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Public-Private Contracting and the Reciprocity Norm

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Public-Private Contracting and the Reciprocity Norm

Keywords

Behavioral economics, Public contracts, Public-private sector cooperation, Contracting out -- Economic aspects, Reciprocity (Commerce) -- Social aspects, Economics -- Psychological aspects

ARTICLES

PUBLIC-PRIVATE CONTRACTING AND THE RECIPROCITY NORM

WENDY NETTER EPSTEIN*

When governments outsource work to private entities—running prisons and schools, administering state benefits, and the like—they tend to write extremely detailed contracts. The conventional thinking is that these private entities need to be constrained lest they act opportunistically. Therefore, governments write contracts that highly specify tasks, contain robust monitoring provisions, and financially reward task compliance. This detailed contracting approach, viewing agents as selfish, profit-driven, and looking for opportunities to shirk, finds support in both the agency cost and public law literatures.

This Article challenges the prevailing approach. It argues that control-based contracts can be not only difficult and expensive to write and costly to monitor, but they can stifle intrinsic motivation and innovation. Such detailed contracts frequently fail in practice with serious negative implications for the public.

Recent literature in behavioral economics suggests that the conventional approach is actually premised on a misunderstanding of human nature. Experiments on the positive reciprocity norm—meaning that people reward kind actions—have shown that less complete contracts induce higher effort levels and a more cooperative principal-agent relationship than the

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traditional approach. This Article incorporates this behavioral research and studies of real world behavior to present an interdisciplinary argument for why the traditional public-private contracting approach should be rethought, both in theory and in practice.

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INTRODUCTION

After the Navy discharged Aaron Alexis, a petty officer third class with a checkered performance record, he found work with a military contractor.¹ His job gave him access to sensitive military installations across the world.² On September 16, 2013, he used that access to kill twelve people at the Navy Yard in Washington, D.C., less than two miles from the Capitol.³

1. Sari Horwitz et al., *Navy Yard Gunman Had History of Mental Illness, Checkered Military Career, Officials Say*, WASH. POST (Sept. 17, 2013), http://www.washingtonpost.com/politics/alleged-navy-yard-gunman-had-checkered-military-career-officials-say/2013/09/17/a136ad0c-1fa1-11e3-8459-657e0c72fec8_story.html.

2. *Id.*

3. Peter Hermann & Ann E. Marimow, *Navy Yard Shooter Aaron Alexis Driven by Delusions*, WASH. POST (Sept. 25, 2013), <http://www.washingtonpost.com/local/>

Edward Snowden, a high school drop-out turned computer whiz, parlayed a job as a security guard for the National Security Agency into information technology work at the Central Intelligence Agency.⁴ After a couple of years, he left the CIA to become a subcontractor for the NSA.⁵ In May 2013, Snowden intentionally disclosed classified details of government surveillance programs to the press, creating tensions between the United States and some of its closest allies.⁶ He was subsequently charged with various acts of espionage.⁷

Alexis and Snowden have one surprising thing in common. They were both vetted by U.S. Investigative Services, Inc. (“USIS”), a private company the U.S. government contracted with to conduct background checks after the government had amassed an untenable backlog for top secret security clearances.⁸ By outsourcing to USIS in a \$2.45 billion, five-year contract, the government hoped to harness

crime/fbi-police-detail-shooting-navy-yard-shooting/2013/09/25/ee321abe-2600-11e3-b3e9-d97fb087acd6_story.html.

4. Farhad Manjoo, *If the NSA Trusted Edward Snowden with Our Data, Why Should We Trust the NSA?*, SLATE (June 9, 2013, 7:44 PM), http://www.slate.com/blogs/future_tense/2013/06/09/edward_snowden_why_did_the_nsa_whistleblower_have_access_to_prism_and_other.html; Eric Schmitt, *C.I.A. Warning on Snowden in '09 Said to Slip Through the Cracks*, N.Y. TIMES (Oct. 10, 2013), http://www.nytimes.com/2013/10/11/us/cia-warning-on-snowden-in-09-said-to-slip-through-the-cracks.html?_r=0.

5. See Schmitt, *supra* note 4.

6. Ellen Nakashima, *Officials Alert Foreign Services that Snowden Has Documents on Their Cooperation with U.S.*, WASH. POST (Oct. 24, 2013), http://www.washingtonpost.com/world/national-security/officials-alert-foreign-services-that-snowden-has-documents-on-their-cooperation-with-us/2013/10/24/930ea85c-3b3e-11e3-a94f-b58017bfee6c_story.html.

7. *Id.*; see Peter Finn & Sari Horwitz, *U.S. Charges Snowden with Espionage*, WASH. POST (June 21, 2013), http://www.washingtonpost.com/world/national-security/us-charges-snowden-with-espionage/2013/06/21/507497d8-dab1-11e2-a016-92547bf094cc_story.html (detailing charges brought including two counts under the 1917 Espionage Act); Schmitt, *supra* note 4.

8. See Trip Gabriel, *Shortcuts Seen by Firm Doing Security Checks*, N.Y. TIMES (Sept. 27, 2013), <http://www.nytimes.com/2013/09/28/us/pressure-reported-in-rush-to-meet-security-clearances-including-edward-snowden-and-aaron-alexis.html> [hereinafter Gabriel, *Shortcuts*] (explaining that government investigations for top secret level security clearances may take as long as 400 days, requiring the government to outsource to meet post-2001 demand for top secret cleared personnel); Dion Nissenbaum, *Bottom Line Drove Security Clearances at USIS: Company Rushed Investigations to Meet Targets, Former Employees Say*, WALL ST. J. (Oct. 25, 2013), <http://online.wsj.com/news/articles/SB10001424052702304330904579137443326694158> (discussing USIS’s financial incentive to quickly process background checks); Jia Lynn Yang, *Security-Clearance Contractor USIS’s Workers Felt Pressure to Do More and Faster*, WASH. POST (Sept. 20, 2013), http://articles.washingtonpost.com/2013-09-20/business/42252868_1_usis-background-checks-edward-snowden (finding that many USIS employees felt pressured to perform their interviews quickly, not thoroughly). Alexis had a history of mental illness and previous gun-related charges, but USIS reported none of these details in its security clearance investigations. Trip Gabriel et al., *Suspect’s Past Fell Just Short of Raising Alarm*, N.Y. TIMES (Sept. 17, 2013), <http://www.nytimes.com/2013/09/18/us/washington-navy-ward-shootings.html>. Snowden had previously been suspected of trying to hack into classified computer files while working for the CIA. See Schmitt, *supra* note 4.

the speed, efficiency, and innovation of the private sector. To incentivize such efficiency, USIS was entitled to payment only when it completed investigations.⁹

USIS succeeded in eliminating the backlog on security checks. But it did so in a way the government presumably did not intend.¹⁰ To meet revenue goals, particularly at month end, senior executives at USIS allegedly gave the directive to flush applications—simply approving them without review—so that the company could receive payment.¹¹ In other words, USIS took shortcuts to accomplish so-called efficient results.¹²

The USIS example is not an isolated one. Recent years have seen a government privatization frenzy fueled by faith that the private sector can outperform the government by reducing costs while *improving* service quality.¹³ But evidence is mounting that at least for certain types of services, governments are not seeing the predicted improvement in quality through outsourcing.¹⁴ Rather than reducing

9. See Gabriel, *Shortcuts*, *supra* note 8; see also S. REP. NO. 113-257, at 3–4 (2014) (reporting on a Department of Justice investigation that revealed that USIS submitted incomplete background checks in order to increase its revenues).

10. See *id.* (describing that USIS had adopted a revenue-driven rather than quality driven work model); see also *Safeguarding Our Nation's Secrets: Examining the Security Clearance Process: Joint Hearing Before the Subcomm. on the Efficiency & Effectiveness of Fed. Programs & the Fed. Workforce and Subcomm. on Fin. & Contracting Oversight of the S. Comm. on Homeland Sec. & Governmental Affairs*, 113th Cong., 7–8, 32–34 (2013) (statement of Patrick McFarland, Inspector Gen. for U.S. Office of Personnel Management).

11. Gabriel, *Shortcuts*, *supra* note 8.

12. Christian Davenport, *USIS Contracts for Federal Background Security Checks Won't Be Renewed*, WASH. POST (Sept. 9, 2014), http://www.washingtonpost.com/business/economy/opm-to-end-usis-contracts-for-background-security-checks/2014/09/09/4fcd490a-3880-11e4-9c9f-ebb47272e40e_story.html (announcing, due in part to these issues, that the Office of Personnel Management would not renew any of its USIS contracts).

13. See, e.g., Wendy Netter Epstein, *Contract Theory and the Failures of Public-Private Contracting*, 34 CARDOZO L. REV. 2211, 2214 (2013) [hereinafter Epstein, *Contract Theory*] (private contractors are perceived to be more efficient and cost effective than government agencies); Jon D. Michaels, *Privatization's Progeny*, 101 GEO. L.J. 1023, 1025 (2013) (denoting the pervasive scope of modern day government contracting); GRANT THORNTON, *THE STATE OF THE GOVERNMENT CONTRACTOR INDUSTRY: 2010 1* (2010), available at <http://www.gt.com/staticfiles/GTCom/Government%20contractors/Government%20contractor%20files/GovConRdtble2010FINALpdf.pdf> (noting the growth rate of government contracting industry despite the economic downturn in other sectors).

14. See *infra* Part II (describing the spectrum of government service contracting and types of services most likely to have high agency costs); see also John D. Donahue, *The Transformation of Government Work: Causes, Consequences, and Distortions*, in GOVERNMENT BY CONTRACT: OUTSOURCING AND AMERICAN DEMOCRACY 41, 48 (2009) (suggesting that certain categories of services do poorly when privatized); David M. Van Slyke, *The Mythology of Privatization in Contracting for Social Services*, 63 PUB. ADMIN. REV. 296, 307–08 (2003) [hereinafter Van Slyke, *Mythology of Privatization*]; Jean Beuve & Lisa Chever, *Quality of Outsourced Services, Rent-Seeking and Contract Design. Evidence from Cleaning Contracts 2* (Chaire Economie des Partenariats Public Privé Institut

cost and improving service through innovation, private providers often reduce cost by cutting corners.¹⁵ This is the USIS story, but it is also the story of the company that ran a private halfway house that chose to reduce security to save money, a factor that contributed to inmate escapes.¹⁶ It is also the story of the private provider of state welfare services that allegedly skimmed on personnel and made mistakes in coverage decisions, leaving needy applicants without crucial benefits.¹⁷

This problem is well theorized by commentators as a principal-agent problem.¹⁸ The interests of the government, as principal, do

d'Administration des Entreprises, Discussion Paper No. 2014-04, 2014), *available at* http://chaire-eppp.org/files_chaire/beuvechevermars2014_1.pdf (“postulating that the cost savings of outsourcing “might be achieved at the expense of quality”).

