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## **POLICY CONSIDERATIONS RELATING TO PRIVATIZATION IN THE FOOD STAMP PROGRAM**

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The Food Stamp Act requires that state civil servants make all decisions about individual households' eligibility for benefits. Throughout the program's history, state civil service administration has been taken for granted. Last year, however, USDA approved a waiver for Florida to partially privatize administration of the Food Stamp Program in several counties. Now, at least two states are developing plans to contract with private entities to take over substantial parts of the eligibility determination process. Florida has decided it does not want to wait for the results of the experiment USDA approved and is seeking approval for a loosely-defined waiver to allow it to solicit bids for privatizing statewide an undetermined number of functions within the eligibility determination process. On June 25, USDA expressed receptivity to Florida's proposal but sought additional clarification. Texas has proposed to close more than half of its local offices, largely replacing them with kiosks and call centers that would determine eligibility based on materials received over the telephone and internet. Apparently some or all of these call centers might be operated by private contractors. Both states are pursuing similar changes in their Medicaid programs.

These proposals raise significant issues, both for these two states and for the future of the national Food Stamp Program. Over one million people received food stamps in Florida during an average month of 2003, with total issuance that year of almost one billion dollars. Texas's average 1.9 million food stamp recipients received \$1.9 billion in food stamps last year. This year, the states rank fourth and first in the country, respectively, in food stamp issuance. Private contractors long have operated some discrete functions for the Food Stamp Program: printing food stamp coupons, designing computer software, operating electronic benefit transfer (EBT) systems, managing employment and training programs, etc. No firm, however, has ever had control of the entire program — or, in particular, the decision about whether particular households receive food stamps. When the Food Stamp Program began to convert from paper coupons to EBT, USDA and states recognized that the conversion would be costly, disruptive, and subject to potentially serious unforeseen problems. Accordingly, they moved cautiously to minimize harm to vulnerable recipient families. This deliberate approach stands in stark contrast to the rapid, large-scale implementation that Florida and Texas are proposing.

Some people oppose privatization based on the principle that discretionary government functions should be performed by government employees. Others just as fervently support privatization as a way of shrinking government or introducing more private-sector efficiencies into public administration. Beyond these basic ideological positions, however, lie a host of practical considerations about how privatization might work. This paper seeks to examine some of those practical issues.

Without a doubt, the current administration of the program has significant problems. A number of eligible families feel badly treated. Some forego benefits that they need as a result. Improving access is a goal shared by many public officials, emergency food providers, anti-hunger advocates, and others. Some have seen privatization as a possible answer. Care should be taken, however, before regarding privatization as a panacea. Although private firms have made important contributions in performing discreet tasks for the program, it will be very difficult to design contracts that will give contractors incentives to improve service to low-income families while protecting the program's integrity. Moreover, hurried or indiscriminate privatization could inadvertently cause significant problems with program access, integrity, and cost.

This paper first considers the inherent limits on states' ability to reap the benefits of competition when contracting out program management. It then analyzes the challenges states face in making the transition from operating a program directly to letting and supervising contracts for program management, the different skills needed for these two functions, and the difficulty of crafting effective contracts for such a multi-faceted function as administering the Food Stamp Program. It attempts to identify the general factors that make a government function a more or less appealing candidate for contracting out. Finally, it suggests some safeguards that might be prudent if a political decision is made to experiment with contracting out food stamp eligibility determinations.

## **The Limitations of Competition for Program Administration**

One of the main advantages commonly cited for privatization is increased competition. The government, it is said, has held a monopoly on performing these functions for too long. Inviting private contractors to bid for the right to provide those services is thought likely to drive innovation that will allow the program to obtain better services for a lower price. The benefits of competition to government programs should not be taken lightly: in numerous areas, public-private partnerships have yielded impressive results. For example, the Special Supplemental Nutrition Program for Women, Infants, and Children (WIC), which provides food vouchers and formula to almost half of the infants born in the U.S., requires infant formula companies to compete for its business. Savings from this competitive bidding process are estimated to be about \$1.5 billion annually, enough to serve more than one-quarter of all low-income women, infants, and children receiving WIC benefits in an average month — over two million people.

Competition for the right to administer a program, however, differs from competition to provide products or specialized services in several important respects. These differences may undermine the value of that competition significantly.

- First, *selecting winning bidders will depend upon a great deal of speculation*. At the time the competition takes place, private bidders generally lack the present capacity to offer those services. No company rents offices and hires eligibility workers on the *chance* that it will be selected to run a program. Thus, the government agency acting on the bids must essentially speculate about what sort of infrastructure the agency will be able to build in the future if it wins the bid. That sort of speculation is inherently error-prone, undermining the value of the com-

petition: the value of any improvements in service and price must be weighed against the risk that the contractor will be unable to perform as promised. Since the government will know the competing bidders' prices but will only be able to speculate about the service they can provide, its selection of a contractor inevitably will be based primarily on price. A bidder that has won the contract by committing itself to operating with the least funding may lack the resources to provide quality service to low-income families.

