wide range of services, from routine matters such as road maintenance and garbage removal to sensitive undertakings such as fire protection and the operation of corrections facilities (Sclar 2000). A 1997 survey by the Council on State Governments documents the use of privatization by state agencies of at least 15 different types, as varied as environmental protection, education, and the treasury (Chi and Jasper 1998).

This diversity of privatization experience applies within the sphere of welfare and related services as well. Under contract with public agencies, private organizations and corporations supply job training and placement, child support enforcement, child care and child protection, the administration of cash assistance programs, and other services.

This chapter describes the current state of social service privatization. It first reviews data from surveys on state and local contracting. It then highlights the types of social services privatized and, finally, describes the types of nongovernmental organizations that provide these services.

A. SURVEY FINDINGS ON THE EXTENT OF SOCIAL SERVICE PRIVATIZATION

While a number of surveys have collected information on state and local governments' use of privatization, few focus specifically on social services. These assessments employ a variety of methods and definitions, making comparisons among them difficult. They do reveal, however, a general trend toward increasing privatization for social service delivery. The findings of three previous studies are particularly informative:

- Survey data collected in 1992 and 1993 by the Reason Foundation summarize the extent of social service privatization in the period before welfare reform.

Agencies in 29 states and 15 counties responded to the survey, with almost all (94 percent of state agencies and 88 percent of county agencies) confirming that they used some form of privatization in providing social services. Nonprofit organizations were the usual provider of these services, receiving about 80 percent of all contracts. Services most commonly privatized included day care, drug and alcohol treatment, child welfare and adoption, programs for the elderly, and employment training (Eggers and Ng 1993).

- Although the Council on State Governments 1997 privatization survey elicited responses from social services agencies in only 27 states, more than half of those who responded indicated that they had privatized at least 15 percent of their programs and services, and nearly nine out of ten reported that privatization activity had increased since 1992. Indeed, an analysis of the survey's findings concluded that "social service agencies were the most likely to raise their level of privatization" among the 15 types of agencies covered by the study (Chi and Jasper 1998). Only three state agencies reported that they had privatized "welfare services," but eight said they had contracted for "client assessment" and 10 or more had outsourced services such as child care, drug and alcohol treatment, employment, and Food Stamp issuance. Three-quarters of the agencies responding to the survey expected the trend toward increased contracting out to continue.
- Research by the GAO (1997b) also found increased privatization of social services. Experts from organizations such as the National Governors' Association, the National Association of Counties, and the National Conference of State Legislators told the GAO that the percentage of state and local social service budgets paid to contractors had grown in recent years. Representatives of state and local governments concurred, noting that since 1990 contractors had both received an increased share of social service budgets and performed a greater number of government functions. The GAO report highlights wide variation in the share of specific program budgets paid to contractors, however, because individual localities operating similar programs make different decisions regarding the extent of privatization.

B. TYPES OF SERVICES PRIVATIZED

A review of state and local governments' experience with privatization suggests that outsourcing of social services takes place, broadly, in two forms. Under one method, government agencies contract with private providers to deliver single components of a larger program—job training and placement for TANF recipients, for example. Alternatively, agencies may look to private contractors to deliver a comprehensive set of program services in a specific location—a full-service operation for child support enforcement, for instance, or a complete TANF program, including intake and assessment, eligibility determination, and case management. To date, governments have employed the former strategy more often than the latter. The rest of this section describes privatization in individual service areas.

1. Department of Labor Employment Services

Contracting out service provision has been common in the U.S. Department of Labor's employment and training (E&T) programs since the 1960s (Nightingale and Pindus 1997). Most of the contractors have been nonprofit or public entities (such as community colleges, the employment service, or public school districts), although in some localities, for-profit companies have also provided services. Job Corps—a residential program for disadvantaged youth—is operated by both private entities under contract to Job Corps regional offices and by federal government entities under interagency agreements with the U.S. Department of Labor.

Nonprofit organizations and private companies have also taken a role in developing and operating the system of one-stop career centers required under the Workforce Investment Act. Affiliated Computer Services, Inc., a large for-profit corporation, manages the operation of several career centers in Polk County, Florida, for example, while the Educational Training Institute, also a for-profit company, provides similar services in Massachusetts (Graham 2001; Roper 1998). More frequently, this function is contracted to public-private consortia or nonprofit organizations.

2. Child Welfare

Child welfare functions, such as foster care, adoption, family preservation, and mental health treatment, have long been candidates for privatization. The City of New York began contracting with nonprofit agencies more than a century ago to provide services for the children in its custody, who now number in the tens of thousands (Bernstein 2001). As of 1998, child welfare agencies in at least 29 states had implemented privatization initiatives of various scales and types (McCollough and Schmitt 1999).

While the involvement of private contractors in child welfare has a long history, new forms of privatization have emerged in recent years. In 1996, Kansas drew national attention by adopting a managed-care system for its child welfare program statewide. Under this system, private-sector organizations were paid a set fee for each child referred, intended to cover the cost of all foster care, family preservation, or adoption services provided. However, the state's Department of Social and Rehabilitative Services recently terminated the managed care approach after discovering that it created significant financial difficulties for contractors. Private providers continue to play an important role in the state's child welfare system but are compensated with a per-child, per-month payment (Kansas Action for Children 2001). The Kansas experience notwithstanding, a number of other states, such as Tennessee and Ohio, have employed managed care as a privatization strategy for child welfare (Kammerman and Kahn 1998).

3. Child Support Enforcement

A marked increase in privatization of child support enforcement has occurred over the past decade. While contracting for functions such as the collection of past-due support was frequent in the 1980s, states and localities have since expanded privatization to include tasks such as payment processing, paternity and order establishment, parent location, and

customer service (GAO 1995). Moreover, some governments have opted to turn entire child support operations over to private contractors, who take responsibility for providing all program services. As of 1996, one or more fully privatized local offices existed in 15 states (GAO 1997a). Today, a single provider of full-service privatization, Policy Studies, Inc., operates such offices in 16 states.