15. *See, e.g., supra* notes 8, 10 and accompanying text (explaining how the increased revenue goal led to a decrease in quality of services in the USIS contract).

16. *See* Sam Dolnick, *At A Halfway House, Bedlam Reigns*, N.Y. TIMES (June 17, 2012), http://www.nytimes.com/2012/06/18/nyregion/at-bo-robinson-a-halfway-house-in-new-jersey-bedlam-reigns.html?_r=1&smid=fb-share (describing how the private organization falsified inmate records to reflect that the inmates were receiving therapy and other services at the halfway house).

17. *See* *Bowman v. Int'l Bus. Machs. Corp.*, 853 F. Supp. 2d 766, 768 (S.D. Ind. 2012) (referencing the complaint, which alleged that the private contractor was negligent in its contractual obligations and failed to properly process the plaintiffs' Medicaid claims); *Privatization Myths Debunked*, IN PUB. INT., <http://www.inthepublicinterest.org/node/457> (last visited August 25, 2014) (listing several areas where privatization proved costlier and more inefficient than government led projects); *see also* Mike Brickner, *States Should Run Screaming From the CCA to Avoid Dangerous and Disgusting Prisons*, ACLU OF OHIO (Feb. 4, 2013, 12:11 PM), <https://www.aclu.org/blog/prisoners-rights/states-should-run-screaming-cca-avoid-dangerous-and-disgusting-prisons> (detailing the numerous violations and problems at a privately run prison); Donald Cohen, *Edward Snowden and the Disaster of Privatization*, REUTERS (July 11, 2013), <http://blogs.reuters.com/great-debate/2013/07/11/edward-snowden-and-the-disaster-of-privatization/>; Maria Dinzeo, *\$50 Million Computer Fiasco in Sacramento*, COURTHOUSE NEWS SERV. (Nov. 25, 2013, 9:59 AM), <http://www.courthousenews.com/2013/11/25/63190.htm> (detailing the failed attempt at privatizing the statewide payroll system in California); Michael D. Shear & Annie Lowrey, *In Tech Buying, U.S. Still Stuck in Last Century*, N.Y. TIMES (Dec. 22, 2013), http://www.nytimes.com/2013/12/23/us/politics/in-tech-buying-us-still-stuck-in-last-century.html?_r=1& (explaining the government's repeated failures at awarding successful technology contracts).

18. *See, e.g.,* Catherine Donnelly, *Privatization and Welfare: A Comparative Perspective*, 5 L. & ETHICS HUM. RTS. 336, 346 (2011) (recognizing that government outsourcing leads to a reversal of power in the principal-agent paradigm, giving the agent more power than the principal); Michaels, *supra* note 13, at 1027 (noting that privatization proponents look for ways to “align principal-agent incentives”); *see also* Mary S. Logan, *Using Agency Theory to Design Successful Outsourcing Relationships*, 11 INT'L J. LOGISTICS MGMT. 21, 22 (2000) (exploring principal-agent power disparities through the lens of transportation outsourcing); Barbara S. Romzek & Jocelyn M. Johnston, *State Social Services Contracting: Exploring the Determinants of Effective Contract Accountability*, 65 PUB. ADMIN. REV. 436, 438 (2005) (explaining that the traditional principal-agent relationship in government contracts is not well suited for contracts in the social service sector); E.S. Savas, *Privatization in State and Local Government*, in RESTRUCTURING STATE AND LOCAL SERVICES: IDEAS, PROPOSALS, AND EXPERIMENTS 91, 99 (1998) (advocating for privatization because of its ability to increase savings without cutting services).

not align with the interests of the private provider, as agent.¹⁹ The private service provider seeks to increase profit by decreasing costs.²⁰ The government, at least in the most flattering view, is motivated to provide high quality service to its constituents.²¹ The way to solve this problem according to the prevailing literature is for the government to use the same approach to mitigating agency costs as contracting parties do in other contexts—write better contracts.²² “Better” contracts are ones that highly specify tasks and financially reward compliance with those tasks—so-called incentive-based contracting.²³ This approach assumes that rational, selfish actors are looking for opportunities to shirk.

This Article challenges both the assumptions and the approach. While the traditional method may work well where tasks are easy to define and monitor and where there is a thick market with switching options, often when the government now outsources, such conditions are not present. In addition, control-based contracts are not only difficult and expensive to write and costly to monitor, but they risk stifling

19. Donnelly, *supra* note 18, at 346.

20. Epstein, *Contract Theory*, *supra* note 13, at 2218.

21. *See id.* at 2216 (suggesting that the government may not always have an adequate incentive to provide quality service, especially to the disenfranchised, but assuming that governments would rather provide high quality service than low quality service when contracting out).

22. *See, e.g.*, Jason Parkin, *Adaptable Due Process*, 160 U. PA. L. REV. 1309, 1348 (2012); *see also* H. EDWARD WESEMANN, CONTRACTING FOR CITY SERVICES 61–62 (1981) (listing provisions which may be mutually agreed upon within a city services contract); Trevor L. Brown et al., *Managing Public Service Contracts: Aligning Values, Institutions, and Markets*, 66 PUB. ADMIN. REV. 323, 327 (2006) (describing the areas in which the principal has the ability to fine tune contract specifications); Nestor M. Davidson, *Relational Contracts in the Privatization of Social Welfare: The Case of Housing*, 24 YALE L. & POL'Y REV. 263, 263 (2006) (“Commentators concerned with capturing privatization’s benefits and muting its potential harms often call for additional government control of private providers through their contractual agreements, specifying in ever-more-careful terms the scope of the engagement and monitoring providers with ever-greater oversight.”); *Developments in the Law—The Law of Prisons*, 115 HARV. L. REV. 1838, 1887 (2002) [hereinafter *The Law of Prisons*] (arguing that clarity is essential in developing a sound performance contract); Lisa A. Dicke, *Ensuring Accountability in Human Services Contracting: Can Stewardship Theory Fill the Bill?*, 32 AM. REV. PUB. ADMIN. 455, 465–66 (2002) (pointing out that government officials try to ensure quality contracting employees through strict contractual provisions); Jody Freeman, *The Contracting State*, 28 FLA. ST. U. L. REV. 155, 170–71 (2000) (suggesting that “[c]ontracts could specify tasks more clearly, [and] detail procedures more thoroughly”); Martha Minow, *Public and Private Partnerships: Accounting for the New Religion*, 116 HARV. L. REV. 1229, 1267 (2003) (discussing contractual mechanisms for ensuring accountability to public values in the context of privatization); Romzek & Johnston, *supra* note 18, at 438 (finding that contractual language could alleviate many problems faced by public service government contracts).

23. *See* Minow, *supra* note 22, at 1262–63 (discussing the benefits and challenges of using this model in the social services context).

intrinsic motivation and innovation.²⁴ Such detailed contracts frequently fail in practice, with serious negative implications for the public.²⁵

This Article argues that where the traditional method does not work and a contractor performs a control-based contract poorly, governments should try the opposite and write *less*-detailed contracts.²⁶ Although less-specified contracts may seem counter-intuitive, a growing literature in behavioral economics on reciprocity supports this method.²⁷ People reward kind actions but view control-based contracts attempting to micromanage agent behavior as unkind. How an agent perceives the kindness inherent in a contract affects the agent's performance under the contract.²⁸ Although this Article focuses on the government outsourcing example, a reciprocity-based approach to contracting may be even more widely applicable.²⁹

There is now a robust experimental literature that assesses how reciprocity functions in a variety of simulated settings.³⁰ The seminal works in this area were either completed by or inspired by Ernst

24. See, e.g., Iris Bohnet et al., *More Order with Less Law: On Contract Enforcement, Trust, and Crowding*, 95 AM. POL. SCI. REV. 131, 132 (2001) (noting that for intellectually honest parties to a contract, strict contractual construction can be overly restrictive); Edward L. Deci et al., *A Meta-Analytic Review of Experiments Examining the Effects of Extrinsic Rewards on Intrinsic Motivation*, 125 PSYCHOL. BULL. 627, 659 (1999) [hereinafter Deci et al., *Extrinsic Rewards*] (positing that rewards are not an effective substitute for intrinsic motivation); Eileen Chou et al., *The Control-Motivation Dilemma: Contract Specificity Undermines Intrinsic Motivation, Persistence, and Creativity* 3–4 (2014) (under review at *Organization Science*) (on file with author) (demonstrating through experiment that less-specific contracts prompt intrinsic motivation in the employment context).

25. See *infra* Part I.D; see also Praxis Solutions, Inc., *Government Contracting and Competition—Another Principal-Agent Problem*, 1 PRAXIS SERIES, no. IV, 2002, at 1, 4, available at <http://www.praxisolutions.com/PrincipalAgent.pdf>. See generally PHILLIP J. COOPER, GOVERNING BY CONTRACT: CHALLENGES AND OPPORTUNITIES FOR PUBLIC MANAGERS (2003).

26. See *infra* Part III.B.

27. See *supra* note 24.

28. See *infra* Part III.A–B; see also Ernst Fehr & Simon Gächter, *Fairness and Retaliation: The Economics of Reciprocity*, 14 J. ECON. PERSP. 159, 170 (2000) [hereinafter Fehr & Gächter, *Fairness and Retaliation*]; Ernst Fehr et al., *Reciprocity as a Contract Enforcement Device: Experimental Evidence*, 65 ECONOMETRICA 833, 833 (1997) [hereinafter Fehr et al., *Reciprocity as a Contract Enforcement Device*] (discussing experimental evidence tending to show that people reciprocate fair or unfair treatment in kind and applying to contract context); Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1663 (2003) (discussing the Ultimatum Game, which revealed social preferences other than self-interest in the bargaining context).

29. This Article focuses on public-private contracting because its common characteristics make control-based contracts a particularly poor fit. Therefore, it is worth addressing public-private contracts first.

30. See Ronald J. Gilson et al., *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377, 1447 (2010) [hereinafter Gilson et al., *Braiding*] (collecting work).

Fehr.³¹ He found that in the contract context specifically, the inclination towards reciprocity translates into less complete contracts that induce a greater level of effort from agents than one would rationally anticipate.³² Other studies have confirmed similar results.³³ Findings in the regulatory context also support a less-detailed contracting approach, where real-world experiences launched a move away from command and control regulation toward a more flexible, standards-based regime.³⁴

This Article does not suggest that contracts should be completely devoid of content or direction. All contracts exist on a spectrum of completeness.³⁵ This Article does not intend to precisely identify where on the spectrum of completeness government service contracts should exist. Rather, it suggests that the majority of contracts are too detailed and too complete, and that contracts should leave more discretion to the agent, fostering the agent's sense of intrinsic

31. See, e.g., Fehr et al., *Reciprocity as a Contract Enforcement Device*, *supra* note 28, at 834 (finding that reciprocity is supported by scientific study); Fehr & Gächter, *Fairness and Retaliation*, *supra* note 28, at 159 (finding that economic analysis supports the theory that human beings are inclined to fairness and are not solely self-motivated).