Many of the notorious problems in military contracting — weapons that do not work, cost overruns, etc. — result neither from incompetence at the Defense Department nor from the venality of defense contractors. Instead, they result from the inherent difficulty of predicting a new weapon's capabilities and problems in advance of its construction. The Defense Department and NASA may have little practical choice but to endure these problems because the government does not want to build and operate weapons and spacecraft factories.

Food stamps and other government assistance programs historically have avoided this highly speculative, risky form of contracting. It stands in marked contrast to the more typical approach to contracting in these programs such as WIC's infant formula procurement system. When WIC accepts a manufacturer's bid to be the sole provider of infant formula in a state, that company is already producing acceptable product; upon winning the contract, it need only ship more of that product into the state. Thus, while it is relatively clear that picking the lowest bidder among WIC infant formula suppliers will get the state the best bargain, the same is not true when selecting bidders to provide administrative services: the lowest bidder may not be able to do all that its bid promises (and that the bidder sincerely believes it can do). Once the state selects a bidder, it is likely to need to establish so many additional requirements that the final contract is quite different from the specifications on which the prospective contractors bid. In the end, the state may have little idea whether one of the unsuccessful bidders might not be able to do a better job of what is actually required.

- Second, *programs like food stamps will be at risk for higher costs because their administration is a natural monopoly.* The overhead required to maintain facilities, develop policies and procedures, train staffs, etc., make it uneconomical for multiple entities — the state and a private contractor or more than one contractors — to operate eligibility determination systems simultaneously. Indeed, even if they could, it is difficult to see the basis on which competition would take place: surely the program would not want households to select which office to visit based on where they believe they will receive more generous benefits. Thus, the only competition will take place at the initial bidding for the contract; the classic type of on-going competition that one sees between Ford and GM, between ABC and CBS, between Coke and Pepsi, etc., is impossible when the Food Stamp Program contracts out responsibility for eligibility determinations. In much the same way, each state has had to contract with only one company to operate their EBT systems. Once the contract is signed, all competition ceases for the duration of

that contract. Poor service by the selected vendor, or the appearance of other vendors offering better service or prices, is irrelevant unless the state has grounds to void the contract.

In other natural monopolies, such as the provision of gas or water and sewer services, public operation or public regulation often have proven necessary to restrain costs. The Food Stamp Program can invite genuine competition at the time it lets contracts, but during the life of those contracts monopoly conditions will exist. During those periods, the system will remain as impervious to market signals as it is in the current, state-run system. Because of the cost and disruption of letting contracts and transferring administrative responsibilities, administrative contracts are likely to run for a number of years, eliminating any competition for long stretches of time.

During the life of each contract, the contractor will seek to reduce its costs so that it can maximize its profits. Where federal law provides state options, contractors therefore will prefer whichever one lends itself best to administrative ease. Thus, contractors are unlikely to volunteer to implement optional programs, such as nutrition education or job training, that increase their administrative burdens even if those options might benefit recipients. Contractors similarly will have incentives to avoid complex determinations of physical or mental disability or other hardship before sanctioning recipients for failing to comply with program rules.

- Third, and related, *whichever contractor is chosen will have great leverage over the state, and great advantages over potential competitors, because the cost of changing program administrators will be very high.* Administering a public program requires significant, irreducible up-front expenditures by each new vendor. These include the costs of hiring staff, months of designing policies and procedures for the program and training the new staff in those policies and procedures, the time required to rent and furnish offices before they can be put into use, etc. A company having to hire an entire staff of people with the intellectual and social skills to learn and implement complex programs policy in a short period of time is likely to have to pay a premium for that staff — or to compromise severely on quality — far more than an agency that only needs to replace its occasional losses to retirement and attrition. For a contractor to improve the cost or quality of a program's administration, it will need to achieve enough new efficiencies to offset these considerable capital costs.

Moreover, these start-up costs will occur each time a new entity takes over administration of the program. Once a program's administration has been contracted out, therefore, the contractor will have a substantial advantage over any competing bidder (including the former public agency, which by then will have had to dismantle its administrative infrastructure). This will allow the incumbent contractor to raise its bid and still defeat prospective competitors, whose bids will have to cover these start-up costs. Indeed, private contractors may increase the start-up costs of potential public and private contractors by requiring their more

skilled employees to sign contracts promising not to work for competitors in the state for some length of time.

If a contractor providing relatively fungible products, such as WIC infant formula, fails to perform its contractual obligations, the state has other options and so can consider voiding the contract and seeking new bids. By contrast, if an administrative services vendor is performing badly, the costs and disruption of selecting a new contractor and having that contractor build up the infrastructure required to operate the program may leave the state with little practical choice but to stay with its existing contractor. This will undercut contractors' incentives to comply.

For just these reasons, several states have stayed with automation contractors whose systems were causing chaos in their administration of their programs. The states reasoned that switching contractors would cause considerable disruption and that any new contractor's system might have comparable problems. The failure of new automation systems caused huge increases in the food stamp quality control (QC) error rates in Florida, Indiana, Michigan, and Los Angeles County, among other places. The disruption, cost, and risk of switching automation systems pales in comparison to that asking a new contractor to set up an entire new eligibility determination infrastructure, with new offices, staff, computers, etc. Thus, states may feel compelled to stay with administrative contractors even if their work is far worse than the severely defective automation systems that states have tolerated in the past.