Among the factors that have encouraged this movement towards privatization in child support enforcement are increased caseload size, new program mandates, and performance incentives implemented by the federal government. As child support agencies have become responsible for a growing number of clients, some have turned to private contractors to address the excess workload without adding to the government payroll (GAO 1997a). In addition, PRWORA has placed new requirements on state and local child support agencies, including the creation of technology-intensive systems to centralize state case registries and implement enforcement techniques, such as automatic income withholding. To fulfill these obligations, many government agencies have tapped the expertise of private-sector organizations. Finally, federal regulations for child support now include specific incentives, in the form of increased funding, for states to improve the efficacy and cost-efficiency of their child support enforcement systems. Private contractors, who can sometimes quickly implement strategies for program improvement, offer state and local governments one possible means of accomplishing these goals.

4. TANF Services

Contracting for services related to public assistance was not uncommon even before welfare reform. Some AFDC agencies contracted with employment and training service providers for the operation of all or part of their JOBS programs. However, as discussed in Chapter I, PRWORA has facilitated the growth of contracting out by fundamentally changing the mission of the welfare system, by giving states substantial leeway in formulating programs, and by increasing incentives for placing welfare recipients in jobs. The law also has encouraged outsourcing by lifting restrictions that had placed eligibility determination off-limits for privatization (GAO 1997b; Sanger 2001).

To examine the privatization of TANF services, it is useful to divide them into four categories:

1. **Case Management.** This can include intake and diversion activities, TANF eligibility and benefit determination, the development of the individual responsibility plan, assessment of the need for services, case monitoring and tracking, and sanctions for noncompliance with TANF requirements.
2. **Employment Services.** These include services to link TANF recipients with employment, such as job search and placement assistance, as well as more specialized employment programs, such as work experience, education, training, supported work, and job retention and advancement services.
3. **Support Services.** These include child care, transportation, mentoring, and other assistance for TANF recipients who are working.

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4. **Specialized Services.** These include services such as mental health and substance abuse treatment, as well as initiatives to prevent teen pregnancy and programs to promote family formation.

Although the forthcoming GAO report will provide the first detailed national picture of the extent to which these services are contracted out, we do know that each of these service types is contracted out by some TANF agencies. The literature suggests, however, that contracting out case management, especially eligibility determination, is much less prevalent than contracting out other services.

At least three states—Wisconsin, Arizona, and Florida—have contracted out the administration of all aspects of TANF, including TANF eligibility determination, in some locations:

- **Wisconsin.** In 1997, Wisconsin put out a request for proposals to operate its TANF program, W-2, in 12 counties that had either chosen not to run W-2 or had not met state performance standards. The contracts were awarded to both for-profit and nonprofit agencies.
- **Arizona.** Arizona operates a demonstration project, Arizona Works, under which TANF services, including eligibility determination, are privatized in Eastern Maricopa County.⁵ In January 1999, a four-year contract was awarded to MAXIMUS, Inc., to administer the TANF program in the demonstration site, while the Arizona Department of Economic Security administers the food stamp and Medicaid cases.⁶
- **Florida.** In 1997, the Palm Beach County Workforce Development Board contracted with Affiliated Computer Services, Inc. to provide TANF services. Since 2000, the contract has included all TANF services, including eligibility determination.

Other TANF agencies, however, contract out only a subset of their case management functions. For example, some agencies contract out assessments, the development of self-sufficiency plans, and case monitoring but maintain direct responsibility for eligibility determination and sanctioning for noncompliance. These include agencies in San Diego, California; Jacksonville, Florida; Aiea, Hawaii; and the District of Columbia. In many cases, contractors provide job search assistance, job placement assistance, and retention services as well as case management (Pavetti et al. 2000). Some TANF agencies maintain separate contracting arrangements for each of these functions, however. The city of New London,

⁵ Excluding Guadalupe and the reservation areas.

⁶ An impact and implementation analysis is being conducted of this demonstration (Kornfeld 2001; Porcari and Peck 2001).

Connecticut, for example, contracts with one organization for assessment and the development of a self-sufficiency plan and with another organization for other aspects of case management.

C. TYPES OF NONGOVERNMENTAL ORGANIZATIONS THAT PROVIDE WELFARE SERVICES

State and local agencies are contracting with a variety of organizations to provide welfare services and related employment and ancillary services. The types of nongovernmental organizations providing these services fall into three main categories: (1) for-profit corporations, (2) large, national nonprofit organizations, and (3) small community-based nonprofit organizations.

1. For-Profit Organizations

Two large, for-profit corporations dominate the market for providing welfare and related services:

- **MAXIMUS.** In business since 1975, MAXIMUS provides program management, information technology, and consulting services to government agencies. Its Government Operations Group administers and manages government health and human services programs, including welfare-to-work programs, job readiness, child support enforcement, managed care enrollment, children's health insurance, and disability services programs. It was the first for-profit organization to receive a contract to provide welfare services when it was awarded a contract by Los Angeles County, California in 1988. It was awarded contracts to administer the W-2 program in District 6 in Milwaukee, Wisconsin, to administer the Arizona Works pilot demonstration in Maricopa County, Arizona, as well as to provide case management or employment services in several localities including California, New York, and the District of Columbia (Sanger forthcoming). It currently holds 15 TANF contracts worth a possible \$56 million (Sanger forthcoming).
- **Affiliated Computer Services, Inc. (ACS).** In July 2001, ACS, a for-profit information technology provider, agreed to purchase Lockheed Martin IMS Corp. Lockheed Martin had contracted with state and local governments to provide TANF services, child support collection, electronic benefit transfers, as well as electronic toll collection, and the processing and collection of parking tickets. Its first employment-services contract, with Dallas, Texas, was awarded in 1996 (Sanger forthcoming). ACS now administers the entire TANF program in Palm Beach County, Florida. It also administers Florida's welfare reform program, Work and Gain Economic Self-Sufficiency (WAGES) program in 13 regions and employment services in 12 workforce board regions in Texas. It currently holds 26 TANF contracts worth a possible \$108 million (Sanger forthcoming).