32. Fehr et al., *Reciprocity as a Contract Enforcement Device*, *supra* note 28, at 834.

33. See, e.g., Bohnet et al., *supra* note 24, at 131–51 (finding incentive contracts decrease cooperation); Bruno S. Frey & Reto Jegen, *Motivation Crowding Theory: A Survey of Empirical Evidence*, 15 J. ECON. SURVS. 589, 589–612 (2001) (suggesting that monetary incentives are not as effective as reciprocity arrangements for providing motivation); Judd B. Kessler & Stephen Leider, *Norms and Contracting*, 58 MGMT. SCI. 62, 62 (2012) (discussing experiment finding unenforceable “handshake agreements” to be most effective); Mark Lubell & John T. Scholz, *Cooperation, Reciprocity, and the Collective-Action Heuristic*, 45 AM. J. POL. SCI. 160, 175–76 (2001) (finding that the use of incentives can crowd out reciprocity); Ernst Fehr & Simon Gächter, *Do Incentive Contracts Crowd Out Voluntary Cooperation?* 13–14 (Inst. for Empirical Research in Econ., Discussion Paper No. 3017, 2000) [hereinafter Fehr & Gächter, *Crowd Out*] (reporting that the incentive contract may not be better than the pure trust contract); Chou et al., *supra* note 24, at 2–4 (demonstrating the crowding out effect of specified contracts in employment contract setting); see also Scott, *supra* note 28, at 1644–45 (showing that experimental study results may predict “deliberately incomplete agreements between strangers is more efficient than the alternative of more complete, legally enforceable contracts). But see Mary Rigdon, *Trust and Reciprocity in Incentive Contracting* 18 (Nat'l Sci. Found., Working Paper, 2006) (finding no evidence that incentives “crowd out” social norms).

34. Cf., JOHN MIKLER, GREENING THE CAR INDUSTRY: VARIETIES OF CAPITALISM AND CLIMATE CHANGE 72–73 (2009) (Japanese car industry motivated by internal sources, not detailed regulation); John Braithwaite, *Rules and Principles: A Theory of Legal Certainty*, 27 AUSTL. J. L. PHIL. 47, 68 (2002) (exploring a study of the role of regulations in the British finance industry, and identifying a trend away from binding rules and towards broad principles).

35. See, e.g., Trevor L. Brown et al., *Contracting for Complex Products*, 20 J. PUB. ADMIN. RES. & THEORY 141, 143 (2010) (“Contract completeness is the degree to which the contract defines buyers’ and sellers’ rights and obligations across all future contingencies.”); Scott, *supra* note 28, at 1641–42 (explaining that all contracts are incomplete to some degree).

motivation.³⁶ While contracts cannot be silent about goals or desired outcomes, they also should not dictate precisely what steps be taken to achieve those goals or desired outcomes.

The Article proceeds in three Parts. Part I describes in principal-agent terms how government service contracting in certain contexts results in cost cutting but fails to improve service quality. It then explores current scholarship suggesting mechanisms to solve the problem through detailed contracting. There has been significant discourse on this issue in both the public law literature and amongst economists who write about best practices in contracting.

Part II explains why the solution that theory predicts to mitigate agency costs (control-based contracting) does not work well in certain contexts. The discussion sets out a multi-dimensional spectrum and suggests that when governments contract out services (1) for which the provider market is thin, (2) where tasks are complex and difficult to specify, and (3) where effective monitoring is elusive, the detailed contracting approach is biased to be ineffective.

Part III sets out the alternative proposal. Where writing highly detailed contracts is not optimal, there is another option. Part III explores the experimental literature on positive reciprocity in contracting. It suggests there is reason to be optimistic about the potential for *less* detailed contracting and parties' abilities to rely on the reciprocity norm as a contract enforcement device. Although this research is very promising, and an analogy to the regulatory context provides real-world examples, work in this area is still preliminary. Accordingly, Part III also discusses this approach's potential limitations and offers suggestions for further study. Ultimately, Part III leaves open the possibility that reciprocity-based contracting might have even broader application outside the government outsourcing context.

I. PRIVATIZATION FAILURES AND THE CURRENT CONTRACTING APPROACH

Widespread budget crises and general complaints of government inefficiency have served to heighten the role for the privatization³⁷ of

36. See Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 *Nw. U. L. REV.* 854, 890–91 (1978); Scott, *supra* note 28, at 1644–45 (reciprocity is an effective motivator for half of the population).

37. The terms “privatization,” “public-private contracting,” “government outsourcing,” “government service contracting,” “contracting out,” and “purchase-of-service (POS) contracting,” all may mean different things in different contexts. But for purposes of this Article, they are used interchangeably to indicate a contract between a governmental entity and a private party, where the private party agrees to provide a government service for the benefit of the public in exchange for

government services in recent years.³⁸ Perhaps it is unsurprising that in the current economic climate, where state budgets in particular are very lean, the use of privatization is on the rise and has enjoyed widespread support across the political spectrum.³⁹

A. *Why Governments Privatize*

Privatization theory suggests that privatizing should both cut costs and simultaneously maintain or even improve service quality.⁴⁰ Privatization proponents argue that governments lack adequate incentives to work efficiently and to innovate to provide high quality services at low cost.⁴¹ Because governments are not motivated by seeking profits or maximizing value and do not face competition for the provision of services,⁴² governments lack market motivation to deliver services efficiently.⁴³

Further, even with the proper incentives, governments are not particularly adept at delivering services efficiently because they are constrained by bureaucracy and civil services laws.⁴⁴ Governments lack the options to motivate their employees that private firms

compensation by the government. See, e.g., Freeman, *The Contracting State*, *supra* note 22, at 161 (recognizing that the bulk of privatization in the U.S. has taken the form of government contracting); Michaels, *supra* note 13, at 1026 (explaining the nature of public-private contracts). This Article does not address procurement contracts.

38. Anna Ya Ni & Stuart Bretschneider, *The Decision to Contract Out: A Study of Contracting for E-Government Services in State Governments*, 67 PUB. ADMIN. REV. 531, 532 (2007) ("As a result [of a growing desire to make government more efficient], government contracts with the private and nonprofit sectors have rapidly increased in volume and extended to various service areas. Indeed, the market for contracts to provide government services has been growing faster than that of any commercial segment." (citations omitted)).

39. See Michaels, *supra* note 13, at 1025 (noting that privatization is a politically expedient means of addressing many governmental services).

40. See, e.g., *The Law of Prisons*, *supra* note 22, at 1877–78 (early economic models actually predicted that privatization would reduce both cost and quality, but recent literature argues that private contractors may be motivated to innovate in a way that cuts cost but not service quality).

41. Michael J. Trebilcock & Edward M. Iacobucci, *Privatization and Accountability*, 116 HARV. L. REV. 1422, 1445 (2003).

42. Epstein, *Contract Theory*, *supra* note 13, at 2235–38. There are exceptions—for instance, the United States Post Office—but generally speaking, this is true.

43. *Id.* at 2238. Governments arguably do, however, have political motivations to deliver efficient service. The problem is, therefore, more pervasive when politically disenfranchised groups are the service recipients. *Id.*

44. David A. Super, *Privatization, Policy Paralysis, and the Poor*, 96 CALIF. L. REV. 393, 400–01 (2008) (noting that the complexity of services that a government may contract out for results in intrinsic difficulties in accomplishing contractual goals). See generally E.S. SAVAS, *PRIVATIZATION: THE KEY TO BETTER GOVERNMENT* pt. 3 (1987) (describing the historical background of privatization).

enjoy.⁴⁵ Most government employees are not at-will, and therefore the government cannot easily terminate their employment.⁴⁶ The government also has fewer tools in its tool belt, such as access to bonuses or the ability to quickly advance high performers.

By contrast, private firms that do seek to maximize profits and do have competitors in the marketplace will, in theory, be driven to innovate and to provide services that are both high quality and low cost. Private firms derive motivation from winning contracts and then keeping the business.⁴⁷ If a private firm does not deliver in a marketplace where there are true switching options, the firm will lose the contract at renewal (or earlier).⁴⁸ Individual employees of profit-seeking firms may also share the motivations of their parent firms.⁴⁹ Indeed, firms take pains to align employees' incentives with their own by rewarding performance that furthers the firm's profit-maximizing goals and by punishing performance (perhaps even by termination of employment) when employees' work is unsatisfactory.⁵⁰ Private entities can also adjust staffing and wage levels more readily than the government and raise capital where necessary.⁵¹

45. See Epstein, *Contract Theory*, *supra* note 13, at 2243 (explaining how private sector employees' economic welfare is often tied to the overall performance of their employer, a scenario that largely does not exist for government employees).

46. PATRICIA H. WERHANE ET AL., EMPLOYMENT AND EMPLOYEE RIGHTS 54, 55 (2004) (contrasting about fifty-five percent of private sector workers who are at-will against government employees with some job security).

47. See Trebilcock & Iacobucci, *supra* note 41, at 1429 (opining that private firms consistently out-perform comparable government services because private firms are able to utilize the principle that maximizing profits is a socially desirable goal).

48. *Id.* at 1428.

49. See WERHANE, *supra* note 46, at 54–55.

50. See *id.* (examining the difference in motivation that job security has on private and public employees).

51. See E.S. SAVAS, PRIVATIZATION AND PUBLIC-PRIVATE PARTNERSHIPS 111–12 (2000) [hereinafter SAVAS, PRIVATIZATION AND PUBLIC-PRIVATE PARTNERSHIPS]; Super, *supra* note 44, at 409–13 (using private entities' choice of internal production over obtaining goods or services from the open market to illustrate firms' increased flexibility in comparison to the government); see also DAVID OSBORNE & TED GAEBLER, REINVENTING GOVERNMENT: HOW THE ENTREPRENEURIAL SPIRIT IS TRANSFORMING THE PUBLIC SECTOR 252–53 (1992) (finding that decentralized institutions offer a greater degree of flexibility and adaptability than their centralized counterparts); Michaels, *supra* note 13, at 1088; David M. Van Slyke, *Agents or Stewards: Using Theory to Understand the Government-Nonprofit Social Service Contracting Relationship*, 17 J. PUB. ADMIN. RES. & THEORY 157, 158 (2006) ("Privatization advocates argue that government will receive better services at lower costs because of the expertise and innovation of private providers. This argument rests on 'introduc[ing] competition and market forces in[to] the delivery of public services.'" (quoting SAVAS, PRIVATIZATION AND PUBLIC-PRIVATE PARTNERSHIPS, *supra* note 51, at 122)).