The government's dependence on a particular contractor may prevent it from reaping the full benefit of competition. In particular, the high costs to the government of shifting from one contractor to another (or rebuilding the infrastructure to administer the program itself) will make the state extremely vulnerable to contractors' possible bankruptcies. Since the contractor will be bidding based on speculation about what administering these programs will cost, once it actually rents and furnishes offices, hires staff, etc., it may find that it significantly underbudgeted. In these circumstances, the contractor may threaten to declare bankruptcy, leaving the state without the means to operate its programs. If the state judges that threat to be credible, it may have no choice but to increase its payments to the contractor. Thus, the state effectively must assume most of the risk of the inherent uncertainty about the costs of shifting administration to a private contractor: if the contract price proves excessive, the contractor keeps the profits, but if it proves insufficient, the contractor has leverage to extract an increase.

Medicaid managed care produced modest short-term savings because plans offered low rates to win their initial contracts. Once states had become dependent on them, these plans insisted on higher rates to continue serving Medicaid and the savings disappeared. Similarly, in the early 1990s, vendors of electronic benefit transfer (EBT) services negotiated contracts under which they were paid on a per-transaction basis. Since participation had been rising rapidly, they assumed this would prove highly profitable. When, in fact, participation plummeted after

1994, these contracts proved unprofitable. Some contractors suggested that they might abandon their contracts, putting great pressure on the states and USDA to increase the agreed-upon payments.<sup>1</sup> The leverage of contractors administering key parts of the eligibility determination process would be incomparably greater.

Even the short-term cost savings that Medicaid managed care and EBT brought states came at a high cost to recipient families. Implementation of both systems was chaotic and caused significant hardship in many places. As time passed, contractors solved many of their initial problems — but also increased what they charged the states.

- Fourth, *the government will have difficulty measuring contractors' performance and ensuring quality.* If an infant formula company delivers expired or otherwise substandard formula to WIC, the program's managers can promptly detect the problem and assess a penalty. If the problem persists, the government will know and can cancel the contract. The enforcement of contracts of this kind is easy because the products the government seeks to procure are fairly straightforward to specify.

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

No program administration, public or private, will excel in all of these areas. Assessing the quality of program administration therefore is very much a matter of subjective judgment, weighing deficiencies in some areas against strengths in others. These assessments typically depend on a wealth of informal communications among various units within the system, a type of communication that contractors will have strong incentives to control tightly. Even if most observers would regard a particular contractor's performance as deficient, the state may not have objective evidence that is legally sufficient to impose penalties or to terminate the contract. Absent such evidence, the prospect of costly and protracted

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<sup>1</sup> Concerns about the reasonableness of private companies' bids were so severe that Texas — one of the states wanting to privatize administration of the Food Stamp Program — decided not to contract with any private firm to be its prime EBT contractor, assigning public employees to take over that role.

litigation is likely to deter states from even attempting action against contractors. Although automated systems lend themselves far more readily to objective performance measures than does overall program administration, states have rarely if ever recovered damages from automation contractors even when systems' catastrophic failures caused huge increases in error rates and workload for eligibility staff. The difficulty of measuring performance under contracts to administer the Food Stamp Program is likely to prevent states from enforcing most quality assurances the contractors provide. Competition thus offers little prospect of improving the quality of program administration or even of allowing states to identify the highest-quality bidder when letting the contract.

- Finally, *contracting could subject the program to massive financial losses*, which would damage the program directly and undermine public confidence in its stewardship of taxpayer funds. No contractor will be able to afford to cover the costs of additional food stamps issued because of serious problems in its administration. Contractors, unlike states, can declare bankruptcy. The burden of any significant losses therefore will almost certainly accrue to either state or federal governments. And, in practice, turnover among state and federal officials and other limitations on the federal-state relationship make it difficult to protect the federal government from severe financial losses if an experiment goes wrong. For example, in the early 1990s, Florida moved rapidly to implement an ambitious new system for automating many aspects of the eligibility determination process. It rapidly implemented the system statewide and ran into severe difficulties. The system mishandled numerous cases, and the state's food stamp error rate spiked. In 1992 alone, Florida overissued more than \$200 million in food stamps. Although the food stamp quality control (QC) system assessed a correspondingly large penalty, by that time the governor who had rushed through the implementation of the flawed automation system had left office. His successor struggled to correct the problem but argued that imposing such a large penalty for something his predecessor had done would hobble his new administration. In the end, USDA required Florida to spend some unmatched state funds to correct its system but did not collect any of the assessed QC penalty. The federal government absorbed all of the \$200 million loss that Florida's hasty experiment with automation caused.