Other for-profit corporations that provide TANF services include:

- **Curtis and Associates.** Established in 1985, Curtis and Associates provides employment services, including self-sufficiency and job training and welfare-to-work programs, as well as intensive case management. The firm received its first employment services contract with the Nebraska Department of Health and Human Services in 1985. Curtis has also undergone recent ownership changes. In July 2000, it merged with Benova, Inc., a subsidiary of AFSA Data Corporation, a financial services company.
- **Policy Studies, Inc.** Established in 1984, it provides consulting on child support enforcement. In 1991, it began the direct administration of child support programs. It currently directs 43 child support programs in 16 states.
- **America Works.** Formerly a nonprofit organization, it became a for-profit in 1984. America Works provides employment services for welfare recipients in locations in New York, Maryland, Florida, and Indiana. It also provides intensive case management.
- **Association for Research and Behavior (ARBOR), Inc.** A Philadelphia-based firm, ARBOR has contracts serving disadvantaged clients (not all TANF) in 30 locations, including a large contract in New York City.

In addition, DynCorp, Anderson Consulting (now known as Accenture), and Electronic Data Systems (EDS) also provide some human services, such as child support enforcement, child welfare activities, and management information systems, but as yet do not provide case management or employment services. Smaller for-profit companies also have contracts. For example, The Training Institute has provided job placement services in Marion County, Indiana.

2. Large Nonprofit Organizations

Several large nonprofit organizations have won contracts to provide case management, employment services, and support services under a wide range of funding streams both government and philanthropic. These organizations are large, national, and have stable and diversified funding. Most have been providing social services for many years. Sanger (2001) argues that they more closely resemble the for-profit organizations than the small community-based organizations in terms of their financial stability. These organizations include:

- **Goodwill Industries.** Through a network of community-based, autonomous affiliates, Goodwill operates human services support programs throughout the United States and Canada. These programs include job training and employment services, including short-term and long-term training, welfare-to-work programs, and job readiness programs.

- **Catholic Charities.** Catholic Charities also provides services through a network of independent, nonsectarian, multi-service agencies across the nation. Although sponsored by the Catholic Church, it offers its services to all people in need.
- **AFL-CIO.** The community services branch of this labor organization is providing job-training services under contract with state and local governments.

3. Community-Based Nonprofit Organizations

Throughout the nation, nonprofit, community-based organizations (CBOs) that have provided social services for many years are now entering into contracts with state and local governments to provide case management, employment services, and other welfare-related services. Some of these organizations (like the New Community Corporation in Newark, New Jersey, and the Urban Leagues and Opportunities Industrialization Centers in many communities) provide an array of social and economic development services. Others provide specialized services or services to a specialized population (such as the Chinese Community Center in Houston). In Broward County, Florida, the Parents Information and Resource Center—a CBO that had experience with substance abuse prevention and HIV services—won the award to provide TANF case-management services in that county.

Although local CBOs do win contracts on their own, they frequently bid as partners or subcontractors with for-profit organizations. The larger for-profits or not-for-profits bring capital and management and financial expertise, while the CBOs provide specialized knowledge of the needs of the clients and the resources in the communities and may provide political legitimacy in communities where contracting with for-profits is controversial. For example, in Broward County, Lockheed Martin IMS won contracts to provide occupational skills training, grant diversion, on-the-job training, and community work experience, in partnership with local nonprofit organizations and another for-profit organization. In Milwaukee, the YWCA won a contract to administer TANF in District 1 by joining with two for-profit organizations (Kaiser Group and CNR Health) to form YW-Works, a limited liability, nonprofit organization.

Nonprofits have also formed collaboratives to bid for government contracts. For example, Seedco, a medium-sized nonprofit agency, has built a collaborative with eight CBOs that provide employment training and placement services in New York City. Seedco provides technical assistance, stable financial support, and a well-developed management structure.

Some CBOs have also formed for-profit subsidiaries. For example, the Nonprofit Assistance Corporation (N-PAC), a subsidiary to Seedco, has structured a limited liability corporation, EarnFair. Earnfair operates as a temporary employment service, hiring disadvantaged workers and then placing them with business and nonprofit organizations for a fee. Because Earnfair is a for-profit corporation, employers can take advantage of tax credits for employing welfare recipients.

CHAPTER III

THE DECISION TO PRIVATIZE

Why do some state and local agencies decide to privatize services while others do not, and how do they decide which services to privatize? This chapter reviews the literature on the factors that contribute to decisions to privatize functions traditionally performed by governments and the factors that help determine which functions are selected for privatization. The first section explores rationales for privatization broadly, and the second section examines models for thinking about what functions to privatize and how to do it.

A. RATIONALE FOR PRIVATIZATION

Several basic arguments are often cited to support a shift from government to private provision of public services, including (1) reducing the cost of government services, (2) improving the quality of government services, (3) the need for skilled staff not available in the public sector, and (4) increasing the flexibility of the public sector. (GAO 1997c; Savas 1987; Donahue 1989; Reason Foundation; Nightingale and Pindus 1987; Blank 1999). In addition, privatization also occurs for political reasons.