B. Principal-Agent Problems

Contracting out is not without problems. In a prior Article, I suggested that there are systematic biases in certain types of government outsourcing such that cost cutting is prioritized over quality service provision.⁵² I argued that this is particularly true where markets are thin, where tasks are difficult to specify and monitor, and where the outsourced service benefits a small, often disenfranchised portion of the population. In such scenarios, I conceived of the cost that contracting parties impose on service recipients as akin to a negative externality that the transacting parties are not forced to internalize. Thus, what appears to be a cost-saving mechanism is often, in fact, a systematic market failure.

In this Article, I continue to explore the problem of the poor service provision that can result when governments outsource, but instead of focusing on incentive mismatches between the contracting parties and third-party beneficiaries, I focus on incentive misalignments between the contracting parties themselves. Here, I assume that a government's goal in outsourcing is to provide good quality service (and not only to reduce cost no matter the effect on service quality), but that governments have difficulty obtaining good service from the private providers to which it outsources. This is a type of agency cost. Whenever one party (the agent) contracts to perform a service on behalf of another (the principal), the goals of the two parties are likely to not entirely align.⁵³ Principal-agent theory addresses the difficulties involved when a principal motivates its agent to act in the best interests of the principal rather than in his or her own interests.⁵⁴

Agency problems often arise when there is information asymmetry.⁵⁵ The agent is the party performing the service. The principal does not know as much about that service provision as the agent actually performing the service. Consider a provider of call center services that obtains a contract to handle customer service calls on behalf of a retail store. Those actually handling the calls know far

52. Epstein, *Contract Theory*, *supra* note 13, at 2238.

53. KIERON WALSH, PUBLIC SERVICES AND MARKET MECHANISMS: COMPETITION, CONTRACTING AND THE NEW PUBLIC MANAGEMENT 36–37 (1995); Brian Galle, *Charities in Politics: A Reappraisal*, 54 WM. & MARY L. REV. 1561, 1591–92 (2013).

54. WALSH, *supra* note 53, at 37.

55. See Kathleen M. Eisenhardt, *Agency Theory: An Assessment and Review*, 14 ACAD. MGMT. REV. 57, 58 (1989) (finding that the “agency problem” arises when a principal and their agent have different attitudes towards control and risk); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 309 (1976) (noting that agency costs rise when the relationship and knowledge between principal and agent is not clearly defined).

better the level of service they are providing than the store on whose behalf the customer service representatives are acting. In this situation, principals can have difficulty ascertaining whether or to what extent a contract has been satisfied. The principal removed from the agent cannot fully monitor its services or it may be too costly to adequately monitor.⁵⁶

If the incentives of the agent and principal are not aligned, and the agent knows that the principal cannot easily detect its actions, the agent will act in ways that the principal would not want it to act. This is known as moral hazard.⁵⁷ Typical examples of these sorts of agency costs are those that arise between corporate management (agent) and shareholders (principal).⁵⁸ The principle extends to the relationship between politicians as agent and voters as principal. In the management-shareholder context, management might lack sufficient incentive to maximize profits of the firm and might instead prefer to maximize personal gain. If the shareholders cannot easily detect that management is furthering personal gain rather than the interests of the company, management will be more likely to act in ways shareholders might frown upon. The political context can be similar. There, voters select their representatives to act in their best interests, but once elected, representatives may act in ways that will maintain their positions of power rather than fulfill their promises to constituents. Both examples illustrate the problems that may arise from misaligned incentives.

The example of the USIS contract discussed above also has these attributes.⁵⁹ The contract incentivized completing the review of applications for security clearance. USIS was therefore motivated to “complete” applications rather than to do quality investigations. The agency costs in that situation resulted from both incentive misalignments (in part created by the payment mechanism under the contract)⁶⁰ and from information asymmetry. USIS was better

56. See Jensen & Meckling, *supra* note 55, at 309 n.10; Steven Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 BELL J. ECON. 55, 66 (1979).

57. Shavell, *supra* note 56, at 66.

58. *Id.*

59. See *supra* notes 8–11 and accompanying text.

60. Gabriel, *supra* note 8 (“In interviews this week, former and current USIS employees detailed how the company had an incentive to rush work because it is paid only after a file is marked ‘FF,’ for fieldwork finished, and sent to the government. In the waning days of a month, investigations were closed to meet financial quotas, without a required review by the quality control department, two former senior managers said.”). There was surely a better way to draft this contract to better align incentives in the traditional model, but even so, this Article argues that a better contract is not one predicated on that approach. Rather, a better

positioned to know how thoroughly it had reviewed applications. The government was at an informational disadvantage. The ramifications of subpar contractor performance in that case were severe.⁶¹

A related issue to information asymmetry and moral hazard is that even if the principal can obtain contract compliance from the agent, it may have difficulty prompting best efforts.⁶² The literature differentiates between perfunctory performance and consummate performance.⁶³ Perfunctory is performance within the letter of the contract, and consummate is performance within the spirit of the contract that goes beyond what is required in pursuit of a greater win-win gain.⁶⁴ For instance, a contract may specify the number of jokes a comedienne must tell, but it would be essentially impossible to specify how funny her jokes must be. A perfunctory comedienne performing just what is required will simply tell the required number of jokes and will be satisfied by a reaction of mild giggles. A consummate comedienne will work to obtain the big laughs. One difficulty that principals face is in motivating agents to give consummate rather than perfunctory performance.⁶⁵ This is particularly true where accepted and objective metrics for consummate performance are lacking.⁶⁶

This issue is often apparent in government outsourcing contracts.⁶⁷ Governments contract out to private providers to decrease cost, but

contract may simply be a less-specific one that trades on the reciprocity value between the parties.

61. For additional examples of government contractors delivering subpar performance due to agency costs, see Epstein, *Contract Theory*, *supra* note 13, at 2220–26.

62. See Ernst Fehr et al., *Contracts as Reference Points—Experimental Evidence*, 101 AM. ECON. REV. 493, 518–22 (2011) (considering two different models regarding social preferences, one based on inequity aversion and one based on reciprocity, for explaining fairness theories in contractual relationships); Yuval Feldman et al., *Reference Points and Contractual Choices: An Experimental Examination*, 10 J. EMPIRICAL LEGAL STUD. 512, 520 (2013); Oliver Hart & John Moore, *Contracts as Reference Points*, 123 Q.J. ECON. 1, 7–8 (2008) (postulating that a party to a contract may only put forth his best efforts if he feels as though he is treated well).

63. Hart & Moore, *supra* note 62, at 6.

64. *Id.* at 6–8.

65. See OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* 100–01 (1975); Hart & Moore, *supra* note 62, at 7; George S. Geis, *Business Outsourcing and the Agency Cost Problem*, 82 NOTRE DAME L. REV. 955, 974 (2007) [hereinafter Geis, *Business Outsourcing*] (possible risks stemming from agency cost problems include “(1) insufficient effort or shirking; (2) lavish compensation or self-dealing; (3) entrenchment; and (4) poor risk management”).

66. Motivating consummate performance is not as problematic when easily observable and measurable performance metrics are available.

67. See, e.g., Donnelly, *supra* note 18, at 346 (explaining that, in the context of governmental outsourcing, the agent has first-hand knowledge, and so it is the agent that has the most influence).

also to improve service quality. However, the contractor may be tempted to provide lower effort levels than the government may want.⁶⁸

Oliver Hart gives the example of a prison manager who can make two kinds of investments: “He can invest in efficiency-enhancing ideas that raise the quality of prison services, e.g., develop new rehabilitation programmes; he can also spend time figuring out how to cut costs and quality, while staying within the letter of the contract.”⁶⁹ A government’s goal, then, is to maximize its agent’s innovative investment while minimizing the quality-shading investment. Often, in practice, and for particular categories of contracts,⁷⁰ the quality-shading kind of investment is what results.

For instance, the City of New York outsourced welfare-to-work services to private vendors.⁷¹ The goal of the project was to move people into jobs that would permit economic independence.⁷² The private vendors, which were paid based on placements, worked to place the easiest candidates and ignored the more difficult cases.⁷³ They also targeted short-term job placement that was unlikely to stick.⁷⁴ They complied with the letter of the contract, but did not perform as the government would have liked.

Agency theory focuses on correcting for opportunistic behavior that can result from misaligned incentives and exploiting asymmetric information.⁷⁵ It typically suggests aligning incentives such that the rational, self-interested choices of the agent comport with the principal’s choices. In outsourcing, agency theory focuses on the ways in which principals can try to align incentives through contract.

68. See Oliver Hart et al., *The Proper Scope of Government: Theory and an Application to Prisons*, 112 Q.J. ECON. 1127, 1141 (1997); Peter H. Kyle, Note, *Contracting for Performance: Restructuring the Private Prison Market*, 54 WM. & MARY L. REV. 2087, 2095 (2013) (explaining that public service employees often lack motivation because they see little return on cost reductions and quality improvements).

69. Oliver Hart, *Incomplete Contracts and Public Ownership: Remarks, and an Application to Public-Private Partnerships*, 113 ECON. J. C69, C71 (2003).

70. See *infra* Part II (discussing frequently used types of government contracts).

71. See Wendy A. Bach, *Welfare Reform, Privatization, and Power: Reconfiguring Administrative Law Structures from the Ground Up*, 74 BROOK. L. REV. 275, 286 & n.41 (2009) (describing the failure of New York’s Employment Services and Placement program).

72. *Id.*

73. See *id.* at 291 (“[T]he incentives are structured in a way that encourages vendors to work with those easiest to place quickly, and leave behind those that need more support and more time for initial placement. Clients realize this and grow wary of a system that is failing to meet their needs.”).

74. *Id.* at 287.

75. Donnelly, *supra* note 18, at 346–47 (explaining “asymmetric information,” a problem that comes about when a private provider may have information that the government does not, and the private provider is then motivated to further its own, rather than the public’s, interest).

Public law scholars who address this same problem typically focus on accountability issues rather than agency cost.⁷⁶ The focus is on providing voters a mechanism for policing the government. Accountability, for public law scholars, is the “central issue” in privatization.

In turning to private actors to supply education, social services, dispute resolution, and other programs to meet basic human needs, governments may duck public obligations and rules, become too closely enmeshed with religion, or divert public resources to private profits without gaining the discipline of a true economic market. Rather than achieving increased efficiencies and improved options, then, the privatization process risks reduced quality, unequal treatment, and outright corruption.⁷⁷

Although the public-private contracting problem does not necessarily stem from the relationship between the two contracting parties, Minow and others turn in part to contract solutions to address accountability concerns.⁷⁸ The next section takes up this issue further, exploring the common mechanisms for mitigating agency costs (or ensuring more accountability), which are also the most common mechanisms suggested and likely employed in government service contracts.