Just this year, the Bush Administration forgave a nine-figure QC penalty against California when Gov. Schwarzenegger argued that he should not have to pay for errors resulting from a deficient automation system mismanaged by his predecessor. The first Bush Administration similarly waived large penalties against states, often in response to pleas from successors of the governors under whom the penalties were incurred. Thus, the losses that the federal government can incur from catastrophic failures of state administration in the Food Stamp Program are more than administrations of either party have been willing to extract from the successors of the governors responsible for those failures. Similarly, both Republican and Democratic administrations have declined to require subsequent

governors to make good on their predecessors' commitments that demonstration projects would be cost-neutral to the federal government.

The same thing could happen again if the current privatization proposals go awry. Fiscal year 2004 is virtually over. It is unclear if Florida could turn over administration to a contractor much before the end of federal fiscal year 2005. Even if it can, USDA will not release the error rate for that year until June 2006. Administrative appeals could easily last for six months, by which time Governor Bush will be leaving office under Florida's term limits. (Texas Governor Perry, although not term-limited, also reaches the end of his current term in 2006.) If something goes wrong, any fiscal penalty will have to be paid by his successor. And with Florida issuing over \$1 billion in food stamps each year, the cost to the federal government if the contractor is unable to perform could be huge. (Texas's annual food stamp issuance exceeds \$2 billion.) And replacing or rehabilitating an incompetent contractor could be far more difficult, expensive, and time-consuming once the state has dismantled its current eligibility determination infrastructure than correcting the defective automation system was in Florida in the early 1990s. Whatever the formal terms of the waiver USDA grants, on a project of this scope the states in effect are likely to be gambling with the federal government's money.

A fundamental problem with states' proposals to privatize the administration of the Food Stamp Program is that the states stand to reap substantial gains from any successes but are largely immune to the consequences of any failure. If privatization reduces administrative costs, states — which pay half of those costs — will reap a financial benefit. If, however, it results in improper issuances of benefits, the federal government — which pays all food stamp benefit costs — and not the state will suffer most of the consequences. In this respect, privatization of program administration in the Food Stamp Program differs fundamentally from similar proposals in TANF, where states have a far higher stake in benefit costs. Benefit costs are many times higher than administrative costs in the Food Stamp Program, meaning that the potential losses far exceed the potential gains. And of course, if privatization results in the delay or denial of food assistance to eligible needy families, benefit costs may decline but at the expense of severe hardship to these families. This imbalance between the potential dangers and advantages they might experience will naturally skew states' cost-benefit analyses, giving them incentives to experiment with risky privatization proposals. A state's proposal in this area therefore does not deserve the same deference that would be appropriate if the state was going to be the primary one suffering the harm of a failed experiment.

The risks are quite real. In states that have privatized administration of TANF, serious disputes have arisen over contractors' operations of the programs and the propriety of some of the charges to states. Moreover, both Texas and apparently Florida contemplate greatly reducing the role of face-to-face interactions with applicants and recipients. The face-to-face interview long has been one of the



Food Stamp Program's primary safeguards against fraud. Direct contact with households also is how states screen applicants for those in need of emergency food stamps, identify persons with disabilities who may need extra help in the application process, and identify other services — job training, nutrition education, child welfare, etc. — to which the household should be referred. The states have presented no evidence that alternative means will prove equally effective at detecting and deterring fraud — or that they can do so without imposing undue burdens on low-wage working families.

None of this is to suggest that competition has no place in program administration. It does mean, however, that policymakers should not assume that competition will have the same effect in one area of program operations that it does in others. Level-headed analysis of the potential risks and benefits of any proposal for increased contracting, rather than generic assumptions about the benefits of competition, will lead to the best use of limited public funds. Any investigation of privatization should proceed slowly, carefully, and with close federal oversight.

### **Imposing New, Difficult Responsibilities on Government: Designing and Assuring Compliance with Contracts for Program Administration**

When the government contracts out administration of important government services, it assumes a fundamentally different role. Where previously the government was required to administer the program, now it becomes responsible for framing requests for bids, negotiating contracts, monitoring performance, and enforcing compliance. Both administration and contracting are functions that government sometimes does well and sometimes does poorly. The vast majority of government administration and procurement go well and largely unnoticed. But just as some agencies are accused of providing shoddy service to the public, so, too other agencies are criticized when they overpay for hammers, toilet seats, and other routine items or when their contractors provide poor service to the public.

The skills required to administer programs and manage contracts are quite different. Good managers must have strong leadership skills and be good judges of people. They must be flexible enough to adapt rapidly to changing circumstances and problems. They must be able to translate policies into instructions their staff can implement. By contrast, letting a sound contract for program administration requires more analytical skills, including meticulous attention to detail. Contracting officers must anticipate problems that have yet to arise because they will not have the flexibility to respond to them once the contract is signed. To the extent that they need interpersonal skills, it is as a negotiator rather than as a leader. They must be able to translate policies into contractual specifications that will cause the contractor to act as the agency intends.

