

# A Review of Contracting Out in US Medicare HMOs: Theories and Hypotheses

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**Abstract :** A striking feature of health policy in the United States is the heavy reliance of Medicare on private institutions including such as health maintenance organizations (HMOs). Medicare HMOs became attractive to the public sector for several reasons for because they seemed to be able to controlling program costs and improving improve beneficiaries' access to quality health care, and quality of care. However, as the number of HMOs increases, there is pressure on managed care entities to reduce their costs. This study, relying which relies on several theories of inter-organizational relationships and contracting out, develops some theories and hypotheses regarding on how Medicare HMOs' organizational factors influence their organizational performance. This study argues that the performance of Medicare HMOs depends on the capability of ability to both managing manage and implement contracting contracts, and implementing or providing contracted service.

## INTRODUCTION

This paper focuses on the performance of contracting out in the public sector. The analysis unit is Medicare HMOs program. Enrolling in Medicare Health Maintenance Organizations (HMOs) is encouraged because of the expectation that HMOs reduce Medicare costs. However, Medicare HMOs, which are paid 95% of the average yearly fee-for-service of Medicare expenditures, are increasingly believed to benefit from selecting a healthier Medicare recipient. Recent GAO reports (GAO, 1995a; 1995b; 1996a; 1996b; 1996c) point out numerous managerial flaws of Health Care Financing Administration (HCFA) related to Medicare HMOs programs. For example, the agency does not routinely examine HMOs' compliance with internal quality assurance plans or limits on provider risk sharing. However, despite the poor performance of Medicare HMOs in Florida, HCFA has been reluctant to use sanctions to enforce federal rules. In addition, the agency neither collects utilization data that could reveal patterns of under service, nor distributes the HMOs performance data to Medicare beneficiaries. The rate setting method has also been a hot topic related to overpayment or waste.

Despite the expectation that contracting out reduces expenses and provides a better quality of service, however the evidence for these beliefs needs to be examined. The public choice perspective argues that a competitive market under government contracting out produces the optimal solution for government agencies, private contractors and clients. However, in the real world, government contracting out occasionally involves a non-market situation (i.e., private bidder, politics and bureaucratic interests) and formidable transaction costs of managing contacting out process. The non-market situation and transaction costs often have a negative impact on the performance of the

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contracted services, which in turn, raises the problem of public accountability.

Contracting out between the government and a private contractor encounters two major problems: asymmetric information and goal conflicts. It is uncertain whether contracting out allows holding private contractors responsible for clients as are legislators and government agencies. Thus, the extensive use of outside private providers tends to create formidable transaction costs in managing the activities of outside providers. Furthermore, the institutional constraints in the public sector tend to negatively affect the performance of the contracted services. Government has its own institutional constraints (i.e., various goals, due process, multiple principals and transparency) that inhibit a public manager's responsiveness. If government cannot appropriately control private contractors' moral hazard and adverse selection, the performance of the contracted services can be worse than in-house production in terms of production costs and quality. Thus, this paper hypothesizes that the overall contracting out performance is a function of the capability of managing contracting out.

In order to test this hypothesis, this paper focuses on how major organizational variables involved in contracting out influence the performance of the contracted services. This paper assumes that the overall performance of the contracting out is a function of (1) the capability of managing contacting out (principal's capability) and (2) the capability of implementing or providing contracted service (agent's capability).

As Prager (1994) argues, contracting out is not a panacea. The history of the US government's contracting out reveals both advantages and disadvantages of contracting out. The main purposes of contracting out are to reduce production costs and the role of government and hold the public sector accountable. However, the recent records of contracting out in human services show that both government and the private contractors can lose their distinctive characteristics. Both "hollow state" and "shadow state" arguments support this pathology of government contracting out.

The hollow state argument is that the growth of contracting out has hollowed public sector accountability. The outsourcing strategy can result in both losing in-house and managing capacity (controlling over prices of the contracted services and frauds). Medicare managed programs show waste and fraud. In addition, controlling Medicare costs is already beyond government capacity. Mutual dependency to reduce uncertainty and information problems is useful for government officials, legislators and private contractors, but not for clients.

In order to test this "hollowness" in the public sector's contracting out, this paper notes (1) contract politics (corruption), (2) institutional constraints (i.e., multiple principals, fairness/transparency, various goals), (3) information dependency on private contractors, and (4) characteristics of the contracted services (complexity and measurement problems). This paper assumes that these factors have a negative impact on contracting outcomes.

The shadow state argument criticizes that the growth of contacting out has not reduced but expanded the role of government. Resource dependency on government funding and contract regime has constrained the autonomy of the private contractors. Thus, the growing dependence on government contracts and grants reduces the benefits gained from encouraging volunteer sectors. This paper argues that this can constrain the private contractors' capability. When bureaucratic incentives coincide with contractors' seeking profit, clients' interests are often neglected.

In order to test this shadow argument, this paper introduces two hypotheses. First, the growing and long-term dependence on government funding encourages private contractors to seek intimate relationships with government. However, this cooption and long-term relationship often result in contractors losing their distinctive characteristics, which are essential to reducing costs and providing better service. Second, contract regimes such as regulations and requirement policies also constrain the positive characteristics of private contractors.

## **THE ORIGINS OF CONTRACTING OUT**

The main purpose of contracting out comes from inefficiency of “in-house production”. No organization is so integrated that it effectively produces all the resources it uses and all the products it provides for its clients. Organizations often contract out when it is not desirable to produce internally in terms of (1) the economies of scale and scope, and (2) the efficiency of organizational structure (Prager, 1994).

First, if the economic scale and scope is not optimal for internal production, outsourcing such as contracting out can be considered reduce expenditures. The firm need not consider contracting out when it is large enough to take advantage of the productive efficiencies that accompany economies of scale and scope. Thus, contracting out may be more efficient for small organizations that cannot take advantage of economies of scale and scope. Governments can contract with other government agencies and private organizations. In particular, public choice theories illustrate that contacting out with profit organizations can create a competitive market, which in turn can increase efficiency and consumer choice and reduce government spending.

Second, organizational constraints sometimes require outsourcing production. Even when a single organization has an optimal economic scale and scope, complex business organizations with layers of bureaucracy increase costs and constrain the responsiveness to their environments. Internal organizational inefficiency can offset the production cost savings resulting from economic scale. In the same way, contracting out may be used in the public sector to improve access necessary services and to avoid management conflict or resource constraints (DeHoog, 1984).

However, unlike private organizations, government has other reasons for contacting out such as political interests, social and national objectives, curbing expenditures and promoting flexibility. Government privatization moves such as contracting out start from a political ideology that it is inappropriate for government to perform tasks that the private sector could completed. For instance, former President Ronald Reagan established the President’s Commission on Privatization (1988) to “review the current activities of the federal government.” Government and contractors may also want to achieve their own ends through contacting out. By developing new technology in environment and defense, government can collaborate with private companies, universities, and other research firms. This is closer to a cooperative partnership than the traditional contractual relationship. In this case, the co-operational relationship can reduce problems such as goal conflicts and asymmetric information, both of which have been a major issue in the principal and agency theories.