C. *Scholarly Solutions to Principal-Agent Problems*

There is much congruence in the literature that careful contract design can align incentives.⁷⁹ The literature contemplates a

76. Because I concentrate on contractor performance in this Article, I conflate the accountability and agency cost analysis, which ultimately both suggest that detailed contracting is the way to improve performance. However, there are crucial differences in the two analyses, most importantly, that many public law scholars concerned about accountability are concerned about accountability to the *public*, not just to the government. For instance, making government contracts publicly available is an equally important dimension to solving this problem.

77. Minow, *supra* note 22, at 1246; *see also* Kimberly N. Brown, “We the People,” *Constitutional Accountability, and Outsourcing Government*, 88 *IND. L.J.* 1347, 1350–52 (2013) (addressing and explaining the “Accountability Problem of Privatized Government”); Donnelly, *supra* note 18, at 339–40 (using a comparative approach to discuss challenges to accountability and human rights that arise from using privatization in the welfare context); Jody Freeman, *Extending Public Law Norms Through Privatization*, 116 *HARV. L. REV.* 1285, 1317–20, 1342 (2003) (suggesting ways to prevent governments from avoiding duties by turning to private actors); Janna J. Hansen, Note, *Limits of Competition: Accountability in Government Contracting*, 112 *YALE L.J.* 2465, 2475 (2003) (arguing that the contracting process of private government contractors is often confidential and without judicial review, leading to accountability issues).

78. Minow, *supra* note 22, at 1260–61 (discussing contractual mechanisms for ensuring accountability to public values in the context of privatization).

79. *See, e.g.*, MICHAEL C. JENSEN, *A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS, AND ORGANIZATIONAL FORMS* 144–45 (2000) (discussing ways to avoid major sources of conflict, thus aligning incentives); Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 *J. POL. ECON.* 225, 226 (1990)

multiplicity of ways to align incentives, from profit sharing to piece-rate compensation to bonding, among others.⁸⁰ Most relevant for present purposes is the method that suggests highly specifying tasks and/or outcomes, monitoring, and relating performance to financial punishments or rewards due *ex post*.⁸¹

1. *Mitigating agency costs through specification, monitoring, and incentive-based compensation*

Agency theory assumes that agents are rational, selfish actors looking for opportunities to shirk under a contract. A rational agent that knows its actions cannot be adequately detected by a principal will act to maximize its own profit even in ways the principal may not want. Accordingly, a principal may better position itself by designing a contract that aligns incentives so that an agent will be honest and follow the rules. Contracts must work within incentive compatibility constraints.

a. *In general*

First, specifying tasks can be an important contracting mechanism.⁸² Although scholars have established that no contract can be entirely complete,⁸³ there are nonetheless a number of benefits to specifying tasks. It gives the agent guidance on exactly what is required so that expectations are aligned. And it gives the principal something to monitor or with which to ensure compliance. It also limits the risk of a court later wrongly interpreting contractual intent.⁸⁴ Ultimately, the argument is that specification of tasks is necessary for agent accountability.⁸⁵

(examining the relationship between contract clarity and compensation policy); Sidney A. Shapiro, *Outsourcing Government Regulation*, 53 DUKE L.J. 389, 394 (2003) (discussing the continual negotiation process that accompanies an incomplete contract); cf. Rigdon, *supra* note 33, at 18, 25 (noting that further study should be conducted on how to efficiently structure incentives through contracting).

80. See, e.g., Jonathan R. Macey, *The Regulator Effect in Financial Regulation*, 98 CORNELL L. REV. 591, 603 (2013) (suggesting several different methods used to aid principals and agents in aligning interests).

81. See, e.g., Hart, *Incomplete Contracts*, *supra* note 69, at C70 (noting the prevailing sentiment that a government need not own a firm to control its behavior: “any goals—economic or otherwise—can be achieved via a detailed initial contract”).

82. See Margaret M. Blair et al., *Outsourcing, Modularity, and the Theory of the Firm*, 2011 BYU L. REV. 263, 263 (stating that large projects can be broken down into smaller “modular” tasks).

83. See Hart, *Incomplete Contracts*, *supra* note 69, at C71 (positing that no contract is considered complete in the property rights model).

84. See Dru Stevenson, *Privatization of Welfare Services: Delegation by Commercial Contract*, 45 ARIZ. L. REV. 83, 121 (2003).

85. In the corporate context, however, there tends to be less reliance on task specification. Particularly where managers can be given flexibility but are incentivized to maximize firm profit, it is less necessary and perhaps less desirable to

Second, and related, monitoring (either directly or through market mechanisms) can be an essential component of mitigating agency costs.⁸⁶ Explicit monitoring rights in transactions range from audit procedures to in-person visits to observe the agent in practice.⁸⁷ Monitoring is costly, but it is generally required to reduce an agent's temptation to engage in self-interested behavior that will harm the enterprise or, in other words, to reduce the information asymmetry that contributes to agency costs in the first place.⁸⁸ In corporate contexts, the market may do some of the work aligning incentives.⁸⁹ Particularly if the principal may become aware of an agent shirking, the principal will utilize switching options, and the agent will suffer reputational sanctions.⁹⁰ Therefore, a thick market and good information can dissuade agents from performing poorly.⁹¹

Third, the literature recommends the use of performance-based compensation to align interests.⁹² Fixed payment regimes unconnected to performance or task completion may do little to incentivize agents to do good work.⁹³ There are, however, many ways to use compensation to motivate agents. Options range from payment for achieving certain pre-defined goals to penalties for failure to achieve goals.⁹⁴ Other incentives aligning compensation are also available. What has become the traditional example is

specify tasks too discretely. William J. Carney, *Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model*, 1988 WIS. L. REV. 385, 416 (suggesting that firms generally prefer to motivate managers through the use of incentives, rather than to specify the manager's duties).

86. Jensen & Meckling, *supra* note 55, at 323–24.

87. See Geis, *Business Outsourcing*, *supra* note 65, at 993 (explaining that there are several ways to mitigate costs, including writing monitoring into the contract or the practice of extensive audits).

88. *Id.*

89. See Carney, *supra* note 85, at 387 (positing that incentives can often be aligned in the corporate context through compensation provisions).

90. See Davidson, *supra* note 22, at 306, 313 (hypothesizing that a relational approach may minimize instances of shirking and that incentivizing providers may help to avoid a stain on the government's reputation).

91. See generally Lawrence A. Cunningham, *A New Legal Theory to Test Executive Pay: Contractual Unconscionability*, 96 IOWA L. REV. 1177, 1187 (2011) (“Divergence of interests between managers and shareholders can be reduced by: (a) investing in monitoring devices, such as oversight, auditing, and internal controls”); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 295–97 (1980) (discussing the extent to which market forces can discipline managers and prevent them from shirking).

92. Carney, *supra* note 85, at 415–16 (recommending the use of incentives based on performance for corporate managers to align interests); Cunningham, *supra* note 91, at 1187 (finding that compensation contracts are often an efficient way to reduce costs and align shareholder and manager interests).

93. Carney, *supra* note 85, at 416.

94. See Feldman et al., *supra* note 62, at 533 (contending that one way to incentivize best efforts is to frame payoffs as losses rather than gains).

incentivizing corporate managers with stock so that the agent is motivated to maximize the overall profitability of the firm.⁹⁵

A study of commercial outsourcing agreements confirmed that firms employ many of these mechanisms.⁹⁶ Particularly in higher agency cost situations, firms are more likely to structure agreements with extensive financial incentives and control rights, considerable monitoring, and economic consequences linked to performance.⁹⁷

b. In government service contracting

Applying general insights from agency theory to government service contracting seems to yield the conclusion that similar mechanisms would work well in this slightly different context. Indeed, the vast majority of economists and public law scholars addressing agency costs in government service contracting have taken a “complete” or “formalist” contracting perspective. Following the assumption that agency costs arise because of asymmetric information, moral hazard, and shirking, they suggest that similar mechanisms may mitigate agency costs in other contexts.⁹⁸ The most common suggestion for obtaining better quality service is to draft more specific contracts (in particular, to better specify tasks and performance metrics), include monitoring provisions, and tie agent performance to compensation.⁹⁹ Public law scholars and economists who write on this topic largely agree as to this approach.¹⁰⁰ As Nestor Davidson has put it, “Commentators concerned with capturing privatization’s benefits and muting its potential harms often call for additional government control of private providers through their contractual agreements, specifying in ever-more-careful terms the

95. Carney, *supra* note 85, at 416.

96. George S. Geis, *An Empirical Examination of Business Outsourcing Transactions*, 96 VA. L. REV. 241, 278 (2010) [hereinafter Geis, *An Empirical Examination*].

97. *See id.* (concluding that a pattern of control and monitoring emerges where parties select “firm-like” provisions to govern incentives).

98. *See, e.g.*, Geis, *Business Outsourcing*, *supra* note 65, at 982–84 (stating that asymmetrical information is persistent and offering strategies to combat it).

99. *See, e.g.*, John Forrer et al., *Public-Private Partnerships and the Public Accountability Question*, 70 PUB. ADMIN. REV. 475, 478 (2010) (“The most common suggestion for obtaining better quality service is to draft more specific contracts with incentives that track to agent performance”).

100. Freeman, *supra* note 77, at 1317, 1351 (“[T]here might be considerable agreement between the economic and public law views about the importance of clear and enforceable contractual terms to the success of privatization.”); *see also* Davidson, *supra* note 22, at 277 (noting commentators’ views that privatization is best approached through contracts that “are clear, thorough, accurate, and unambiguous” (quoting SAVAS, PRIVATIZATION AND PUBLIC-PRIVATE PARTNERSHIPS, *supra* note 51, at 188)).

scope of the engagement and monitoring providers with ever-greater oversight.”¹⁰¹

The logic is evident. The government as the only buyer has substantial bargaining power. It can, therefore, set the parameters of the relationship. In addition to standard contract terms such as compensation and contract duration, some scholars encourage parties to specify tasks, outcome measures, and incentives or sanctions.¹⁰² By specifying tasks, the government defines the actions the vendor must undertake to ensure the service meets the government’s specifications.¹⁰³ For example, a contract may specify how many times a vendor should meet with mental health patients. Outcome measures (performance-based criteria) dictate results that a vendor must accomplish, for instance, moving a designated percentage of people off of the welfare rolls. Finally, monetary incentives or sanctions reward or penalize the vendor for either failing to meet or succeeding in meeting certain goals.