1. Cost Savings

A basic tenet of economic theory is that competitive markets will result in cheaper and higher quality goods and services as consumers shop around for the best deal and suppliers work to provide the best products at the lowest cost. This theory suggests that contracting out saves money as the positive pressures of competition force organizations to find ways to work more efficiently. This is thought to hold true for competition broadly, not only for competition by for-profit corporations. In fact, for some observers, what matters most is the extent of competition rather than simply whether the public or private sector is the provider (Kettl 1993; Donahue 1989; Osborne and Gaebler 1992; Nightingale and Pindus 1997).

The empirical evidence about cost savings through contracting out social services tends to be mixed, although overall it suggests the potential for somewhat lower costs.

- A 1993 survey, conducted by the Reason Foundation, found that cost savings were the most common reason for privatizing social services, but officials estimated that savings in this service area were lower than those in other services. About a quarter of agencies reported that their cost savings for social services were 10 percent to 20 percent, while the remaining 75 percent reported that they saved 10 percent or less (45 percent reported no cost savings). Savings in other areas were estimated at 20 percent to 40 percent. Insufficient competition in bidding for contracts was cited as one reason for the limited cost savings (Eggers and Ng 1993).
- The 1996 GAO child support enforcement report examined the cost effectiveness of privatized services at four sites in three states—Arizona, Tennessee, and Virginia—where cost effectiveness was defined as the administrative costs of collecting one dollar. The study found that in the Arizona and Virginia sites, the privatized operations were 18 percent and 60 percent more cost effective respectively than the public operations. In Tennessee, however, one public operation was 52 percent more cost effective than its privatized counterpart, while at another site, the private and public operations were about the same (GAO 1996).
- A 1997 survey by the Council on State Governments of state social service agencies found that 53 percent privatized more than 15 percent of their programs but that the reported cost savings were modest. Of those agencies that provided an estimate of savings, 76 percent said they saved less than 5 percent, and no agency reported saving more than 15 percent of its budget (Chi and Jasper 1998).

Some observe that cost estimates, however, often do not include the transaction costs entailed in the contracting process (Sclar 2000). Agency officials might not always include the expense of effective contract design and monitoring in survey estimates. In addition, the cost comparisons between the private and public sector should control for variables, such as the proportion of clients who are “difficult to serve” or other relevant differences (Walters 2000; Yates 1997c).

2. Improved Quality

Dissatisfaction with the quality of public services and the perception that privatization will result in higher quality services have provided another impetus for privatization (Eggers and Ng 1993; GAO 1997c). The belief that the marketplace and competition will discipline organizations that provide low-quality goods or services by driving them out of business is prevalent and contributes to support for privatization and contracting out.

The perception that government agencies have failed consistently to provide high-quality services, particularly in areas such as education, child protection, child support enforcement, and welfare, has motivated some jurisdictions to pursue privatization of social services. Kansas privatized its entire child welfare system, in part in response to a widespread sense that under the publicly managed system, children were remaining in foster care too long after removal from their families (Gurwitt 2000). In 2001, the state of Pennsylvania announced it would take over and privatize the Philadelphia school system, where 57 percent of students failed required state math and reading tests and the drop-out rate was about 50 percent (Fletcher 2001).

Government systems and government workers are often seen as too slow, too inflexible, too focused on process, and too indifferent to results (Gurwitt 2000; Walters 2000). The common belief that the AFDC system was hampered by an inflexible focus on the benefit process, rather than encouraging recipients to leave welfare for jobs, was part of the impetus for privatization and other changes in the welfare systems that states such as Wisconsin, Texas, Ohio, and Colorado undertook during the 1990s (Walters 1997).

The private sector is often seen as simply better at providing services than the public sector. Private nonprofit organizations are often believed to be motivated by a strong sense of mission, which may lead them to offer higher quality services, especially social services for vulnerable people (Sanger 2001; Blank 1999). For-profit companies are generally held to be well-managed, the assumption being that if they are not, they will be driven out of business. They are often able to offer higher salaries and better benefits and working conditions than government; this contributes to the belief that they attract more productive employees. Private for-profit firms, especially large ones, might also have easier access to capital, which can allow them to move into new service areas, expand capacity quickly, or enhance the quality of services (Sanger 2001; Nightingale and Pindus 1997).

Research on the quality of privatized social services is very limited, but, like that on cost savings, it appears to be mixed. A number of experts argue that the different sectors will have different relative strengths, depending on the primary goals of the services (Nightingale and Pindus 1997; Osborne and Gaebler 1992). The empirical evidence, limited though it is, suggests that the quality of privatized services might generally be the same or somewhat higher than when these services are provided by the public sector. However, experts note that these analyses may be somewhat biased in favor of the private sector because privatization often occurs only when public services are particularly ineffective, providing a point of comparison that might not be typical of public-sector provision (Nightingale and Pindus 1997; GAO 1996). The results of several research efforts reflect this complicated picture of service quality:

- The 1996 GAO child support enforcement study concluded that the privatized operations achieved performance levels as good as or better than those of public child support enforcement operations. Outcomes, such as the success in locating noncustodial parents, establishing paternity and support orders, and obtaining collections, were compared between private and public offices, controlling for differences between the offices in the composition of the caseload. In Arizona

and Tennessee, the GAO found no significant differences in the outcomes between the privatized operations and the public operations. In Virginia, the GAO found that the privatized office performed significantly better than the public comparison office in establishing paternity and support orders and making collections (GAO 1996).

- A California evaluation of two contracts for the GAIN employment and training program in one county found that one contract resulted in good service quality, while the other contract, which dealt with case-management services, resulted in lower performance than county workers on some measures, but comparable performance on others (GAO 1997b).