## **THE HISTORY OF CONTACTING OUT IN THE US GOVERNMENT**

Contracting out has long been used by American governments as a privatization mechanism. For example, when George Washington commanded colonial troops, he complained about private contractors because they were so slow and often stole the highest quality supplies, which they resold for profit (Kettl, 1993, 6). As Kettl argues, waste and fraud in America defense contracts began even before the country did. Despite these problems, contracting out continued. From defense to nuclear weapons, social services to health programs (i.e., Medicare), environment regulations (i.e., Superfund program) to the savings-and-loan bailout, the federal government has chosen to build partnerships with the private sector rather than doing the job itself. In fiscal year 1991, the federal government spent more than \$210 billion of a \$1.4 trillion budget on contracting out. Although the data on contacting out by state and local governments are unavailable, they have dramatically increased their reliance on the contracting out (Kettl, 1993, 13). The following section introduces the historical background to contracting out in the United States and focuses on the Medicare program.

### **The Traditional Contracting Out Period**

From the Civil War until World War II, the basic rules governing government contracts with the private sector was based on an arm's-length relationship with its suppliers. The government contract required specifics for the goods and services it purchased. The lowest bidder was awarded the contract. This approach provided stable rules and uniform products, which in turn, reduced costs and encouraged business to compete.

### **The Cooperative Period**

After World War II, the government changed its role in the contract process and goals. The traditional contract process based on technological certainties and cost savings assumed a passive role in designing the contract. Instead of writing clear specifications and contacting for thoroughly tested and proven goods, government officials began to assume risks with their procurement system. Military officials worked cooperated with private contractors to design new systems. This contributed to promoting innovation, but the arms'-length relationship between buyers and sellers was replaced by a cooperative partnership. Thus, the government began relying on the private sector for new technology and initiatives in space, agriculture, health, natural resources and defense policy. In particular, federal funding for research and development rapidly increased. The nation's space program shows that the National Aeronautics and Space Administration has relied on private contractors to perform research and development, build spacecraft and manage the systems that make them fly (Kettl, 1993, 6-10). Most of the dramatic efforts in space, defense and atomic energy would not have been possible without the partnership of industry, universities nonprofit laboratories, and government. University, industry and the volunteer sector all implement government projects.

In addition to the U.S Department of Defense, the Department of Energy (DOE) and the Environment Protection Agency (EPA) utilize contracting out. In the early 1990s,

the DOE had approximately 160,000 employees but only about 19,000 were civil servants. The rest were DOE' contract employees for cleaning up hazardous and toxic wastes at plants. The EPA's Superfund program to clean up hazardous waste sites contracted out \$10 billion to private firms. In Florida, some public housing, public schools and state university affairs have been contracted out. In California, parole violators have been housed in facilities run by contractors (O'Leary, 1996, 263-264).

## **Contracting Out and the Welfare State**

Since the enactment of the Great Society legislation of the 1960s, most social programs have been managed through a two-step approach (Kettl, 1993, 10). First, the federal government defines general goals and then awards grants to state and local governments to manage these programs, which have contracted out most of the programs to local nonprofit organizations.

The delivery of health and social services has mainly been conducted by federal funding with private contractors and non-governmental (both nonprofit and for-profit) organizations. Because of ingrained American hostility to the central government, rarely does the federal government deliver services directly. Rather, it tends to operate through other entities (Salamon, 1992, 46) such as state/local governments and private business, and increasingly since the 1960s, private nonprofit organizations. The federal government generates funds but turns the actual delivery of services to other organizations.

Both the profit and nonprofit sectors have been the major beneficiaries of this contracting out process. New social service and community development programs provide grants-in-aid to state and local government, which in turn often contract with local nonprofit organizations to provide such services as "Meals on Wheels," day care, residential care, adoption assistance, etc. Between 1971 and 1978, the contacting out of social services funding increased from 25 to 54 percent. (Mueller, 1979, 47).

However, the long-term relationship between government and private contractors raises major problems such as reduction of accountability and a decreased advocacy role of the nonprofit sector. The mutual dependence has reduced the organizational capability of both government and contractors. A major argument that support this negative view of the extended long-term contractual relationship is the "Hollow state perspective" that argues that the governmental capability in monitoring the contacting out process decreases as the contract relationship becomes more intimate and dependent (Kettl, 1993; Smith and Lipsky, 1993). A second argument, the "Shadow state view," contends that contacting out has not reduced the role of government, but on the contrary, has extended the role of government through its mutual dependence on the private sector (Wolch, 1990). The nonprofit sector has been so seriously compromised by the intervention of government that it is rapidly losing its distinctive qualities. Formerly positive terms such as "pioneer," "gap-filling" and "partnership," which defined the nonprofit sector's positive characteristics, are no longer adequate. In other words, the private contractor's capability has decreased as government contracting out has increased. In sum, these two perspectives suggest that the loss of autonomy and the blurred boundary between two parties may negatively affect organizational performance.

## **Contracting Out and Medicare**

Medicare is a federal health policy based on the contracting out. In the United States, hospitals, clinics and physicians in the private or nonprofit sector provide Medicare, not government agencies. The program is based on the contracting out relationship between government and private providers. Although the federal government finances the program, the private and nonprofit sectors administer it. The contracting out is divided into two major different financial systems: fee-for-service program and managed care program.

The recent growth in market-based contracting out and the ascendancy of managed care has generated substantial changes in the health care delivery system. Following the private sector's trend, the two largest public health programs, Medicaid and Medicare, have looked to managed care to constrain their expenditures. However, privatized health care in the form of government contracts has failed to control costs and the growth of government as its advocates contended. Ironically, this form of privatization has expanded the role of government by forcing increases in public expenditures and by requiring many new regulations (Smith and Lipsky, 1992). In this sense, it seems that contracting out does not follow market principles and is fraught with politics and inadequate information.

In 1996, Medicare's fee-for-service program covered almost 90% (35 million) Medicare beneficiaries. Health Care Financing Administration (HCFA) administers Medicare's fee-for-service program primarily through a network of about 70 claims processing contractors (i.e., insurance companies such as the Blue Cross and Blue Shield plans). As Medicare contractors, these private fiscal intermediaries administer the program, which includes receiving bills, reviewing the claims for compliance and procedure, and making payments (Kettl, 1993, 10-11). The contractors pay health care providers and beneficiaries with federal funds, and they are reimbursed for their administrative costs. They are also responsible for the payment safeguard activities that are intended to protect Medicare from making inappropriate payments. The contractors have broad discretion in conducting these activities, which results in significant variations across contractors in implementing payment safeguards (GAO, 1997c; 1997d).