In addition to specifying tasks, outcome measures, and incentives, governments are also encouraged to include reporting requirements and monitoring rights in their contracts.¹⁰⁴ If the government utilizes these contractual control mechanisms it can, in theory, ensure compliance with program goals. This is particularly true, so the

101. Davidson, *supra* note 22, at 263; *see also* Laura A. Dickinson, *Public Values/Private Contract*, in *GOVERNMENT BY CONTRACT*, *supra* note 14, at 335, 336, 338 (arguing that performance metrics, monitoring, and enforcement mechanisms in international outsourcing contracts should be bolstered); JOHN REHFUSS, *DESIGNING AN EFFECTIVE BIDDING AND MONITORING SYSTEM TO MINIMIZE PROBLEMS IN COMPETITIVE CONTRACTING* 6–8 (1993), *available at* <http://reason.org/files/02e4e0b06250ddff83fe1732c011f696.pdf> (arguing specificity of the contract, and in particular service specifications, is important for both the bidding process and the monitoring process); Savas, *Privatization in State and Local Government*, *supra* note 18, at 99; Laura A. Dickinson, *Government for Hire: Privatizing Foreign Affairs and the Problem of Accountability Under International Law*, 47 WM. & MARY L. REV. 135, 172 (2005); Freeman, *The Contracting State*, *supra* note 22, at 170–71; Freeman, *Extending Public Law Norms*, *supra* note 77, at 1341; Minow, *supra* note 22, at 1267; Parkin, *supra* note 22, at 1348 (“[W]ithout contractual provisions that counteract incentives to cut recipients off the rolls, the post-1996 rise in privatization increases the risk that welfare benefits are erroneously terminated.”); Romzek & Johnston, *supra* note 18, at 438 (arguing contract specificity of parties’ duties and obligations is important for accountability and proposing contracts that clearly articulate responsibilities); Stevenson, *supra* note 84, at 126–31 (arguing for more stringent contractual safeguards to protect welfare recipients); Kyle, *supra* note 68, at 2111–12 (suggesting a graduated bonus system tied to recidivism rates in private prisons); Beuve & Chever, *supra* note 14, at 3–4.

102. Brown et al., *Managing Public Service Contracts*, *supra* note 22, at 327.

103. Trevor L. Brown et al., *Trust and Contract Completeness in the Public Sector*, 33 *LOC. GOV.’T STUD.* 607, 609 (2007).

104. Brown et al., *Managing Public Service Contracts*, *supra* note 22, at 327–28.

argument goes, if it can adequately monitor the private service provider to observe compliance with performance metrics.¹⁰⁵

Although the next Section addresses some of the incomplete contracting literature, the extent to which there is majority scholarly agreement over use of formal contracting mechanisms in the privatization context cannot be overstated.¹⁰⁶ For instance, Jody Freeman has advocated for “greater specificity of terms, graduated penalties, and oversight by a ‘contract manager’” in the nursing home context.¹⁰⁷ Martha Minow has suggested: “As drafter of the contracts, and the piper calling the tune, the government can set extensive and detailed public requirements.”¹⁰⁸ Alexander “Sasha” Volokh states: “there is no substitute for performance contracts that encourage quality improvements, effective monitoring, and information gathering and disclosure.”¹⁰⁹ Writing about the privatization of foreign affairs functions, Laura Dickinson suggests “[c]ontracts could be drafted to explicitly extend relevant norms of public international law to private contractors, provide for enhanced oversight and enforcement, and include more specific terms”¹¹⁰

2. *Relational contracting*

Although detailed, incentive-based contracting is the most prevalent scholarly suggestion, other contracting approaches, namely relational contracting and contracting for innovation, are methods worth considering.

Relational contracting is often considered the counterpoint to the traditional transaction contemplated in the prior Section.¹¹¹ There is no universally adopted definition of relational contracting, but it generally refers to a scenario where the relationship between the parties takes center stage, not the language of the contract itself.¹¹²

105. *Id.* at 328; *see also* RUSSELL W. HINTON, COMPONENTS OF AN EFFECTIVE CONTRACT MONITORING SYSTEM 4 (2003), *available at* http://www.dca.ga.gov/housing/housingdevelopment/BestPractices_ContractMonitoring.pdf (explaining that contract monitoring ensures adequate performance).

106. *See* Freeman, *supra* note 77, at 1350–51 (arguing that “there might be considerable agreement between the economic and public law views about the importance of clear and enforceable contractual terms to the success of privatization”).

107. Freeman, *The Contracting State*, *supra* note 22, at 202.

108. MARTHA MINOW, PARTNERS, NOT RIVALS: PRIVATIZATION AND THE PUBLIC GOOD 33 (2002).

109. *The Law of Prisons*, *supra* note 22, at 1887.

110. Laura Dickinson, *Contract as a Tool for Regulating Private Military Companies*, in FROM MERCENARIES TO MARKET: THE RISE AND REGULATION OF PRIVATE MILITARY COMPANIES 217, 218 (Simon Chesterman & Chia Lehnardt eds., 2007).

111. *See supra* Part II.C.1.

112. Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1090–91 (1981).

One view distinguishes traditional contract arrangements specified at the time of contracting from circumstances, usually involving long-term contracts, where it is not feasible to draft a completely contingent contract at the time of entering into the transaction.¹¹³ In such a scenario, parties resort to broader standards to dictate behavior, such as “best efforts” clauses, or they find ways to solve agency costs through monitoring or bonding mechanisms (like unilateral termination clauses).¹¹⁴ But the touchstone of relational contracting is a focus on building trust through repeated or long-term interactions.¹¹⁵

There is also a broader view of relational contracting, where contracts are deemed “relational” when the parties act according to norms that do not exist in the written contract.¹¹⁶ In that view, the written contract itself might be very specific. Nonetheless, it does not completely govern the parties’ relationship. The focus is on the informal ways parties ignore the terms of the contract through conduct.¹¹⁷ Under the broader definition, every contract is relational to some extent.

The second alternative to highly specified, formal, incentive-based contracting is “contract[ing] for innovation” through a process called braiding.¹¹⁸ Proponents of braiding argue that there is too much focus on formal contract mechanisms and informal contract mechanisms as distinct approaches.¹¹⁹ In practice, braiding advocates

113. *Id.* at 1091.

114. *Id.*

115. *See, e.g.*, Macneil, *supra* note 36, at 886–87. *But see* Goetz & Scott, *supra* note 112, at 1090–91 (stating that “temporal extension per se is not the defining characteristic” of relational contracts).

116. *See* Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724, 1725 (2001) (using the cotton industry as a case study to consider the importance of external factors beyond the written contract that strengthen contractual relationships in industry); Ian R. Macneil, *Relational Contract Theory: Challenges and Queries*, 94 NW. U. L. REV. 877, 877–78 (2000) (surveying the theory of relational contracts and defining “contract” as “relations in which exchange occurs,” rather than as specifically prescribed transactions); *see also* Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 56, 62 (1963) (finding that, among a sampling of the manufacturing industry, the role of non-contractual practices in exchanges is often significant); Macneil, *Contracts*, *supra* note 36, at 888–89 (arguing against a neoclassical theory of contract law that mandates the entire contractual relation could or should be “encompassed in some original assent to it”).

117. *See, e.g.*, Shawn J. Bayern, *Rational Ignorance, Rational Closed-Mindedness, and Modern Economic Formalism in Contract Law*, 97 CALIF. L. REV. 943, 945–46 (2009).

118. Gilson et al., *Braiding*, *supra* note 30, at 1382–83. “Braiding” refers to the process of incorporating both formal and informal contracting to accommodate uncertainty and to foster mutual innovation between contracting parties. *Id.*

119. *Id.* at 1388.

suggest there is often an intertwining of the two.¹²⁰ Particularly where two parties enter into a transaction where the ultimate product or service cannot be specified because it is not yet determined, formal and informal terms must be weaved together.¹²¹ A contract for innovation will be formal in the sense that it defines a governance process¹²² and specifies formal mechanisms for sharing information, but it will be informal in terms of substantive performance requirements.¹²³

One challenge to the braiding concept is that experiments have found a crowding out effect against the backdrop of formal contracts.¹²⁴ Braiding does still rely on formal contracts to some degree.¹²⁵ There is speculation that the informal aspects of contracts for innovation will mitigate the effect of crowding out, but this theory has yet to be tested.¹²⁶

Braiding is essentially a specific application of relational contracting because its primary goals are to permit the parties to build trust and to enhance the likelihood of a successful long-term relationship through a focus on contract governance.¹²⁷ But, while the idea of relational contracting dates back to the 1960s and 1970s with the seminal works of Stewart Macaulay and Ian Macneil, two of the preeminent scholars on relational contract theory, the primary focus in government service contracting remains on the classical, formal approach.¹²⁸

D. Current Practice Likely Matches Theory: Writing Detailed Contracts with Monitoring

There has been far too little study of the actual content of government service contracts. However, it is widely believed that detailed and incentive-based contracting is the most utilized model in

120. *Id.* at 1388–89.

121. *Id.* at 1383.

122. *Id.* at 1384 (suggesting that formal contracts are utilized for “exchanging information about the progress and prospects of their joint activities” where such information exchanges “provide the foundation for raising the existing level of trust”).

123. *Id.*

124. *See id.* at 1381 n.6 (cataloging studies that have shown the crowding out effect under formal contracting).

125. *Id.* at 1382 (noting that parties “are responding to rising uncertainty” by “writ[ing] contracts that intertwine elements of formal and informal contracting” mechanisms).

126. *Id.* at 1386 (“We argue that the endogeneity of the informal mechanisms in the contract—i.e., that they are largely created by the information exchange established in the formal contract—may well eliminate the risk of crowding out.”).

127. *Id.* at 1386–87.

128. *Supra* note 99 and accompanying text.

practice.¹²⁹ Further, government contracts are generally understood to be even more detailed than entirely commercial counterparts.¹³⁰ Limited studies confirm these intuitions, but there is much room for additional work in this area.¹³¹

It is, however, relatively easy to locate examples of detailed, incentive-based contracts in government service contracting. For instance, when Indiana contracted out to IBM to administer public benefits for the state, the contract “contain[ed] more than 160 pages plus extensive attachments, including 10 exhibits, 24 schedules, and 10 appendices, encompassing all aspects of the parties’ working relationship.”¹³² In substance, there were a wide variety of control mechanisms, including detailed performance metrics and performance-based compensation.¹³³

In addition, studies of outsourcing in the analogous commercial context have confirmed that in higher agency cost situations, principals try to exert more control over their agents through contract mechanisms like detailed task specification and monitoring.¹³⁴ The government contracting context is likely to be similar.

Although better agent control is the primary motivating factor behind detailed contracting, there are additional reasons for parties to prefer detailed contracting. For instance, a detailed contract may insulate a government agent from fallout if the service provision is

129. See, e.g., Parkin, *supra* note 22, at 1346 (discussing the prevalence of welfare privatization contracts that contain performance-based incentive compensation despite limited efficacy).