Some observers take issue with the common assertion that private-sector services are likely to be of higher quality, arguing that the management of private organizations and the quality of their services are not always good. The nonprofit sector has come under some criticism for poor management practices (Cohen and Eimicke 2000). At times for-profit companies have been cited for mismanagement or for providing lower quality services in order to reduce costs and increase profits (Service Employees International Union 1997; Rodrique 1997; Hartung and Washburn 1998). Some suggest that quality may suffer with privatization because the public sector loses some of its accountability (Milward and Provan 1993). Others suggest that it is too soon to know if any single sector will consistently provide the highest quality social services, and they stress the importance of careful program implementation, regardless of whether public or private agencies are the providers (Nightingale and Pindus 1997; GAO 1997a).

3. Need for Skilled Staff

Another related reason that government agencies have been drawn to contracting with the private sector, especially with for-profit companies, has been their need for personnel with specialized skills. This has been particularly acute in the area of information technology. With the recent radical changes in welfare policy, including the institution of work requirements, federal and state time limits on aid, and other provisions that require tracking client data in new ways, state and local welfare agencies have been attempting to create new management information systems and to modify old ones. PRWORA also required states to track new child support data and to ensure that their child support collection data systems interface with other federal and state systems. Many states had to make major enhancements to their systems to meet these requirements.

Workers with the necessary skills are often in short supply in public agencies but can be “bought” from the private sector. Contracting out can also make available a range of other areas of expertise that might be hard to find in government (GAO 1997b; Eggers and Ng 1993; Nightingale and Pindus 1997).

4. Flexibility

Another common motivation for contracting out public services is the potential for greater flexibility in private-sector organizations, both nonprofit and for-profit. Civil service regulations and collective bargaining agreements that often apply to government organizations, as well as other rules, are seen as inhibiting the ability of these organizations to provide services efficiently or to address necessary system changes with flexibility (Osborne and Gaebler 1992; Nightingale and Pindus 1997; Cohen 1999). Many opponents of privatization view this flexibility negatively, arguing that it circumvents necessary protections for citizens, public employees, and service recipients.

Government agencies can have difficulty hiring new employees, changing managers or staff, or cutting the workforce when the need for particular services changes suddenly. It also may be harder to reassign employees to new functions or to discipline or fire ineffective workers. The 1996 GAO report on child support enforcement found that state and contractor officials believed that contracting agencies benefited from more freedom in managing staff and gaining resources and from having better access to technology (GAO 1996). According to this perspective, government agencies, in effect, can “farm out” their work to private organizations through contracts and reap the advantages of the greater flexibility.

5. Political Support

Finally, an ideological preference for employing market-based approaches to address public problems has been on the increase across political party lines, along with skepticism about the value and role of government and a demand for more and better public services (Cohen and Eimicke 2000; Ryan 1999). Privatization allows policymakers to maintain their distance from the political liabilities associated with government programs, while satisfying their constituents’ demands for a variety of public services. As has been discussed in the political science literature, Americans support specific public programs or causes they favor while at the same time endorsing the concept of minimal government (Almond and Verba 1989). With the popular and political focus on “shrinking government” in recent years, the public is often unaware that much of government’s work is nonetheless being done by private-sector workers.⁷ Also, because it is generally easier to end a contract than to lay off public employees, resources might be made available for a contract budget that would not be for a permanent increase in agency staff.

The privatization of specific programs, at least on the state and local level, has benefited from the advocacy of key political leaders (GAO 1997c). Support can come from the office

⁷ Despite this ideological preference for smaller government, the number of state and local employees has increased more than the number of workers in the federal government has declined, leading to an overall increase in government employees at all levels of about 7 million over 30 years (Cohen and Eimicke 2000).

of the governor or mayor, from a top agency official, and/or from members of the legislature, or from other influential political actors. This promotion has been central to the ability of privatization proponents to gather broad political and operational support, to meet the demands of implementation, and to work to reduce or overcome opposition.

The political support for privatization may also lead policymakers to provide more resources for functions such as child welfare, if these services are seen as being provided by competent private-sector organizations rather than public organizations that have come under criticism (Gurwitt 2000). Private organizations or companies might also have lobbying capacity that traditional providers lack, helping to increase support and resources.

B. MODELS OF WHAT AND HOW TO PRIVATIZE

A range of models exists for thinking more rigorously about what specific services should be privatized and under what circumstances. Here we discuss three views: (1) the economist perspective, (2) the public administration and management perspective, and (3) the political science/legal perspective. Each highlights valuable but distinctly different issues that might arise with contracting out. And elements from each have made their way into the policy and scholarly debate about privatization.

1. The Economist Perspective

Economists approach the question of whether to privatize services by starting from the premise that well-functioning, competitive markets without “market failures” will provide services at least as efficiently as the government. Hence, their approach is to identify those circumstances under which the markets do not do well, suggesting that in these cases privatization is not appropriate (Blank 1999). Four market failures may exist in the provision of social services, limiting their suitability for privatization or at least suggesting that certain safeguards might be necessary.⁸

1. **Externalities.** Externalities in social service provision will occur when persons other than the intended recipients are affected by the social services. An example of a positive externality is when job training leads to a reduction in crime. An example of a negative externality is when the opening of a drug rehabilitation center reduces property values in its neighborhood. A private organization, not taking into account these externalities, would not provide an optimal level of the service.
2. **Incomplete Information about the Services.** For competitive markets to work effectively, buyers must have reasonably complete information about the

⁸Equity of distribution—providing equal access to everyone—is also an issue when considering whether to privatize some social services, such as health care or child care. This is less relevant for the provision of welfare services, where the aim is to provide additional services to a particular group.

services they are choosing. But in many social services, this level of information might be difficult to achieve. In some cases, the services are simply too complex for untrained consumers to fully understand, as in the case of some health care services or training programs.