The Medicare program covered about five million beneficiaries at the end of 1996. The managed care program is funded by both Part A and Part B trust funds and is mainly composed of risk contract HMOs that enrolled about four million Medicare beneficiaries in 1996 (GAO, 1997b). Risk contract HMOs are Medicare's principal managed care option.<sup>1)</sup> However, despite the option of receiving managed health care through HMOs, Medicare beneficiaries have enrolled in HMOs to a much lesser degree than persons who have other private-sector health insurance. Since the initiation of Medicare in 1965, the program has traditionally provided health insurance coverage to the elderly and disabled although HMOs have had the legal ability to contract with Medicare beneficiaries on a fee-for-service basis. For Medicare, the traditional fee-for-service has dominated the contract type.

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1) Other Medicare HMOs include cost contract HMOs and health care prepayment plan (HPP) Cost contract HMOs allow beneficiaries to choose health services from their HMO network or outside providers. Health care prepayment plans may cover only Part B services. Together, both types of managed plans enroll fewer than 2% of Medicare enrollees.

The effectiveness of the Medicare HMO program requires adequate federal monitoring and oversight. However, recent GAO reports suggested that there were a number of problems with HMOs. For one, HCFA has been lax in enforcing HMO compliance with program standards. Moreover, the agency was reluctant to take action against non-compliant HMOs even when there was a history of abusive sales practice, delays of beneficiaries' appeals of HMO decisions to deny coverage and patterns of poor quality care.

In addition, HCFA does not provide beneficiaries with any of the comparative consumer guides that the federal government and other employer-based health insurance programs routinely distribute to their employees and retirees. Comparative performance data are a key to promoting HMO competition. However, HCFA missed an opportunity to show beneficiaries which HMO plans are better and hindered the HMOs' effort to benchmark their own performance. Instead, HCFA collects information on each HMO's premium requirements and benefit offerings, enrollment and withdrawal data, records of enrollees' complaints and results of certification visits to HMOs only for its internal use. Another issue of administering the contract is Medicare's rate-setting method for risk payments to contracted HMOs. Due to a methodological problem in HCFA's approach to paying HMOs, the contract program has actually spent more for HMO enrollees than would have been spent under a fee-for-service (FFS) arrangement. Researchers attribute this result to "favorable selection," or the tendency for healthier than average individuals to be enrolled in HMOs.

## **THE THEORETICAL ISSUES OF CONTRACTING OUT**

Several theoretical perspectives show that contracting has both advantages and disadvantages. First, public choice perspective stresses the benefits of contracting out on the assumption that market competition creates savings and avoids inefficient bureaucratic processes. However, the basic assumptions such as sufficient information and market competition in contracting out are not always satisfied. Public choice theory also neglects transaction costs involved in the contracting out. Furthermore, the politics surrounding contracting out and organizational capacity of managing the contacting out process can eliminate the positive aspects of contacting out. Organizational theories show that the performance of contracting out is a function of various dimensions such as contractual politics, organizational capacity (institutional constraints, contract regime, motivation and leadership) and characteristics of the contracted services (measurement problems).

### **Public Choice Theories**

Various public choice theorists have focused on the positive aspects of contracting out (Dehoog, 1984). They maintain that contracting out lowers costs and improves the quality of services, which in turn leads to a reduction in government growth. Their arguments start from the following assumptions. First, market competition requires more than two contractors; otherwise, a single contractor has little incentive to reduce

costs and provide a higher quality of services. Secondly, the principal is assumed a rational decision maker who can identify whether it is better to provide the service in-house or contract out and is capable of choosing the best contractor among alternative outside delivery agents. Finally, the principal must monitor the agent's compliance and service performance to prevent illegal activities and mismanagement of funds. However, this perspective requires three major conditions: competition in the environment in the contracting out procedures, rational decision makers and effective oversight (DeHoog, 1984).

Market imperfection occurs because of imperfect competition and information. In many professional and technical fields, since that requires a large initial investment for specialized equipment, there are usually only one or two contractors. For example, the Department of Defense regularly uses sole source purchase procedures because only one contractor can produce the specified product. In this situation, competitive market pressures are minimal. In contracting out, information is needed to review costs, performance and effectiveness; however, it is difficult to obtain objective and accurate information. The quality of service is difficult to measure and information is often collected from the contractors themselves. The contractors, of course, have incentives to manipulate the information about outputs to their own advantage; market competition and the adequate information necessary for efficient contracting out are unlikely to materialize.

Whether these conditions are satisfied, this perspective does not consider the politics between principals and agents such as goals, conflicts and cooptation because it assumes that conflicts are small. Thus, it assumes that the basic management of any contract is to induce an agent to behave as if the agent were maximizing the principal's welfare. This perspective argues that the impact of the contractual relationship or the contract process is a neutral outcome of the contracted service. The contract is expected to create positive results for both parties if the conditions are competitive. However, many studies show that contract involves both advantages and disadvantages because of internal and external constraints (DeHoog, 1984; Ferris and Graddy, 1986; Prager, 1994; Bachman, 1996).

### **The Limits of Public Choice Perspective**

Public choice perspective assumes that bureaucracies in the public sector are inherently inefficient and oppressive. This perspective argues that the contract can spur competition among providers, lower costs and improve the quality of service. Realistically, however, contracting out faces barriers such as uncertainty and institutional constraints.

Traditional agency theories are based on rational choice theory. Individuals are rational actors with complete information and seeking to maximize utility within a free market. In the market context, the principal-agent relationships tend to access a point at which principal preferences and agent actions interact. This equilibrium is decided at the point to maximize the benefits of both principals and agents. However, this assumption often sacrifices descriptive accuracy in a complex reality. Without complete information on preferences, principals and agents are both in the dark (Worsham, Eisner and Ringquist, 1997). Thus, a paucity of information leads to disequilibria.



In addition, the public choice perspective neglects such factors as political environments, organizational constraints, and an imperfect market and information (DeHoog 1984, Bachman 1996). Most previous studies focused on cost comparisons between in-house production and contracted services. In other words, previous studies tended to focus only on outcome such as costs. Previous research does not extend beyond cost comparisons such as an analysis of comparative efficiency. Although quality of service and effectiveness are key issues in human services, there are few studies. While contracting out may reduce costs, clients do not necessarily continue to receive the same quality of service.

Another weakness is that most contacting out studies have focused on the results of contracting out, not on the decision making process. Decision-making involves the administrative costs of determining procedures and awarding, negotiating and monitoring procedures. The contract management directly influences the outcome of the contracted services by controlling contractors and intervening in the market for competition. According to organization theories, the effectiveness of this process depends on organizational resources and structure, incentives, and the relationship with contractors.