Many excellent administrators are ill-equipped to negotiate important contracts. On the other hand, many people skilled at drafting contracts lack the expertise in operating the Food Stamp Program to anticipate all the contingencies that must be addressed in a contract for the program's administration. A team is clearly needed, but even if a state agency has the right combination of talents to make an effective team, the novelty and enormity of the proposed transfer makes significant problems inevitable: some important aspects of program administration will

be taken for granted and some contingencies will not be anticipated. This suggests that any agency proposing to put program administration out for bid should be scrutinized carefully to determine if the personnel it intends to put in charge of contracting have the necessary skills. If it does, a gradual approach to contracting — contracting out some limited functions and for limited parts of the state — is prudent to allow the team to develop the necessary expertise and to limit the consequences of oversights and errors in drafting its first contracts.

States have encountered serious difficulties when trying to make other sharp changes in the way they administer other benefit programs. For example, Medicaid's conversion to managed care required state health departments to switch from working to prevent the *overuse* of services to trying to ensure that managed care contractors did not cut costs by *denying* services: in a conventional fee-for-service system, providers' incentives are to provide as many services as they can, while in managed care the providers' incentives are reversed. It took about a decade for many states to master the Medicaid managed care contracting process. In the mean time, a host of serious problems ensued. Some contractors with inadequate financial planning spent their capitation payments quickly and went bankrupt. This left thousands of Medicaid beneficiaries with no way to receive care until the state was able to scramble around and piece together alternative arrangements, sometimes paying a premium to do so. The doctors and other care providers left unpaid by the bankrupt plans became even less willing to treat Medicaid patients than they had been previously, and some moved out of already-underserved low-income communities. Other contractors apparently concluded that the turnover among Medicaid recipients made it cost ineffective to immunize children; a measles epidemic in Milwaukee resulted in 1989-90. Still other plans became adept at "skimming:" recruiting Medicaid beneficiaries likely to require little care while discouraging enrollment by those expected to be unprofitable. Some of the worst problems occurred where states rushed broad scale implementation — as Florida and Texas are proposing to do with privatization.

Yet after all of this disruption, Medicaid costs in the states that converted to managed care have continued to rise at rates largely indistinguishable from those in states without managed care. Mainstream managed care plans have been unwilling to accept low Medicaid fees, and the small number of Medicaid-oriented plans have had the market power to extract steady rate increases from states. Thus, there are no assurances that the burdens and risks of this sort of massive transformation will ever produce the hoped-for savings.

No one set out to recruit incompetent or irresponsible managed care plans. Nonetheless, states' experience with fee-for-service care left them ill-equipped to judge when the low-bidding plans could, and could not, be counted on to provide adequate care. In Medicaid managed care, as in food stamp administration, no immediate market correction is available since program recipients cannot walk away from unsatisfactory contractors.

Similarly, Medicare's shift from per diem payments to diagnostic related groups (DRGs) for reimbursing hospital care transformed the risks the program faced in ways that were difficult to anticipate. Previously, with hospitals receiving more funds the longer they kept patients, the program struggled to prompt faster discharges. When DRGs gave hospitals flat payments for each illness without regard to the length of a patient's hospitalization, some hospitals began discharging patients while they were still seriously ill. Here again, the change in providers' incen-

tives required entirely different monitoring and enforcement activities. Here, too, some hospitals became adept at skimming: recognizing and recruiting patients with relatively inexpensive-to-treat forms of conditions covered within a broad DRG. A similar story could be told about Medicaid's experience contracting with nursing homes. Over time, the programs adapted. In the short term, the losses in both human and financial terms were substantial.

It is no disparagement of states or USDA to say that they will be unable to anticipate all of the problems that need to be addressed in contracts for administering the Food Stamp Program. Starting the privatization of program administration with rapid statewide implementation in the states ranking first and fifth in food stamp issuances would seem to court excessive risks.

Anticipating all contingencies, or even all important ones, when drafting a request for proposals or a final contract is effectively impossible. A partial parallel can be seen in federal-state relations. The Medicaid statute is, in a sense, a contract between HHS and the states for the program's operation. States have repeatedly identified flaws in this statute that allowed them to increase the proportion of the program's costs that the federal government bears beyond that anticipated by the statute's drafters. Time and again Congress has closed loopholes: disproportionate share hospital (DSH) payments, providers' donations and taxes, intergovernmental transfers, skillful use of the upper payment limit (UPL), etc. Time and again, enterprising states identify others. The states' behavior, while perhaps annoying, is in no way illegal or inappropriate: they are simply pursuing the full scope of their rights under the law. Governors, budget chiefs, and Medicaid directors are responsible to make the best fiscal arrangement for the people of their states within the law; they owe no duty to the federal government.

In the same way, one need not suppose that contractors hired to take over administration of the Food Stamp Program will inappropriately exploit their positions. Nonetheless, their primary goal is to maximize returns on their shareholders' investments. Indeed, failing to maximize shareholders' profits would be unethical and could conceivably subject company managers to liability. Just as Medicaid lost large sums of money in the months or years it took Congress to plug loopholes in the federal statute, the Food Stamp Program can be expected to suffer serious losses as states are forced to await the termination of their contracts — or pay a premium to renegotiate early — to amend portions of their contracts that are found to be flawed.