3. **Agency Problems.** An agency problem may occur when the person purchasing the service is not the customer or recipient of the service. This might occur if the beneficiaries are not thought to be able to make good decisions about their own interests. Examples of such beneficiaries include young children or severely developmentally disabled adults. It has also been argued that welfare recipients might not have the capacity to act in their own best interests.
4. **Insufficient Competition.** Finally and critically, competitive markets for any type of service cannot function effectively if there is not adequate competition. If the cost of entry into the market is high, new firms or organizations will have difficulty entering it, and competition will be constrained. Other major barriers to entry or local markets that are simply too small will also inhibit competition (GAO 1997b, 1997c).

2. The Public Administration and Management Perspective

A second type of literature has approached the question of whether services should be contracted out from the perspective of public administration and management, sometimes taking a “how-to” approach (Cohen 1999; Cohen and Eimicke 2000, 2001; Yates 1997b; O’Looney 1998). This literature tends to address pragmatic considerations such as the extent of political support for privatization, the potential cost savings, the administrative structures necessary for effective contract implementation and oversight, management goals such as service integration, and strategies for making the transition from a public to a private workforce. In particular, this literature emphasizes the need to make the bidding and selection process competitive and open, to design effective contracts, and to provide adequate monitoring and oversight (GAO 1997c; Yates 1997b, 1997c; Cohen 1999; Cohen and Eimicke 2000, 2001; O’Looney 1998).

One approach argues for “functional matching,” in which decisions about what to privatize and how to do it are determined pragmatically and based on an analysis of the specific details of the services and the larger environment in which they are provided (Cohen 1999). It emphasizes a number of issues, including:

- The political or social constraints on contracting out, particularly with for-profit companies
- The essential goals of the program, which might at times be in conflict or inconsistent with each other (such as lowering welfare caseloads and moving families out of poverty)
- The specific tasks that must be performed to meet the program goals, how these tasks will be designed, and who will be involved in doing this

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- Whether the government currently has the capacity in-house to perform these tasks or whether nongovernmental organizations have more experience with them and seem likely to perform them more efficiently or effectively
 - The extent of competition in the market, the depth of the local market, the potential to create an expanded market through privatization, how capital intensive the activities are and how available capital is, and the potential efficiency and other gains from privatization
 - The extent to which an activity's outcome or results are measurable, whether data on these outcomes can be collected in a feasible way, and whether it can be verified independently or if contract monitors must rely on the veracity of the contractor
 - The degree of risk entailed in the activity and what the risks are, the impacts if the services are performed badly and how reversible or irreversible they might be, and the potential political, social and economic impacts of failure

This approach suggests that a careful analysis, incorporating questions such as these, can help jurisdictions decide appropriately whether to embark on privatization for specific functions, and if they do, to do so more effectively.

3. The Political Science/Legal Perspective

A body of literature explores the broad political and legal ramifications of privatizing certain services (Diller 2000; Moe 1987; Milward and Provan 1993). It generally argues that contracting and greater use of competition and market forces risk altering the systems that provide certain public services in ways that decrease fairness and due process and limit public accountability. The shift from public structures that emphasize adherence to rules and procedures (means-based systems) to structures based more exclusively on specific performance results (ends-based systems) contributes to greater provider discretion, which might be misused, and to less emphasis on protecting client or employee rights.

A number of these scholars argue that contracting out moves public accountability for service provision back a step. The provider no longer must answer directly to an elected government official, and government officials exercise less direct control over services that are paid for with public funds. They contend that privatization further decreases citizen involvement in the governance of public services because contractors typically need not be as responsive to citizen demands as public agencies must be (Milward and Provan 1993).

Finally, some of this literature also argues that contracting out might inappropriately place “inherently governmental” functions with private organizations. These functions can include those that involve coercion—usually considered a prerogative only of the state—such as incarceration or decisions to sanction welfare families and remove them from the welfare rolls.

CHAPTER IV

CHALLENGES FACED IN PRIVATIZING SOCIAL SERVICES

While privatization might offer the potential for increased efficiency and flexibility in delivering social services, appraisals of state and local efforts to privatize have revealed a number of challenges that government agencies must address if contracting is to be successful. Among the many hurdles that officials face, seven issues receive special emphasis in the literature: (1) guaranteeing a competitive bidding environment, (2) developing effective requests for proposals (RFPs) and contracts, (3) monitoring contractor performance, (4) addressing political opposition, (5) involving community-based organizations, (6) avoiding “brain drain,” and (7) protecting the integrity of the procurement process. This chapter discusses each of these challenges in turn and, when applicable, notes strategies proposed to address them.

A. GUARANTEEING COMPETITION

While proponents of privatization argue that service improvements and cost efficiencies will arise, in large part through the incentives inherent in a competitive market, Sclar (2000) and others point out that the market in which government contracting takes place might not realize this ideal, for a number of reasons. One factor that frequently contributes to an imperfect market for social service privatization is a limited number of qualified providers. Because of the specialized nature of social service delivery—which, in many cases, requires well-trained professionals and imposes significant start-up costs—the pool of capable contractors might be quite small. In these situations, bidders have reduced incentives to minimize costs and operate more efficiently (Sclar 2000; GAO 1997b; Cohen and Eimicke 2001b). A desire for continuity in service provision can also hinder switching among potential service providers, further restricting the choices available to public agencies (Kettl 1993). One tool for encouraging providers to enter a market is government grants for “capacity building” within these organizations. Another possibility is to offer payment terms that help cover the costs of contractor expansion, such as the purchase of facilities or the hiring of new staff (Cohen and Eimicke 2001b). Both these approaches to increasing

competition, however, reduce any potential cost savings from privatization, at least in the short run.

Lack of complete information—about the actual costs of providing services or the abilities of contractors—might erode the benefits of a competitive market. A government agency awarding a contract cannot make the most favorable decision, in terms of price and quality, without such knowledge (Sclar 2000). The result may be poor services for clients at a cost above what the agency would pay if it provided the services directly. This type of market failure is especially problematic in the context of social services, where quality service provision is both highly important and difficult to confirm (Blank 1999).