Third, the process of the contacting out is based on politics and other social objectives. Conservative politicians tend to support contracting out as a method of curbing big government. In addition, contracts can promote social and economic objectives. Examples include nurturing small business, promoting minority business, using recycled materials and employing the handicapped (O'Leary, 1996). However, political factors such as a long-term contractual relationship have tended to negatively affect the contracting out performance (Smith and Lipsky, 1992; Smith, 1996; Wolch, 1990).

## **Organizational Theories of Contacting Out Management**

The main reason for preferring contracting out to inside production is that it is usually assumed there will be cost reduction and better quality. However, the outcomes of contacting out are a combination of factors. Organizational theories show that the outcomes of government contacting out depend on (1) transaction costs, (2) institutional constraints, (3) characteristics of the contracted services and (4) the politics of contacting out.

### **Transaction Costs**

Transaction costs result from the change from inside control (hierarchy) to a contract between two organizations (arranged network systems). Contracting out changes the organizational process from intra-organizational to inter-organizational. In the case of in-house production, organizational procedures are usually based on a bureaucratic hierarchy (a chain of authority from policy to product). However, separating policy makers from policy output creates costs involved in choosing contractors and monitoring performance.

Various institutional arrangements work against achieving a long lasting, system wide equilibrium solution. Complex business organizations involve drive costs upward and prevent a rapid response to market. In this case, the diseconomies of coordinating operations of a large firm can overwhelm the production saving costs from a large

economic scale. The firm's managers exert direct control over the firm's assets and employees. However, the firm's control over contractors is more indirect and subject to the parties' interpretation of the contractual agreement. As Oliver Williamson notes, no contractual arrangement can resolve this asymmetry and specify all possible contingencies between parties.

### **Institutional Constraints in the Public Sector**

Previous studies have done little to distinguish between contracting out with private firms and with government, but there are differences between the two. Traditional principal-agent theories have several limitations in explaining the similarities and differences between both sectors. Thus, it should be noted differences between public and private management surrounding principal-agent relationship (Knott, 1993). This approach shows that the contractual relationships between government and the private sector tend to be more affected by external constraints and internal management (inter-dependence, information asymmetry, and conflict of interests), compared to the one between private sectors.

#### **Profit Role and Incentives**

The profit motive is different in public and private sectors (Knott, 1993, 107). Efficient production in the private sector is reflected in the profit motive because firms can retain earnings so their operations are based on sales revenues, not budgets. Savings from contracting out is directly related to their earnings. Private managers can retain savings in the form of profit. However, there is little direct connection between taxes and spending on contracting out. In the public sector, the motivation to minimize costs is found in power, prestige and responsibility rather than monetary rewards. The pecuniary rewards of public sector employees may be a consideration. The bottom line is whether the financial incentives are equal to non-financial incentives.

#### **Multiple Principals**

The difference between the public agencies and the private firms is the number of external stakeholders. Private managers operate primarily within the hierarchy of the firm. In business, management is centralized in an individual: the Chief Executive Officer (Knott, 1993). However, public organizations are composed of numerous principal-agent linkages both within and between organizations (Worsham, Eisner, and Ringquist, 1997). Under multiple hierarchies (a legislative body, a chief executive, interest groups, and the courts), public agencies are presumed to have less control over the contacting out process than their private sector counterparts.

Organizational complexity in the public sector limits agencies' ability to identify principals' preferences, which in turn, delays contracting out. The US Congress is as a complex organization. Although there is a nominal hierarchy, jurisdictions overlap; subcommittee autonomy and the persistence of localism makes it difficult to know what Congress really wants. A bureaucracy is also a complex organization. Despite a hierarchical distribution of power and task specification, various environment sources create coordinating problems. Moreover, agencies often receive conflicting directives (e.g., savings and higher quality) and pressures from elective institutions. The existence of

multiple principals, multiple policy dimensions, limited information and blunt tools of control may force agencies to engage in a search process as they grope for a policy that satisfies the greatest number of principals (Worsham, Eisner, and Ringquist, 1997). However, this process has a cost.

Limited information about agents also constrains the public sector. Congress assumes that the administering agency act in good faith. A chief executive appoints agency heads with the expectation that the executive aims will be followed. However, delegating authority is necessary, and it creates uncertainty because of asymmetric information. Thus, elected officials may find it difficult to ensure that administrators faithfully pursue established goals. This uncertainty creates various institutional constraints.

#### Publicness {Not a Word no Idea What is Meant}

Transparency and fairness are high priorities of good government (Prager, 1994). The public sector bidding process must be structured to assure equal access (e.g., adequate time, sealed bids). If problems emerge during internal production, goals and management can be adjusted within a government organization. However, in the contacting out relationship, goals must be more specific than in the internal production in order to improve the fairness of the contracting out (Kettl, 1993, 26). Government contracts award must be perceived to be fair by all. The media is also more likely to focus on public sector inefficiency than t private sector inefficiency. Thus, Government faces a more complex bidding process that is also a more time-consuming one. The private sector is relatively free to these constraints.

#### Various Goals

Public service contracting out s has various goals; one is to reduce costs. However, other goals such as political support, social or national objectives and bureaucratic motives sometimes play important roles in introducing contracting out. Government officials who contact out may not be interested in single-mindedly pursuing efficiency.

Operational goals may be formed by individuals' needs, professional norms and other pressures (Smith, 1996). For the state mental health programs, purchasing agencies have many goals (savings building political support, the maintaining accountability of public funds and fairness). In general, many organizational goals limit maximizing organizational capacity.

#### **Characteristics of the Contracted Services**

Privatization is less appropriate when human services are involved. This is because human services outputs are difficult to measure, the risk of failure is more serious and the need for accountability greater (Gormley, 1991, 311). The difficulty measuring quality in social services influences the monitoring of the contacting out process and evaluating the outcomes. This may encourage private contractors to cut costs and reduce the quality of the service in order to maintain profit margins.

#### **The Politics of Contacting Out**

##### Bureaucratic Politics

Organizations develop their own internal standards, but there are different internal

standards between public and private agencies (Wolf, 1988, 66-68). Thus, government and private firms manage contacting out differently. The internal standards of the market organizations are related to market signals such as revenues and consumers' responses. Market signals directly influence the survival of the market organizations. Thus, the internal pricing system is connected to the external pricing system. However, the internal standards of government organizations are less sensitive to market organizations because of the absence of output measures and consumer feedback. The internal process may be independent of the public interest, which is contrary to rational for public agencies. Internal management can revolve around a constituency that has succeeded in cooping a public agency.

Internal management in a public bureaucracy can also complicate government contracting out. Internal power struggles can sometimes become more important than for what the agencies are contacting out. In an uncertain political environment, agencies sometimes concentrate their energy on building political support rather than on managing their programs (Ingraham and Rosenbloom, 1990). Communication barriers between political appointees and career officials also muddy the internal management waters. In the same way, a communication gap between technicians and higher-level managers complicate the contacting out management.