130. See, e.g., Mary K. Marvel & Howard P. Marvel, *The Ratio of Beef Cubes to Onion (6:1) in Hungarian Goulash and Public Sector Contracting: Market-Like or Market-Lite?*, POL’Y CURRENTS, Summer 2003, at 2, 2 (noting that the nature of public sector contracts may “vary systematically” from that of commercial contracts in terms of complexity and specificity); Praxis Solutions, Inc., *supra* note 25, at 4.

131. See Jérôme Barthélemy & Bertrand V. Quélin, *Complexity of Outsourcing Contracts and Ex Post Transaction Costs: An Empirical Investigation*, 43 J. MGMT. STUD. 1775, 1776 (2006) (analyzing a number of outsourcing contracts to compare contract complexity against *ex post* transactional costs); Dickinson, *Government for Hire*, *supra* note 101, at 142–43, 171 (describing the privatization of governmental functions in the international context and suggesting that more highly specified contracting could bring oversight and accountability); Marvel & Marvel, *supra* note 130, at 2–3 (comparing food vendor contracts for public and private entities and finding that government contracts tend to be more specified than commercial contracts for the same services); Romzek & Johnston, *supra* note 18, at 436–37 (2005) (assessing state social service contracts in Kansas to determine the factors that increase contract accountability).

132. *Indiana v. Int’l Bus. Machs. Corp.*, No. 49D10-1005-PL-021451, slip op. at 9 (Ind. Super. Ct. July 18, 2012).

133. *Id.* at 15–17.

134. See Blair et al., *supra* note 82, at 293–94 (discussing specification of terms and procedures in the context of analyzing law firm outsourcing contracts); Geis, *An Empirical Examination*, *supra* note 96, at 271–72 (quantifying offshore business outsourcing contracts to gauge, among other factors, control features).

ultimately poor.¹³⁵ In other words, the government actor could argue that he or she wrote a “good” contract and, therefore, should not be blamed for contractor errors. With pressure to enhance public accountability, detailed contracting provides some insulation for the drafter and a possible reduction in risk.

Economically rational outside legal counsel (for both sides) likely also prefer drafting detailed contracts for similar reasons, but also because the cost of drafting thorough contracts *ex ante* is likely to be higher, leading to higher compensation for the lawyer (assuming hourly-based or complexity-based payment structures).¹³⁶ A large part of the role of the lawyer in contract drafting is to anticipate potential problems *ex post*. There is pressure to be as detailed and specific as possible not only to set expectations for contractor behavior, but also to have contractual language to point to if litigation later materializes.¹³⁷

The private provider might also prefer more detail. With a better sense of exactly what is required, the contractor can more accurately bid on its services. The contractor can also make a better case that it successfully completed work when what counts as “success” was clear from the contract *ex ante*. A contractor might argue that it needs to know what the government has hired it to do.

All are potentially valid reasons to prefer detailed contracts that highly specify tasks. However, the next Part discusses why such detailed contracts often do not work in complex government service contracting.

II. THE CURRENT APPROACH OFTEN FAILS

Despite the relative unanimity of theory and the intuitive appeal of the detailed contracting approach, there are many problems with the approach in practice, particularly for certain types of government service contracts. In prior work, I defined a category of government service contracts with high agency costs.¹³⁸ I argued in particular that where a service is difficult to specify and monitor, the market for private providers is thin, and service recipients amount to a narrow, disenfranchised segment of the population, we tend to see contracts that are biased to result in cost savings at the sacrifice of service

135. See Epstein, *Contract Theory*, *supra* note 13, at 2242 (noting that outsourcing permits the government to “point its finger at the private entity”).

136. Wendy Netter Epstein, *Facilitating Incomplete Contracts*, 65 CASE W. RES. L. REV. (forthcoming 2015) (manuscript at 3) (on file with author) (discussing the sociological deterrents to incomplete contracting).

137. *Id.* at 29.

138. Epstein, *Contract Theory*, *supra* note 13, at 2215–16.

quality.¹³⁹ This is because the government lacks adequate incentive to procure good quality service and lacks the tools to obtain such service from its private agent.¹⁴⁰ I conceived of low quality service as a negative externality imposed on service recipients that the transacting parties were not forced to internalize.¹⁴¹ Because of the very characteristics that bias contracts to result in negative externalities, I suggest in this Section that the traditional methods for mitigating agency costs tend not to be effective.

Government service can be conceived of as existing on a three-dimensional spectrum, where the axes are ease of specification and monitoring, extent of market competition, and portion of the population affected by the service. In one quadrant are outsourcing contracts that are more likely to succeed at reducing cost while improving service quality. The public management literature describes such contracts as those for “hard services.”¹⁴² Hard services are easy to specify and monitor.¹⁴³ Typically, there is a competitive market for providers of hard services.¹⁴⁴ And they are easy to specify and monitor and affect a large portion of the population. Conventional examples include garbage collection and road repair.¹⁴⁵

Traditional mechanisms for controlling agency costs are likely to work relatively well for these services.¹⁴⁶ For instance, using the garbage collection example, it is easy to specify what the government seeks—a contractor to collect and dispose of trash at all residences and businesses in a community pursuant to a schedule. If the contractor fails in this task, it will be obvious. Residents and business owners will see their trash not being collected and will complain. Their complaints will be heard and will effect change because the whole community is affected and collectively has political power. The contractor will heed these complaints and remedy any performance not in keeping with the requirements of its detailed contract or else risk being replaced by another contractor available in the marketplace.

139. *Id.* at 2216.

140. *Id.*

141. Other scholars have described this category of contracts as one that simply should not be outsourced at all. *See, e.g.,* Donahue, *The Transformation of Government Work*, *supra* note 14, at 49 (listing three criteria that should be present before a government function may be “split off[:] specificity, ease of evaluation, and competition”).

142. Epstein, *Contract Theory*, *supra* note 13, at 2218–19.

143. *Id.* at 2219.

144. *Id.* at 2219–20 & n.37.

145. *Id.* at 2219. It happens that typically, hard government services also affect a wide segment of the population and tend to have a competitive market for providers. *Id.*

146. *Id.* at 2219–20 & n.37.

Knowing of these potential consequences will cause the provider to refrain from opportunistic actions. A garbage collector is not likely to shirk when faced with a contract that specifies tasks because it knows the government has switching options if service quality is poor. And it knows that the government will likely discover when service quality is poor because even if the government does a poor job monitoring, the market will convey performance information. In short, the traditional detailed contracting method is likely to work well against the backdrop of hard contracts.¹⁴⁷

On the other end of the three-dimensional spectrum are “soft services,”¹⁴⁸ where the traditional detailed contracting is likely to work much less well. In soft services, people are typically the service-focus, and there is more difficulty defining, measuring, and monitoring execution.¹⁴⁹ Soft services have been termed “complex human services” and usually involve significant discretion on the part of the service provider.¹⁵⁰ Examples include running prisons and administering welfare benefits.¹⁵¹ These services also happen to involve small, disenfranchised portions of the population.

One might argue, and several have, that soft services simply should not be outsourced.¹⁵² There might be merit in that argument. Nonetheless, the reality is that this category of service is subject to increased government outsourcing,¹⁵³ and there is little reason to believe that the trend will reverse. As such, this Article focuses on how contracting mechanisms might obviate the most common problems.

147. Beuve & Chever, *supra* note 14, at 2–6 (citing quantitative studies showing that outsourcing contracts—for hard services such as cleaning and garbage collection—actually “allows to reduce cost” but “at the expense of quality”). Also, relatively speaking, not much innovation is required in such contexts.

148. Epstein, *Contract Theory*, *supra* note 13, at 2218–19.

149. *Id.* at 2219. This dichotomy of course is overly simplistic because few services fall clearly into one category or the other. It is more accurate to conceive of services existing somewhere along a three-dimensional spectrum.

150. *Id.*

151. *Id.* It happens that many soft services impact narrow, disenfranchised segments of the population, and markets for providers are thin. *Id.* at 2219–20.

152. Eduardo Porter, *When Public Outperforms Private in Services*, N.Y. TIMES (Jan. 15, 2013), http://www.nytimes.com/2013/01/16/business/when-privatization-works-and-why-it-doesnt-always.html?_r=0 (proposing that the private sector will be better-suited than the public sector to perform a given task when “the task is clear-cut and it’s possible to define concrete goals and reward those who meet them” and the parties can “rule out cream-skimming and can ensure the measure is not gamed,” as opposed to tasks in contracts with “complex and diffuse” objectives that “mak[e] it difficult to align profit with goals,” which are less suitable for privatization).

153. Epstein, *Contract Theory*, *supra* note 13, at 2213 (“[S]tate governments’ use of privatization is on the rise.”).

A. *Task Specification Is Ineffective and Costly*

The first tenet of the traditional method for mitigating agency costs is task specification.¹⁵⁴ By definition, for the universe of contracts contemplated in this Article, there are difficulties in defining tasks or in clearly defining outcomes that are measurable and subject to monitoring or reporting.

For many complex services, it can be difficult to “writ[e] clear contracts with specific goals against which contractors can be held accountable.”¹⁵⁵ While it may be easy to specify what it means to be an effective pot-hole filler, consider how difficult it is to specify what it means to run a good prison or what it means to do a good job investigating files for purposes of security clearance decisions.¹⁵⁶ If it is difficult to clearly specify tasks or outcome measures, it follows that task specification will not work well to constrain agency costs.¹⁵⁷ Take the theoretical example of the government hiring a private agency to conduct foreign affairs. It would be nearly impossible to specify in advance the exact requirements of the private firm. The government could not even predict *ex ante* what issues might arise.¹⁵⁸ Any attempt to highly specify tasks would necessarily be incomplete.

Focusing on outcomes can similarly be problematic because the methods used to obtain the outcomes might not be desirable. For instance, in the welfare-to-work context, setting a goal of returning more applicants to work resulted in profit-seekers “creaming” applications—selecting those who are easier to serve or more likely to be successful, and avoiding the harder cases.¹⁵⁹

When the U.S. government outsourced security clearance processes to USIS, the impetus for the decision was the backlog in applications.¹⁶⁰ The contract, therefore, focused on rewarding the timely processing of the applications.¹⁶¹ It now seems obvious that

154. *Cf. id.* at 2234.

155. Michele Estrin Gilman, *Legal Accountability in an Era of Privatized Welfare*, 89 CALIF. L. REV. 569, 600 (2001) (quoting U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-98-6, SOCIAL SERVICE PRIVATIZATION: EXPANSION POSES CHALLENGES IN ENSURING ACCOUNTABILITY FOR PROGRAM RESULTS 14 (1997)).

156. It may seem that the federal government just wrote a poor contract for USIS and perhaps that is the case. But even outcome-based contracts are criticized for failure to prompt consummate performance.

157. On the other hand, the traditional method will often work well for more discrete tasks. For instance, one could easily imagine a contract for road repair that awards the filling of a certain number of potholes within a certain time period.