B. DEVELOPING EFFECTIVE RFPs AND CONTRACTS

Another challenge is the complexity of establishing relationships between the government and private-sector organizations through requests for proposals and contracts (Sclar 2000; Yates 1998; Cohen and Eimicke 2001a). When well designed, these documents create a durable understanding about the services the contractor will offer and the cost. Insufficient detail or clarity in contract language, on the other hand, can lead to confusion regarding basic issues such as the frequency of service provision, arrangements for billing and payment, and standards for data collection and reporting (Yates 1998; Cohen and Eimicke 2001).

Effective contracting relationships begin with a suitable match between the services required and the type of contract drafted. Governments might use at least three varieties of contracts, each presenting specific advantages and disadvantages:

- **Fixed-Price Contracts.** Under fixed-price contracts, the amount a contractor will receive is established in advance and cannot be altered unless the contract is amended.
- **Cost-Reimbursement Contracts.** Cost-reimbursement contracts set payments in line with the costs actually incurred by the contractor.
- **Performance-Based or Incentive Contracts.** These agreements provide for payment to contractors as they accomplish a predetermined set of results. Payments might be related to services performed by the contractor, such as recruiting and enrolling a target number of clients in a training program. Performance also can be defined according to outcomes achieved by clients—for example, obtaining employment, obtaining employment with a wage above a certain level, receiving employment with certain benefits, and/or staying in a job for a certain number of days.

Contracts may incorporate more than one of these approaches. For example, a cost-reimbursement contract might be combined with an incentive structure, so that a service provider's total compensation is based both on costs and the achievement of desired goals.

The advantage of a fixed price contract is predictability—both the service provider and the government agency know in advance how much will be paid—but it is not easily adapted to unforeseen circumstances such as excess service demand or operational costs. Contractors also might have the incentive to reduce the quality of the service. In contrast, a cost-reimbursement contract reduces financial risks for the contractor, but provides no incentive for the contractor to reduce costs and potentially obligates the public agency to spend more for the service than it has budgeted.

Performance-based contracts, if well defined and monitored, can create incentives for service providers to meet the government's objectives. However, these incentives can lead to unintended consequences. For example, if payment is made for employment but not for job retention, the service provider might not have the incentive to find a job that is a good match for the client. If payment is made only on the basis of employment outcomes, the provider may have the incentive to “cream,” recruiting most aggressively the easier-to-employ clients. In addition, collecting the documentation necessary to verify that the contractor has met the performance targets can be burdensome. Another issue arising with performance-based contracts is that payment might not be made until some time after the costs are incurred. This can cause cash-flow problems, especially for smaller contractors. Finally, performance-based contracts can place contractors at considerable financial risk if the flow of clients to the contractor is not as expected or if unexpected changes in the economy occur.

The drawbacks of performance-based contracts led one state agency, the Pennsylvania Department of Public Welfare (DPW), to switch from performance-based to cost-reimbursement contracts to operate its employment retention program, Community Solutions (Paulsell and Stieglitz 2001). Initially, the contracts were all purely performance-based, with payments based on a client completing a five-day assessment and reporting for the first day of program participation, job placement, and job retention. Many contractors faced financial problems under these contracts because they hired staff to serve the expected number of participants, but referrals turned out to be lower than expected. Moreover, the payment system was challenging to implement for both DPW and the Community Solutions contractors. Contractors had to obtain documentation necessary to report and substantiate participant outcomes and then request payment for achieving performance goals. DPW then had to compare the contractors' reports with participant data collected in its management information system. Payments were not made until the documentation was available and any discrepancies between the information provided by contractors and information collected by DPW were resolved.

In general, prior research suggests that several characteristics distinguish effective RFPs and contracting arrangements (Cohen and Eimicke 2001a, 2001b; Yates 1998; GAO 1997b and 1999; Johnston and Romzek 2000). These include a well-defined request for services, a carefully designed incentive structure that focuses on results instead of outputs or program rules, and the freedom to renegotiate contract terms as necessary. Specific service requests and correct incentives increase the likelihood that government agencies and contractors will work toward common goals. The ability to renegotiate contracts permits a constructive

response to new circumstances or to contracting arrangements that do not function as planned.

An additional prerequisite for effective contracting is the capacity within government agencies and private contractors to develop productive and fair agreements. Johnston and Romzek (2000), studying contract implementation in Kansas, note that “executing a contract prove[d] to be surprisingly difficult for all parties involved.” Substantial attention to detail, understanding of program components, and knowledge of applicable laws and regulations are necessary for the process to move forward smoothly. Government staff new to contract management—including those with substantial experience in program operation—might require specific training and mentoring in order to develop this expertise (Cohen and Eimicke 2001b; Yates 1998).

C. MONITORING CONTRACTOR PERFORMANCE

Once a government agency has entered into a contract with a private service provider, it faces the challenge of verifying that the services delivered meet expected standards for implementation and quality. This entails the development and use of accurate performance measures, a task that the literature identifies as both particularly difficult and essential to successful privatization of social services (Kammerman and Kahn 1998; GAO 1997b; Sclar 2000). Creating measures of contractor performance and refining them to suit a specific program frequently require time and experimentation. It is especially difficult to identify and measure desired results for social services. This is because the objectives of many social services, including improved family and child well-being, are often difficult to define simply and clearly.

The challenge of contract monitoring extends not only to the definition of performance measures, but to the mechanics of the measurement process as well. Government agencies and contractors must decide who will conduct the monitoring, how data will be collected and reported, and how feedback will be communicated (Johnston and Romzek 2000). Without deliberate attention to these details, the value and impact of the monitoring system may be undermined. To ensure effective monitoring, many contracting agencies would need to invest heavily in staff training.