Bureaucratic interests influence contract management. Unlike pluralist assumptions that government is neutral, government contracting out tends to be cooped by those interests that are the most organized (Lowi, 1969). The politics of co-optation shows that making contract decision is neither competitive nor truly open; each of the players gain through mutual regularized, supportive relationships. In order to survive and expand, bureaucrats mobilize political support through strong clientele relationships. Thus, bureaucrats can favor certain contractors and thereby achieve predictability, cooperation and political support in their program areas. Contracting decisions are often colored by officials' personal goals rather than lower costs. For the Department of Defense, federal contracts are influenced by relationships between officials and contractors, or by senators eager for political rewards. At the local level, for political reasons city officials may offer contracts to hometown firms rather than outside competition (DeHoog, 1984).

### Interest Group Politics

Interest groups are criticized for restricting the ability of government to enforce standards. Private producers are among the most active lobbyists in the United States. They lobby for higher appropriations and use their influence to secure favorable terms for government contracts and reimbursement systems. Interest group leaders take their cues from legislators, purchasing officials and the executive. The close ties between contractors and government officials facilitate an exchange of information (Smith, 1996).

If agents create political ties with principals, the relationship between principals and agents suffers. In such cases, contractors are partners rather than agents. The partnership can help shape contracting out and remove any oversight and beneficiaries of the program. This may result in reduced accountability and the lack of effective government contract management. Thus, a contract is usually renewed if the provider has support within the government.

### **Triangulation (Interest groups, Congressional Committees and Bureaucracy)**

Contractors have incentives to employ their resources for bureaucrats and legislators in order to reduce competition and gain advantage. In some cases, private contractors lobby for their programs; in other cases, government officials use private contractors to justify the political and organizational objectives they might otherwise be unable to justify through the normal legislative process (Rainey, 1997, 119).

In service areas in which investment in contracts are substantial, selection may be influenced by legislative partisanship as legislators reward constituents, neutralize opponents, or provide patronage to concerned neighborhoods (Kramer and Grossman, 1987, 38). Thus, legislators have incentives to assist contractors that offer political support to a legislative district.

In environments where cooption is rife, governmental officials have few incentives to monitor compliance and service performance. Because of their long-term relationships, officials will be overwhelmed by contractors' political strategies. The contracting out of government services is subject to various political pressures from elsewhere in government and interest groups. Agents' ability to make direct links to legislators, elected officials and administrators also increase contractors' autonomy (Kettl, 1993). In a contracting out relationship, government purchasers are accountable to multiple constituents such as the private contract agency, interest groups, legislators, the executive branch and the media (Moe, 1991).

## **ORGANIZATIONAL CAPABILITY AND CONTRACT PERFORMANCE**

### **Mutual Dependence, Contract Regime, and Contract Performance**

The original contractual relationship is based on the principal and agency model. In this model, the agent is commissioned to act on the principal's behalf, but their interests do not always coincide. However, contracting out always faces the difficulty of ensuring that the principal is faithfully served, and the agent is fairly compensated. The contractual relationship becomes more complex, especially when multiple principals are involved and the measurability of contracted services is ambiguous. If the principal does not have complete control over the agent, how does one avoid exploitation by the agent? This uncertainty in the process tends to introduce two strategies: mutual dependence and contract regime.

#### **Mutual Dependence and Performance**

Contractual relationships involve contract politics such as mutual dependency and cooptation. To reduce uncertainty, buyers and sellers tend to become more closely coupled. In this case, as Kettl (1993, 182-186) shows, the federal government's relationships with its contractors does not always adhere to the rules of the marketplace because of various social and national objectives (i.e., protecting minority, developing new technology and community economic development). When the political interests of both parties coincide, the relationship becomes more intimate; the growing interdependence blurs the boundaries. As boundaries blur, organizations face greater uncertainty of their goals, especially about

the technical aspects of programs and the political environment in which they must function in the public sector. However, it is unclear if the mutual dependence creates positive or negative effects.

According to the paradigm of partnership conception, the relationship between government and contractors is not inherently conflicted. In this view, these two sets of institutions are highly complementary and create important avenues for cooperation. For example, an informal long-term relationship between government and private contractors may open lines of communication (adverse selection and moral hazard). The intimate relationship suggests that trust develops with long-term relationships.

In contrast, intimate relationships tend to eliminate distinctive characteristics, which in turn create corruption. Sometimes, a government contract office relies on information from the private providers. The long-term politics can reduce accountability and to decrease the capability to manage it. Meanwhile, government is criticized for increasing resource dependency to constrain the autonomy of the private providers. As the voluntary sector become more dependent on government funding, the ability of the nonprofit organizations to advocate for the poor and oppressed is reduced (Wolch, 1990).

### **Contract Regime and Performance**

The criticisms about the leakage of accountability or the corruption from mutual dependency force government introduce various monitoring systems and regulations. However, contract regime based on rules and regulations to build competition and fairness affect the ability of federal managers to manage the contacting out process (Kelman, 1990) and private contractor's implementation.

The contract regime can limit the ability of public managers to exercise common sense and good judgment. Agencies sometimes complain about the extensive record keeping and burdensome reporting requirements. Kelman (1990) suggests that public managers be given more freedom to manage the contacting out process since they are responsible for the contracted results. It seems that the public sector's contacting out process inhibits managers more than does the private sector's process. The private sector tends to enjoy a more flexible and open solicitation process to select contractors.

The contract regime (i.e., rules, regulations and laws) is criticized as constraining the autonomy of private contractors. The contract regime can inhibit the innovation and creativity of nonprofit organizations that are outside the government and market. In social welfare policy, this has tended to limit innovation and expand the gap between service providers and recipients. However, such regulations are sometimes essential for protecting clients and maintaining the quality of service. In the case of Medicare HMOs, there are various regulations across 50 states that protect Medicare beneficiaries.<sup>2)</sup> It is uncertain whether government requirements concerning eligibility, staffing and quality assurance are serious threats to independence and market activities.

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2) In addition, a recent analysis of HMO licensure statutes and regulations in all 50 states showed that most states regulate marketing activities and require basic benefits, protections against insolvency, consumer complaint systems, quality assurance plans and external quality audits (Institute of Medicine, 1996, 306). However, the study also pointed out the diversity in state HMO licensure laws and found that few states set explicit standards for access (such as provider-to-enroll ratios, referral requirements, or maximum distance or appointment waiting times), prohibit self-dealing arrangements, establish specific quality standards or require a consumer role in plan governance.

## **Ironies of the Contacting Out Process**

Contracting out involves two major ironies. Proponents for privatization tout it as a cure for bad government, but it requires excellent government to make it work. However, the mismanagement of privatization may result in negative phenomena such as the lack of accountability and the increase of ineffective governmental intervention although contracting out can create savings and enhance flexibility.

### **Hollow State**

The expansion of contracting out can blur the lines of accountability and involve a greater bureaucratization of the private sector than a privatization of government. Contracting out may dilute government control and accountability. Through contacting out, government funds the contracted services while contractors provide them. In other words, contracting out separates public organizations from their output.