Similarly, although Congress has amended the WIC program's statute numerous times over the past three decades, it had not anticipated that stores could increase prices by selling exclusively to WIC participants.<sup>2</sup> Fortunately, the rapid growth of these WIC-Only stores coincided with a reauthorization of the program, and Congress acted to try to rein in their prices. Had the rules for how much WIC paid for foods been locked into a multi-year contract, however, the program would have been powerless to avoid spiraling losses from these stores' legal but un-

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<sup>2</sup>WIC gives participants vouchers for specific food items — a certain number of ounces of orange juice, a certain number of cans of infant formula, etc. It then reimburses food retailers for whatever the shelf price of a product may be. Competition with other stores for non-WIC customers' business keeps down the prices for WIC items at supermarkets and other regular retailers. By selling exclusively to WIC participants — who have no reason to care about the prices of the products they obtain with their vouchers — WIC-Only stores can charge the program much more than it would cost to obtain the same products at other stores. The rapid emergence of WIC-Only stores in California and some other states is imposing millions of dollars of unanticipated costs on the program.

anticipated activities. And yet despite this legislation, USDA recently amended its budget request to propose that Congress prohibit any new WIC-Only stores from entering the program — apparently an indication that USDA is uncertain if it can quickly or effectively correct the problem with stores already in the program. If problems arise with contractors administering the Food Stamp Program, USDA may feel it can do little more than impose corrective requirements on *future* contracts for administration of the program. Addressing problems with vendors already involved with a program can be extremely difficult and time-consuming.

Crafting effective contracts for the administration of the Food Stamp Program is particularly difficult because, as noted above, it requires accommodating many different policies that at least partially conflict. For example, we want eligibility workers to verify applicants' statements about their income — but not to the point of pestering low-wage workers' employers, or requiring workers to take so much time off the job, that they are fired, denied promotions, or discouraged from applying for food stamps. States can provide financial incentives for contractors to achieve one goal or another, but achieving the right blend of incentives to induce the contractors to strike the right balance between those objectives, — particularly where some, such as service to low-wage workers, are difficult to measure — may be all but impossible; at best, it will require extensive trial and error over the negotiation of several contracts.

Designing contracts that can adapt appropriately to changes in participation also will be very difficult. Serving more households costs more money; if the contract does not increase administrative costs sufficiently in response to increases in participation — or if it reduces them too little in the event of falling participation — the contractor will have incentive to create barriers to access for eligible families that need food assistance. But if contractors receive too much additional funding for serving more families, they may feel insufficient pressure to maintain program integrity or to support effective job training and similar programs that might help families raise their earnings to exceed the food stamp gross income limits.

Designing contractual terms to handle changes in program rules also would be a challenge. After the contract has been signed, Congress may amend the Food Stamp Act, USDA may change federal food stamp regulations, or the governor or legislature may conclude that some options it has elected no longer serve the best interests of the state and its low-income families. Some of these changes may significantly increase or decrease the cost and burden of administering the program. The state and the contractor may disagree, however, on how much of a difference these changes will make and hence how they should affect the contractual payment rate. States may find that they are unable to adopt beneficial new state options without paying a premium to their contractors and may lobby against otherwise meritorious federal food stamp legislation because they cannot afford the additional costs their contractors will charge to implement it. Where public agencies administer a program, by contrast, no complex negotiations are needed to adopt or implement new program policies.

On any items where contractual requirements are not explicit, contractors will face competitive pressures to minimize their investments. Thus, for example, if the contract does not specifically spell out what assistance contractors must provide to people whose disabilities prevent them from using automated application systems or people in rural areas without sufficient

internet access, any contractor that voluntarily builds such accommodations into its budget will be at a disadvantage against bidders that commit only to doing what the terms require.

Crafting reliable systems for monitoring contractors' performance also poses new and difficult challenges to state administrators. With no experience contracting out administration of the program, even the most conscientious state officials are unlikely to anticipate what data they will need to monitor the contractor properly. Once the contract is signed, the contractor will be under no obligation to honor requests for additional information. One state reported recently that when it asks its EBT contractor for information not required under its contract, the contractor commonly responds by quoting a price the state would have to pay to receive that information. If the contractor believes that certain information will reflect badly upon it, the contractor will have every legal right simply to refuse to supply the information. More generally, contractors may withhold information their contracts do not require them to submit on the grounds that that information is proprietary. Thus, state officials may have no real idea how the contractor is doing. Even if they receive complaints, they may have no way of knowing how widespread a problem may be.

Contract terms must be particularly clear because litigation with contractors can profoundly disrupt program administration. If a state terminates a contractor that is performing badly, the contractor is likely to sue for the fees it would receive under the remainder of the contract. If the state misjudged in terminating the contract, or if its lawyers perform badly, the state could end up having to pay twice for administering the program during the same period: once to do the work itself (or through another contractor) and again to the dismissed contractor. No state's budget can readily absorb this kind of blow. Moreover, states effectively will be unable to plan (and to make long-term hires or enter into any new long-term contracts) during the months or years required to resolve the litigation finally. States therefore are likely to be extremely reluctant to terminate even the worst contractors — and quite eager to settle any litigation that does arise.