Although monitoring can serve as a beneficial link between government agencies and contractors, observers have noted that conflict occasionally arises between government demands for accountability and contractors’ interest in maintaining autonomy (Frumkin 2001). This issue is especially salient for nonprofit organizations that see themselves as social innovators. Well-designed incentive structures have helped resolve this conflict in some instances. Under a “milestone payment system” used in Oklahoma, for example, contractors are compensated as they accomplish a set of predetermined program results, which were designed cooperatively by the service provider and the government agency (Frumkin 2001). Generally, the nature of the service being provided, and the risks that outsourcing poses to clients and the government, will affect decisions about the proper balance between promoting innovation through outsourcing and maintaining direct control over program operations (Blank 1999; Cohen 1999).

D. ADDRESSING POLITICAL OPPOSITION

Some state and local governments wishing to privatize services have faced considerable political opposition from unions and advocacy groups. Public sector unions such as the American Federation of State, County, and Municipal Employees have been among the most determined foes of privatization. Concerns over job security have led these groups to publicize scandals and poor performance among contractors or to file suits challenging the authority of government agencies to contract out specific services (SEIU 1997). Meanwhile, organizations such as the Applied Research Center voice skepticism over the ability of private-sector firms to maximize value for shareholders and safeguard the public interest simultaneously (Berkowitz 2001).

To address this opposition, governments have implemented strategies for “workforce transition,” including involving public employees in privatization planning, offering training in skills necessary for implementing privatization, and providing special benefits for workers displaced due to the privatization of services (GAO 1997c). In some localities, public employees have themselves been invited to vie for contracts against private companies (Sclar 2000).

E. INVOLVING COMMUNITY-BASED ORGANIZATIONS

The entrance of for-profit corporations into the market for social service contracts raises questions among some observers about the viability of nonprofit organizations in a newly competitive environment. While local nonprofits often contribute in important ways to their communities, they might not have the financial or organizational wherewithal to compete successfully against well-capitalized corporations. A lack of financial assets is especially problematic when the government does not reimburse the full cost of the employment services until the client is placed in employment. The small size of most community-based organizations also can prevent them from realizing the economies of scale and cost savings of larger companies. Some community-based organizations perceive a conflict between their core missions, which emphasize responsiveness to client needs, and pressures to establish new priorities—such as accurately measuring performance and improving cost efficiency (Sanger 2001; Saxon-Harrod and Heffron 1999). Sanger (2001) expresses the concern that for-profit corporations will capture a sizable portion of government funding that formerly supported community-based organizations, a shift could that weaken the social infrastructure in needy communities and put the traditional clients of community-based organizations at risk.

F. AVOIDING “BRAIN DRAIN”

Close working relationships between governments and contractors create another set of potential challenges to privatization. In some instances, private organizations that have received government contracts begin recruiting employees of public agencies to access the talent necessary for implementing and operating programs (Sanger 2001). GAO research on senior staff turnover in child support and TANF programs offers evidence of this. Of senior program directors who left their positions from 1993 to 1998, 25 percent went to

work for private contractors providing TANF or child support services. A major reason for these departures was the opportunity to earn a higher salary (GAO 1999). The loss of personnel—both management and those with specialized expertise in areas such as information technology—can affect government agencies' ability to design and monitor contracts effectively as well as to deliver services again once the contract expires.

G. PROTECTING THE INTEGRITY OF THE PROCUREMENT PROCESS

Government agencies, both at the federal and state levels, have long recognized the potential for conflict of interest in the procurement process. Indeed, allegations of unlawful lobbying or irregularities in the contracting process have dogged several private providers of social services (Berkowitz 2001; Hartung and Washburn 1998). Some have argued that the so-called “revolving door,” the movement of employees between the public and private sectors, could give contractors with former government employees an unfair advantage. However, a GAO study of TANF and child support enforcement contracts in four states found that listing former government employees as key personnel did not increase the chance of a bid's success. In response to concerns about the integrity of the procurement process, most states have established some ethics policies designed to help ensure open and fair procurement (GAO 1999).

CHAPTER V

RESEARCH NEEDS MET BY MPR / ASPE CASE STUDIES

As state and local agencies increasingly contract out services traditionally provided by the public sector, issues arise concerning what should be privatized and how to do it most effectively. Research on the privatization of welfare services is still in its infancy. However, ongoing research is important, especially given the recent, rapid changes in the welfare system and the increasing prevalence of privatization. Our review of the literature identified the need for three broad types of research in the privatization of welfare services that can be met by the six MPR/ASPE case studies.⁹

1. **Information on the Relative Quality and Cost Effectiveness of Privatized Welfare Services.** No careful study has been conducted on the quality or cost effectiveness of welfare privatization. While the case studies will not be able to quantify the quality or cost effectiveness, we will report the perceptions of TANF agency staff and other stakeholders on the success of privatization.
2. **Information on How Best to Implement Privatization.** Research shows that the effectiveness of privatization depends critically on the nature of the market and the extent of competition, on the level of political and operational support, and the effectiveness of the design of contracts and of the accountability processes. Information is needed on how welfare agencies should plan and implement the privatization process. By describing the experiences and lessons learned of six TANF agencies that have privatized case-management services, the six case studies will address this need.

⁹ A need also exists to develop a national picture of the extent of privatization of TANF services. A forthcoming GAO report will address this need.

3. **More Information on the Privatization of Case Management.** Most of the research has focused on the privatization of TANF employment and support services, and little has been conducted on privatization of case management, mainly because it is rarer and has occurred more recently. However, the issues surrounding privatization of case-management services might differ from those surrounding the privatization of other services. For example, it might be more difficult to define appropriate contract goals or to monitor the quality of case-management services. Contracting out broad case management requires a specialized set of performance incentives. By focusing on TANF case management, the case studies will address this need.

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