The disconnection between funding and provision hinders accountability. Thus, contracting out raises the important question about how public programs can be held accountable if private contractors provide them. This public management results in the expansion of nongovernmental organizations into the delivery of government services or “government by proxy” (Kettl, 1993). In addition, once the relationship between the payment and the ultimate result is severed, then the principal becomes vulnerable to agency manipulation (i.e., unnecessary health care). The experience of government’s growing dependence on the private contractors has been troubled by lack of governmental capacity to oversee the behavior of its private partners (GAO, 1996a). These processes support the view that “as private contractors increasingly take over governmental authority and activity, government is becoming hollower.”

### **Shadow State**

The “shadow state” perspective suggests that the growth of the state eliminates for-profit and nonprofit activity and renders them functionally obsolete. This view argues that the long-term relationships based on (1) resource dependency and (2) contract regime (regulations and laws) tend to destroy the nature of contractors.

Contracting out has increased the role of government through funding and regulation. It can lead to a governmentalization of [the] private sector, in which government draws segments of the private sector (Moe, 1996). Contracting out hides the growth of government from scrutiny (Smith and Lipsky, 1992, 248-250). Governmental expenditures in social services have expanded enormously as the number of employees working for the contractors’ agencies has dramatically increased.

Rather than reducing the size and influence of government, privatization has resulted in unprecedented growth and involvement of government in private organizations. The expansion of government shows how profit/nonprofit agency providers lose their identity and when they function as public agents.

### **Nonprofit Sector and Shadow State Argument**

Nonprofit sectors have unique characteristics such as “advocacy” and the presence of a moral commitment to keep this function alive. Both market and government have limits

on performing this positive function. Thus, the “market failure/government failure” theory of the nonprofit sector considers nonprofit organizations principally as an alternative to the state in the provision of collective goods.

However, several studies show that the growth of government funding can result in a failure of nonprofit sector. This view argues that as government increases funding of nonprofit activity, the advocacy role declines (Salamon, 1996). First, large nonprofit organizations tend to receive more government funding. Many nonprofit agencies are relatively small and undercapitalized and may have a few paid staff and scant resources to devote to political activity. These agencies may lack well-established political ties. In contrast, larger nonprofit agencies are usually more politically powerful. However, as agencies become larger, older and more professional, they can lose their commitment to advocacy (Salamon, 1996). This line of thinking leads us to expect that the larger and more mature and more professional an agency, the less likely it will engage in advocacy activity. As organizations professionalize, they inevitably become more conservative and adverse to advocacy.

In contrast, agency size and professionalism may not be detrimental to agency’s function. There is little evidence whether government support undermines the advocacy role of nonprofit organizations. It is unclear whether the expanded role of government is related to their function. There are few solid empirical studies about how an increase in government involvement affects the capacity of nonprofit or for-profit organizations.

As a response to the strict contract regime and the increasing resource dependency, private providers have used various strategies (Kramer and Grossman, 1987). First, they rely on a political strategy by forming a coalition of providers. The various forms of collaboration allow providers to achieve economies in operation and increase their competence. Such consortia can compensate somewhat for the competitive disadvantage of small, single program agencies.

Second, they use “creaming selection strategy,” which means selecting the more promising or the least expensive cases as a means of demonstrating cost efficiency. Contractors also use saving staff strategy that resorts to low or unpaid staff: they employ volunteers, low-paid paraprofessionals, pre-professional interns, unlicensed professionals. However, this strategy has negative aspects such as (1) high turnover, (2) coordination difficulties resulting from many short-term staff and (3) morale problems resulting from the large numbers of staff without employment security.

Third, they try to introduce more efficient systems of financial control and personnel management. However, seeking and managing contracts is especially burdensome for small agencies. Thus, a large well-established agency is usually able to obtain a more flexible contract than are smaller newer organizations. Contract conditions favor large bureaucratic agencies with grant preparation and management skills and political influence.

## **POTENTIAL HYPOTHESES IN MEDICARE HMO PROGRAMS**

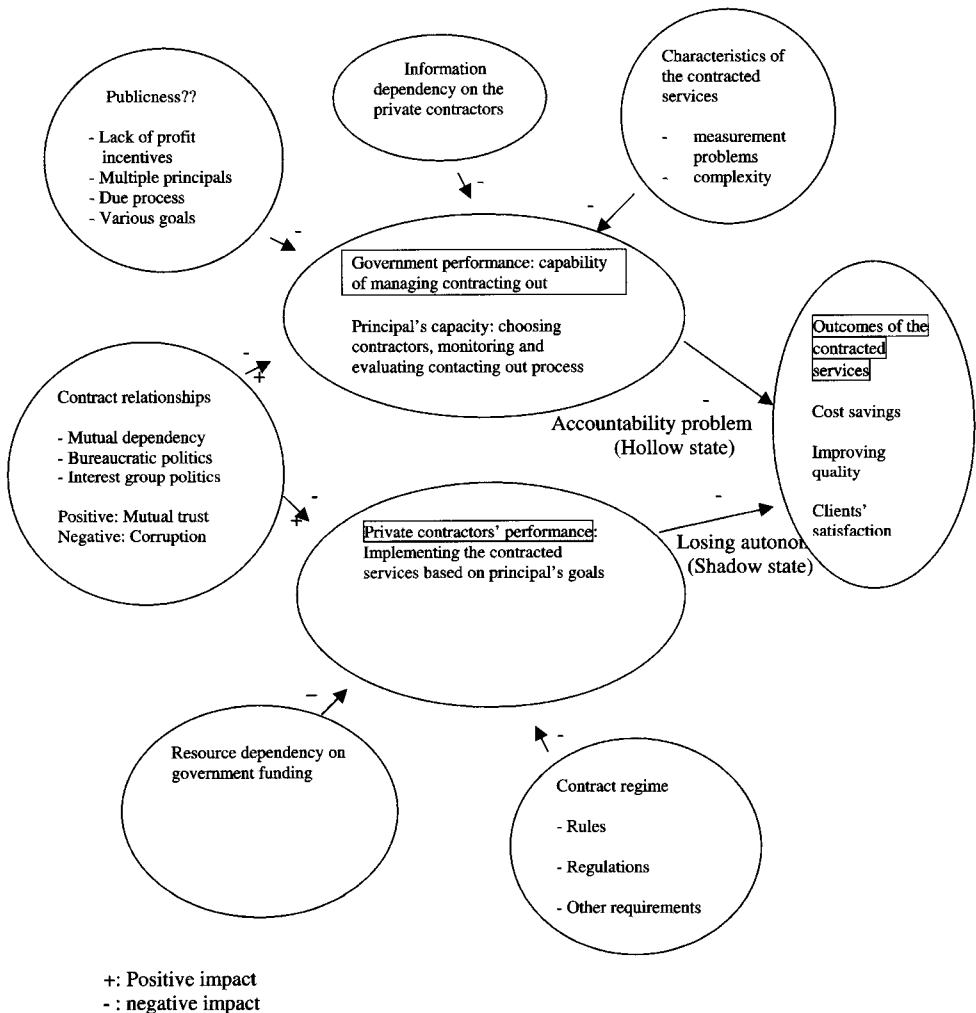
Research hypothesis focuses on how major organizational variables surrounding contracting out influence the performance of the contracted services. This paper assumes that the overall performance of the contracting out is a function of (1) the capability of managing contracting out (principal’s capability) and (2) the capability of implementing



or providing contracted service (agent's capability).