## **The Types of Activities Most Effectively Contracted out to Private Entities**

Some functions are most efficiently performed by the government directly; others are best contracted out. The key to sensible program management is to identify which kinds of activities fall in each category rather than to allow an ideological preference for or against privatization force an unwise decision.

One key criteria for determining whether the public or private sectors can most efficiently provide a particular service is which one has the necessary infrastructure. The Food Stamp and WIC Programs rely on private stores to distribute the food they purchase because these stores already have effective food purchasing, distribution, and storage systems; the government would duplicate their investments if it had to build a parallel system for the food assistance programs. Medicare and Medicaid similarly rely primarily upon private hospitals, doctors, and other health care providers because of the inefficiency of developing a duplicate health care delivery system. Most government employees travel on regular commercial airplanes because it would be inefficient for the government to duplicate the airlines' fleets, route plans, ticketing systems, and other

infrastructure. Data processing for states' food stamp eligibility determination systems similarly is efficiently contracted out because private companies already have invested in the massive servers required to perform that work: a contractor may schedule a batch of computations for the Food Stamp Program in between similar runs for large corporations or other governmental agencies. Early EBT demonstration projects cost far more to deliver benefits than paper food stamps; once the private sector developed the infrastructure to support electronic purchases in grocery stores to serve credit card customers, costs to the Food Stamp Program plummeted.

In some cases, neither government nor the private sector may have the infrastructure ready to perform a particular job. In those cases, the government may choose to contract for the work rather than assume the responsibility of building the infrastructure itself. Thus, when the Defense Department or NASA wanted to acquire new types of weapons or spacecraft, neither they nor any private companies were equipped to do the necessary work. Because the U.S. government historically has been reluctant to build and operate factories, it chose to contract for that work, essentially paying for private companies to develop the necessary infrastructure.

On the other hand, where the government already has the necessary infrastructure in place, and where private contractors have few other present or future uses for that kind of infrastructure, paying to have the wheel reinvented rarely makes sense. No one would seriously suggest that we should abandon the national parks and contract with private companies to acquire and operate a comparable park system: what would be the point of it? No state is ready to hire private contractors to replace its university system: the investment necessary to create that system has already been made and does not need to be duplicated.

Although not nearly as conspicuous or imposing as the Everglades or Texas A&M, the infrastructure states have developed to administer the Food Stamp Program also reflects a substantial investment. Selecting, renting, and furnishing offices, developing policies, forms, and computer systems, hiring, training, and supervising staff, and myriad other steps are necessary to establish a system for determining households' food stamp eligibility. Numerous problems arise in administration that agencies' staff learn to handle by trial and error; that experience, too, represents an investment. A private contractor could eventually reproduce that infrastructure, but why we should want it to do so is unclear. No economies of scale are present: the contractor is unlikely to be able to perform work for other customers with the food stamp eligibility determination infrastructure the way mega-servers handle work for private companies with data processing needs or check-out stand terminals process non-food stamp customers' credit card purchases. Any savings are likely to come from reductions in service, such as closing offices. Those reductions, however, can be implemented just as easily by the existing state agencies, without privatization, if they are deemed desirable. Privatization by itself offers no obvious ways of producing significant efficiencies.

Contracting also is more appropriate where the government's requirements are relatively clear, objective, and stable. Most obviously, the government relies on private vendors for most products it needs rather than building factories of its own. The government also purchases numerous services that can be concisely and specifically described. Among other things, the Food Stamp Program long has rented space for its national headquarters from a private landlord. Many state food stamp agencies similarly rent space for their headquarters and local offices. Pri-

vate contractors design and print the program's informational brochures and posters. Other kinds of services mentioned above — data processing, air travel, etc. — can be reduced to simple, clear specifications that are amenable to private contracting.

By contrast, governmental functions that require the exercise of judgment to weigh competing priorities are difficult to privatize successfully. For example, although many have criticized the Federal Emergency Management Administration (FEMA), few would argue that its core functions should be contracted out. Assessing each disaster and determining the nature and extent of help the victims require is an intensely discretionary task. Writing a contract that successfully captures all of the factors FEMA must consider would be virtually impossible. Even the State Department's harshest critics generally would not propose that private contractors make decisions about this country's relations with foreign powers.

Similarly, where the way the service is provided needs to adapt to changing circumstances, a contract that locks in a certain set of specifications for an extended period may not be ideal. This was one of the factors that led the federal government to discontinue its reliance on private contractors for airport security. As new threats emerge, the Department of Homeland Security can adapt security precautions much more quickly by giving orders directly to the airport staff rather than by negotiating new terms in contracts with private companies. Airport security also requires a delicate balancing of the need to prevent terrorist attacks with the need to avoid the economic damage that would result from making air travel too burdensome. The federal government's direct control of this process allows it to make adjustments more quickly if it finds security vulnerabilities or excessive delays in one or another part of the system.