In order to analyze the capability of managing contracting out, this paper introduces (1) contract politics (corruption), (2) institutional constraints (i.e., multiple principals, fairness/transparency and various goals), (3) information dependency on private contractors, and (4) characteristics of the contracted services (complexity and measurement problems). This paper assumes that these factors have a negative impact on contracting out outcomes. The contract performance is also a function of the private contractors' capability. This paper hypothesizes that private contractors' capability will be constrained by (1) the level of resource dependency on government funding (2) interest group politics and (3) contract regime constrain contractor's positive aspects.

Figure 1 depicts the overall conceptual model, showing hypothesized relationships between the capability of managing contracting out, the private contractors' organizational capability and the performance of contracting out.



**Figure 1.** Contracting out Performance Model

## **The Capability of Managing Contracting Out**

*Hypothesis 1a: Mutual dependency tends to destroy managing capability and responsiveness of governmental contracting out.* For the last few years, HCFA's regional office in San Francisco has produced HMO comparison charts for selected market areas. HCFA's regional office in Philadelphia has also produced comparison charts. However, the regional offices distribute these charts mainly to HMOs and federally supported insurance counselors in the Information Counseling and Assistance program (ICA). Beneficiaries may request the charts from the regional offices, but few beneficiaries know the chart exist. Even the ICA insurance counselors, most of whom are volunteers, may be unaware of the charts.

The CareFlorida case illustrates that it takes HCFA a long time to respond effectively to problems found in its own investigations, which leaves Medicare HMOs free to violate Medicare marketing and enrollment rules with impunity. HCFA was reluctant to take action against non-compliant HMOs even when there was a history of abusive sales practices, delays in processing beneficiaries' appeals of HMO decisions to deny coverage and poor quality care.

*Hypothesis 1b: As the information dependency on contractors' increases, the institutional capability of designing contracts, controlling the contract process and evaluating of the quality of the contracted services will be more constrained.* The Department of Defense, the largest single contractor, has itself observed that accurate information on the nature and extent of contract studies within the department is difficult and often impossible to obtain. For example, this issue was raised in the relationship between the Environmental Protection Agency and its contractors. The contractors not only cleaned up toxic waste sites under the Superfund Program but also designed the requests for bids and even wrote testimony for the top EPA officials to give to Congress (Kettl, 99-127). A community mental health system also illustrated that the nonprofit mental health authority and the providers designed and implemented policy (Smith and Lipsky, 1992; Smith, 1996).

*Hypothesis 1c: The complexity of the contracted services involves significant expenses to measure and evaluate the contracted outcomes.* Even though the government operates a new information system to measure outcomes, the complexity of the process can be a hindrance. For example, HCFA recently introduced the Medical Transaction System (MTS) to detect fraud and abuse. However, the GAO reported that HCFA's management of its claims processing controls and Medicare's automated information systems were unsatisfactory. Medicare information systems and the staff monitoring are less than effective at spotting potential fraud (GAO, 1997c).

*Hypothesis 1d: As the complexity of the contracted services increases, the capability of managing the contracting out is further constrained.* The capability of the contract management is constrained by inherent methodological difficulties in evaluating the outcomes. The elusiveness of outcome measures makes it difficult to defend terminating a contract. Thus, many contractors challenged the termination because they are being

held accountable on the wrong measures.

Another example is Medicare HMOs' payment method. The problem of overpayment arises from difficulties of Medicare's rate setting for risk contract HMOs (GAO 1996a, 1997a). Because of a methodological problem in HCFA's paying HMOs, the contract program has actually spent more for HMO enrollees than their costs would have been under fee-for-service (FFS). Researchers attribute this to "favorable selection," or the tendency of healthier-than-average individuals to enroll in HMOs. Although the Congress gave the Department of Health and Human Resources authority to limit incentives, it seems that HCFA has paid little attention to risk-sharing arrangements. In 1995, HHS was still developing regulations and could not gauge how much risk a HMO could legitimately pass on to providers, or the requirements that providers had to meet to accept the risk.

*Hypothesis 1e: As costs involved in the contacting out process (monitoring, evaluating, and changing contractors) increase, the overall capacity of managing the contacting out process becomes more constrained.* The fragmented structure of the delivery system leads to excessive supervisory costs for staff time and monitoring. Termination and dispute resolution are complex acts because agencies typically accept goods and services from contractors over a long period. In addition, terminating a contract often has adverse effects on the officer as well as for the contractor. Often a contract cancellation disrupts the careers of government administrators, private contractors, and physicians.

*Hypothesis 1f: The lack of human resources constrains the capability of managing the contracting out.* HCFA's inadequate supervision is partially the result of a lack of human resources (GAO, 1997c). The GAO reported that HCFA's efforts to fight Medicare fraud and abuse are inadequate to prevent substantial losses because the available tools have been underutilized. Thus, it appears that HCFA's compliance monitoring reviews do not go far enough to verify that HMOs monitor and control care quality. The reviews check only that an HMO has procedures and staff capable of quality assurance and utilization management. They do not check for effective operation of these processes. Second, HCFA's review and certification is conducted without the participation of trained clinical staff or consideration of Medicare Peer Review Organization (PRO) findings. HCFA monitoring officials expressed the need for more trained staff to properly assess HMO's quality assurance systems.

In contrast to HCFA's approach, NCQA<sup>3)</sup> reviews primarily focus on quality assurance (GAO, 1997d). The NCQA review team includes two physicians and a clinician or administrator experienced in HMO operations. Accepting the GAO comments, HCFA has been studying ways to improve both quality standards for HMOs and quality-assurance review methods of since 1994.

*Hypothesis 1g: The Internal process in the public bureaucracy tends to result in delays in monitoring and correcting problems when compared to the private sector.* The

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3) The National Committee for Quality Assurance (NCQA) is a private agency that works with large employers on HMO quality standards. Its standards focus primarily on quality assurance in HMO's management of medical operations; its review and enforcement methods differ from HCFA's.

Internal standards of government organizations come from a responsibility for the public, rather than profit incentives. The private sector on the other hand reacts to market signals such as revenues and consumers' responses. Market signals have a strong influence on organizational survival.

In contrast, the public sector faces institutional constraints (i.e., fairness and due process) other than market signals. For example, Medicare, private health plans, is subject to the Administrative Practice Act and the Medicare statute, which in turn, can delay decision-making (Fox, 1997).

Decision-making processes based on fairness and transparency make government officials cautious and risk-averse while many decisions by private plans are judgmental and furtive. Government agencies must justify their decisions and are concerned about outside criticism from the press, Congress and the Office of Inspector General and the General Accounting Office is present. A consequence may be inaction or slow decision.

In the case of HMO contract management, private employers who contract with HMOs tend to respond effectively to HMO's poor performance. For example, large employers and the HMO industry seek ways to ensure quality and value in HMO care and demand HMO accountability beyond existing federal regulations. Some large employers are requiring the HMOs industry to undergo quality accreditation reviews conducted by the National Committee for Quality Assurance (NCQA). In addition, a group of large employers and HMOs are working with NCQA to develop standard HMO performance measures to enable stakeholders to compare HMOs and make informed choices.

In addition, the private sector has developed standards that enable stakeholders to compare different HMOs (GAO, 1997d). They are working with NCQA and developing the Health Plan Employer Data and Information Set (HEDIS). These data constitute a set of performance measures to evaluate quality of and access to care, member satisfaction, utilization of service and financial stability. Some employers already require their plans to submit HEDIS-based information. HCFA has now noticed the private sector's approach and begun developing HEDIS-type HMO performance measures. HCFA recently began testing the measures in 5 states and 23 HMOs.

By contrast, HCFA's responsiveness seems to lag. Federal standards require that HMOs have information systems to report utilization data and management systems to monitor utilization of services, yet HMOs often lack these data, and HCFA has not standardized the data submitted it to HCFA and to the PROs.

*Hypothesis 1h: Previous Medicare functions based on fee-for-service systems (policy inheritance) will constrain managing new tasks based on managed care systems.* Medicare has traditionally acted more as a bill payer than a private-sector purchaser has. In the past, HCFA made little effort to inform Medicare enrollees of their health care provider choices, treatment options or competing private health plans. There are several exceptions: for example the disclosure of nursing home inspections, public listing of high mortality hospitals, mailings containing preventive care information and some use of centers of excellence arrangements (Institute of Medicine, 1995, 72).

*Hypothesis 1i: Institutional constraints with multiple principals will be more likely to limit the capability of managing the contracting out.* The response to Medicare HMO

overpayment problems troubles in multiple principals. According to the GAO, HHS recently agreed that the current payment methodology might have resulted in Medicare's overpaying HMOs because Medicare HMO enrollees tend to be healthier than FFS beneficiaries are. The department of Health and Human Services (HHS) estimated that about \$1 billion was overpaid in fiscal year 1996. However, HHS noted that the President's fiscal year 1998 budget process to address the excess payment problem by lowering HMO capitation rates in calendar year 2000 and developing a new payment system to be phased in 2001. {These last two sentences deal with old data. Suggest deleting or updating.}

### **The Private Contractors' Organizational Capability**

*Hypothesis 2a: The increase of resource dependency limits the autonomy and distinctive characteristics of private providers.* Resource dependency theories have argued that contractors are expected to adapt to the contract regime in order to maintain contracts. This adaptation may result in losing contractors' own characteristics because contractors must conform to governmental requirements for expenditures and other accountability rules.

*Hypothesis 2b: Contract regime such as government laws, rules and patterns constrain the contractors' autonomy.* The power of the contract regime may have a great impact on the contractors as government funding increases. Less autonomy of contractors can constrain their performance: for example, contract regime can limit contractors' market activities (contractor's positive characteristics).

*Hypothesis 2c: Private contractors corrupt the contracting out process by offering generous campaign contributions to politicians and attractive jobs to helpful administrators.* Professional contractors associations are relatively powerful political actors who use campaign contributions and the other lobbying methods to influence the legislators who oversee the agencies they contract with (Cooper, 1980).

## **CONCLUSION: FURTHER RESEARCH PROSPECTS**

Contracting out in the United States demonstrated complex trade-offs. To date, it is unclear whether contracting out has improved the quality of service and reduced social and health services costs. It is also uncertain whether contract regimes such as the regulations and policies governing contracting out have a positive (preserving accountability) or negative (loss of autonomy of private sector) impact.

The picture of human services contracting out that emerges reveals a quasi-market system shaped by market forces, political influence and other contextual factors. Under the framework of welfare pluralism and interest group politics, the separation of government funding from provision is assumed to promote cost effectiveness, diversity, innovation and responsiveness. In contrast, some of the features of contracting out have shown a weakening of public accountability and the growth of political, bureaucratic

and commercial influences on human services. Public choice perspective, which provides the theoretical backgrounds for contacting out, does not entirely capture these contradictions of contacting out because of the unreasonable assumption that market can produce an optimal solution. The theory ignores the asymmetric information and goal conflicts that surround government contacting out involve formidable transaction costs, stakeholder politics and the decrease of organizational capacity to manage the process. Various organizational perspectives are expected to complete complex areas beyond the public choice theory.

Above all, future research based on organizational theory must tackle the following question: "Under what conditions are government and the private contractors accountable for reducing costs and providing better services?" Thus, research questions will move on to casual relationships between (1) contract outcomes and capability of managing contacting out and (2) contract outcomes and the private contractors' capability. To test these relationships, this paper has suggested several hypotheses; however, it is difficult to identify the relative impact of the methodological problem variables in the model in terms of measurement and controlling other confounding factors. Thus, future research should develop the most relevant model and include relevant variables and data.

Another important policy issue relates to how we identify the relative power of various factors that influence on the performance of the contracted services. An effective policy design requires the most relevant variable for policy goals. To date, it is unknown which factors are more important for the outcomes of contracted services. Some scholars (Smith and Lipsky, 1992; Smith, 1996) argue that the institutional design of the contacting out process is important and this view relates to organizational issues in the public sector. This perspective assumes that the outcomes depend on the institutional characteristics of the public sector that are distinct from private firms. Others (Ferris and Graddy, 1986; Moe, 1991) argue that bureaucratic incentives are more important for the outcomes. Combining institutional constraints and bureaucratic interests, we view the poor performance of the contracted services as agency problems.

However, many other confounding factors are involved in these arguments. At the macro level, organizational environments are assumed to control contacting out. In particular, both political ideologies favorable for privatization and huge budget deficits have been main influence on the origins and outcomes of the contracted services. At micro level, the complexity and sensitivity of the contracted services have constrained the capability of managing the contacting out process. These issues relate to a risk-averse bureaucracy that limits innovation and responsiveness and delays the decision-making process. In addition, the difficulty of measuring the outcomes of the contracted services, especially health outcomes, makes us wonder whether contacting out is effective, and which managerial strategies are relevant. It is important to disentangle such unsolved issues in order to develop organizational theories and future policy designs.

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