Administering the Food Stamp Program requires both front-line and more senior staff to make numerous nuanced judgments in response to changing circumstances. As evidence begins to suggest that many households are misunderstanding a particular notice, administrators must decide whether to rewrite that notice, instruct eligibility staff to explain it differently in interviews, or to simplify the rules that the notice is trying to explain. Eligibility workers must judge whether an applicant's hesitant answers result from embarrassment or from an effort to defraud the program. Aggressively questioning every reticent applicant will drive off many eligible low-wage working families that badly need the program's help; ignoring signs of possible prevarication will open the program to abuse. Similarly, when an applicant seems to be having trouble understanding the program's rules, the eligibility worker needs to decide if the problem is a confusing explanation, a mental disability that requires an accommodation, or limited English proficiency, which requires an interpreter. The state has no hope of being able to specify how these and countless other delicate judgments should be made in the terms of a contract. Instead, all employees of the contractor will be obliged, out of duty to its stockholders, to make decisions based on its bottom line. Although not all state employees may live up to the lofty vision of public service, at least that vision is the goal to be strived for; employees of a for-profit concern are expected to base their actions on what will best enhance its bottom line.

The acceptability of contracting also depends on tolerance for risk. Transferring responsibility to a new entity entails risks both in the transition and over the long term if the contractor proves not to be up to the task. The government no doubt could obtain a great bargain contracting out responsibility for transporting the President — what airline would not be willing to

absorb substantial losses to be able to advertise that it is the official airline of the President? — but obviously no one would consider doing so because the consequences of even a brief error in communications could be disastrous. On the other hand, we are comfortable contracting out refreshment stands in public parks because any failure would cause few serious problems. Decisions about whether to contract out administration of the Food Stamp Program to companies currently lacking the necessary infrastructure therefore depend in part on a judgment about how troubled we would be if those contractors failed and left many eligible low-income families without food assistance for some period of time.

## **Possible Strategies for Safeguarding Program Integrity and Effectiveness while Exploring Privatization**

Privatization need not be an all or nothing proposition. Private contractors already perform numerous functions for the program, including the design and operation of automation systems, electronic delivery of benefits, research and evaluation, the design of outreach materials, etc. Indeed, the most significant difference between the Food Stamp Program and the commodity distribution programs that preceded it (as well as today's TEFAP) is privatization of the distribution of food through commercial food retailers. That decision sharply reduced program costs and increased recipients' choices among foods. Thus, the question about whether private contractors would have a role in the Food Stamp Program has never been seriously in doubt. The key questions are, first, *how much* of the program's operations will be turned over to private contractors, and, second, *which* aspects are best turned over to them and which are best kept in the hands of public officials.

If a political decision is reached to explore further privatization of the Food Stamp Program, a state could try contracting for some kinds of functions to see whether it saves money and improves the program's operations. State and federal officials should collaborate to develop a detailed list of specifications that should be in any contract to administer the program. Prior to implementation of EBT — a far simpler process — federal and state officials conducted numerous studies and tests of technical issues, contract specifications, etc. A state also could try contracting for administration in some parts of the state before making a decision about whether, and how, to make statewide changes. The private contractor should open its office first; only when that office is running smoothly should the public office be closed. In automating food stamp benefit delivery, states maintained the infrastructure of paper coupon issuance until their EBT systems were up and running. They should follow a similar approach here. If the state's initial contract specifies that the contractor will take over statewide, its best employees will find jobs with better long-term prospects and the state will have little choice but to proceed with the roll-out even if the contractor's performance in the initial counties is highly problematic. Just as importantly, the state will not know what issues it needs to address in a contract for statewide administration until it sees the results from a limited pilot. Neither of the plans currently under discussion appears to give the states this opportunity.

A rigorous, in-depth evaluation of any contracting also is essential, both to identify corrections needed within the states affected and to help develop expertise to guide any future contracting ventures. This is particularly true because of the reduced availability of programmatic



data that, as discussed above, is otherwise likely when the state agency is displaced. In addition, strict limits should be imposed on contractors' ability to protect as proprietary information, or to destroy, the policies under which they administer the program and the files and data they compile in doing so.

To avoid the sort of loss to the federal or state governments that the failures of automated systems have caused in California, Florida, Michigan, and other states in the past, any contractor should be required to be bonded against possible bankruptcy, against the inability to pay any penalties assessed for non-compliance, and against any increase in the food stamp QC error rate. Requiring bidders to satisfy bonding companies that they will not produce losses like the \$200 million Florida experienced in 1992 will provide the program with additional assurance about their competence. Contracts also should include large penalties against contractors that cease to perform before the contract expires; these should be sufficient to compensate the state for the inflated salaries and rents it likely will have to pay to reconstitute its eligibility determination system on short notice.

Privatization ought to be approached with the care appropriate for any dramatic change in the role and responsibilities of government. Contracting problems are inevitable. Beginning on a limited scale, and with an intense evaluation, will help identify those problems while they are still affecting relatively small numbers of people. They also will allow the government to negotiate broader contracts from a position of strength — while it is still free to decline to work with contractors — rather than with its own infrastructure already disbanded.