158. Shapiro, *supra* note 79, at 417–18 (noting that specifying tasks in advance is particularly challenging where, as with many enforcement issues in foreign affairs, the “resolution . . . inevitably involves a discretionary judgment”).

159. Epstein, *Contract Theory*, *supra* note 13, at 2249, 2253.

160. Gabriel, *Shortcuts*, *supra* note 8.

161. *Id.*

the contract incentives (completing the processing of applications over thoroughly investigating backgrounds) were the wrong ones, but often it is difficult to create performance-incentives because of incompatible goals (in the case of USIS, speed versus thoroughness). Whereas one instinct might be that the USIS example is just one of a poorly designed contract, almost any other outcome or performance-focused alternative has significant problems.

Outsourcing education can be similarly troubling in this regard. In the context of education, one might also specify desired outcomes rather than tasks; for instance, one might state that students are to achieve particularized scores on standardized tests.¹⁶² Specifying desired outcomes, however, only incentivizes teaching to the test instead of encouraging good teaching.¹⁶³ The distinction between perfunctory and consummate behavior comes back into the analysis here. Accordingly, it is difficult to force compliance with overall service provision goals solely through more detailed requirements or even outcome-based rewards.¹⁶⁴

Even if it is possible to specify either tasks or outcomes, the best possible outcome for the principal is to get just what it requested. Extreme specification kills the very innovation that contracting out was supposed to enable. In other words, privatization theory suggests that private service providers not constrained by government bureaucracy are more likely to innovate to provide better quality service at lower cost. In practice, however, the intense specification of tasks in incentive contracts vastly reduces the space in which providers are left to innovate.

If a highly specific contract defines tasks that must be completed, the best case scenario is that agents will comply. “The more we reward those things that we can measure, and not reward the things we care about but don’t measure, the more we will distort behavior.”¹⁶⁵ Put another way, “[i]f what gets measured is what gets managed, then what gets managed is what gets done.”¹⁶⁶

162. JOHN D. DONAHUE, *THE PRIVATIZATION DECISION: PUBLIC ENDS, PRIVATE MEANS* 219 (1989).

163. See Porter, *supra* note 152 (“Unsupervised apple pickers who are paid by the apple will probably pick them off the ground.”).

164. See, e.g., Wisconsin Works (W-2) Contract and Implementation (C&I) Committee, Meeting Minutes 1 (July 18, 2008), *available at* http://dcf.wisconsin.gov/w2/ci/2008/pdf/07_08/july_08_ci_final_notes.pdf (specifying issues that state agencies in Wisconsin expressed with regard to the disconnect between performance standards and “overarching goals”).

165. Porter, *supra* note 152.

166. *Id.*

Finally, highly specifying contracts carries with it a large cost. In a bid situation, the government contracting agents spend many hours specifying the terms of the bid up front. In a negotiated contract scenario, both parties may negotiate the terms of the deal over a lengthy period. The traditional argument is that this ex ante cost is justified (or at least may be justified) to prevent the ex post cost of litigation. Nevertheless, if the intense specification does not actually produce better results by means of better agent performance, as I argue, then the cost incurred in specification is actually decreasing the net gain for the parties.

Accordingly, although task specification is supposed to deter opportunistic behavior on the part of the agent, for complex services, specification is not likely to have the desired effect.¹⁶⁷

B. Monitoring Is Both Difficult and Expensive to Conduct

A related problem is that it is both difficult and costly to monitor complex government services. Monitoring theoretically mitigates agency costs by constraining a contractor's opportunity to shirk.¹⁶⁸ In practice, however, the efficient use of monitoring depends on the precision with which the government defines the tasks and the observability of relevant behavior.¹⁶⁹

Monitoring is also costly, and with increased monitoring difficulty comes increased cost. Monitoring is particularly difficult for soft government services that are large, complicated, and removed from the public eye.¹⁷⁰ While government officials can make unannounced visits to private prisons, it would be difficult to adequately observe the

167. Shapiro, *supra* note 79, at 417 ("The literature on outsourcing government services recognizes . . . that it is easier to contract for government services in cases where the parameters of a vendor's performance can be clearly specified in advance."). In her work, Shapiro compares the relative ease of contracting for garbage pickup against the more difficult prospect of contracting for private prisons, noting that "the former function does not require discretionary judgments by private employees in circumstances in which it is difficult to specify in advance how the employees should act." *Id.*

168. See Trevor L. Brown & Matthew Potoski, *Transaction Costs and Contracting: The Practitioner Perspective*, 28 PUB. PERFORMANCE & MGMT. REV. 326, 328, 330 (2005).

169. See *id.* at 330.

170. See *id.* at 332 (explaining that government services with low asset specificity, or a high likelihood that the resources applied to delivering the service can be applied to other services, are easier to monitor because the services can be performed by a greater number of potential vendors and the services can be easily measured and directly observed).

goings on at entire institutions. Monitoring also requires expertise, which government officials often lack.¹⁷¹

Many studies have found that governments under-monitor when they outsource complex services.¹⁷² This may have to do with the difficulty of monitoring when tasks are not adequately specified, the cost involved in effectively monitoring, or the imprecision in monitoring. For instance, one study of local government outsourcing conducted in 2007 found that 58% of the sample “questioned the validity of the information obtained from monitoring.”¹⁷³

The accuracy of the data was questioned primarily because quality assessments are based on infrequent visits (18%) and evaluations are made based on snapshot depictions (40%) of on-site conditions that are susceptible to manipulation by providers (i.e., this response reflects concern that conditions on-site are “staged” for visits by monitors).¹⁷⁴

Other studies have found similar results.¹⁷⁵

As with task specification, monitoring is not likely to have the desired effect of constraining agency costs.

C. *Thin Market Does Not Constrain Opportunism*

The absence of a well-functioning market provides an additional challenge to the function of the traditional contract approach. The traditional method assumes that an agent will be dissuaded from performing poorly because the principal will know what amounts to poor performance, will become aware of poor performance, and will have switching options in the marketplace. An agent who wants to avoid losing the contract at renewal, or who is concerned about reputational consequences of poor performance, will make every effort to perform well. A well-functioning market is integral to the success of the traditional approach because without true switching

171. See Richard Frankel, *Regulating Privatized Government Through § 1983*, 76 U. CHI. L. REV. 1449, 1499 (2009) (alluding to the government’s lack of expertise by pointing out that it often monitors the easiest measurement available, which is cost).

172. See Mildred E. Warner et al., *Contracting Back In: When Privatization Fails*, in THE MUNICIPAL YEAR BOOK 2003 30, 36 (2003) (noting that in a survey most of the respondents reported some level of contracting out but fewer than half reported any monitoring).

173. Dicke, *supra* note 22, at 460.

174. *Id.*

175. In one study, fewer than half of the responding municipal governments reported doing any monitoring. Mildred E. Warner & Amir Hefetz, *Cooperative Competition: Alternative Service Delivery, 2002–2007*, in THE MUNICIPAL YEAR BOOK 2009 11, 14, 18 (2009) (reporting private entities responsible for more than 25% of local or municipal service delivery); see also Sharon Dolovich, *State Punishment and Private Prisons*, 55 DUKE L.J. 437, 491 (2005) (describing a December 1997 survey of state and federal government agencies reporting that almost 30% did no monitoring at all).

options in the marketplace, the agent would not be dissuaded from acting opportunistically because the agent would not fear losing the contract at renewal or general reputational sanctions.

This precondition of a well-functioning market, however, oftentimes does not exist. In one instance in New Jersey, there was only one bidder for a contract to run a 450-bed immigrant detention center.¹⁷⁶ The list of outsourcing contracts entered into after a single bid, or a low number of bids, is a long one.¹⁷⁷ Studies have also confirmed the anecdotal evidence of thin markets for certain types of government services.¹⁷⁸

There may be many reasons for thin markets. Sometimes the government contracts out for services that did not previously exist.¹⁷⁹ While markets may develop, for instance for private prisons, only resource-rich companies are likely to be able to compete.¹⁸⁰ Even so, once a provider wins the initial contract, it gains an advantage that may be hard for other companies to overcome. For this reason, there tends to be consolidation of firms in specified markets for government services over time.¹⁸¹

Whereas effective markets can help overcome principal-agent problems, public-private contracting markets are thin. For this reason, as well, traditional methods of specifying tasks, monitoring,

176. Sam Dolnick, *Reversing Course, Officials in New Jersey Cancel One-Bid Immigrant Jail Deal*, N.Y. TIMES (Aug. 15, 2011), <http://www.nytimes.com/2011/08/16/nyregion/esssex-county-reverses-decision-on-detention-center-bid.html>.

177. For example, in Connecticut, Colonial Cooperative Care, Inc. was the only bidder for its contract to determine eligibility for disability-based cash assistance. See generally Stevenson, *supra* note 84, at 91, 105.

178. For instance, a 2007 survey of city and municipal governments found that, on average, there are fewer than two provider options for city service contracts. See Warner & Hefetz, *supra* note 175, at 11, 17. State governments also experience thin markets as they increase their reliance on contracts for service delivery. For a good summary of studies competition in local and state-level outsourcing, see Jocelyn M. Johnston & Barbara S. Romzek, *Social Welfare Contracts as Networks: The Impact of Network Stability on Management and Performance*, 40 ADMIN. & SOC'Y 115, 141 (2008) (providing an example from Kansas, where a few primary contractors have dominated and shifted negotiating power away from the state purchaser); Van Slyke, *Mythology of Privatization*, *supra* note 14, at 299 (providing a summary of studies regarding competition in local and state-level outsourcing); Mildred E. Warner & Germã Bel, *Competition or Monopoly? Comparing Privatization of Local Public Services in the US and Spain*, 86 PUB. ADMIN. 723, 725 (2008) (explaining the concentration of private contractors in the waste industry).

179. In reality, governments often buy a wide range of goods and services for which there is no preexisting market so there are only a limited number of suppliers.

180. Stevenson, *supra* note 84, at 91.

181. See Bach, *supra* note 71, at 299 n.100 (stating that over time vendors tend to become established as the providers for a particular program); Mark Schlesinger et al., *Competitive Bidding and States' Purchase of Services: The Case of Mental Health Care in Massachusetts*, 5 J. POL'Y ANALYSIS & MGMT. 245, 253 (1986) (describing the multiple forces encouraging consolidation among contractors for mental health services in Massachusetts—forces such as economies of scale in both provisioning and bidding).

and tying performance to compensation often do not adequately constrain opportunistic behavior or, even better, prompt best efforts.¹⁸²

D. Risk of Corruption

The traditional model does little to account for the risk of corruption, which is particularly high in the world of government service contracting. As myriad examples indicate, the companies that receive lucrative contracts may do so on the basis of political or economic connections, rather than merit.

For instance, in Pennsylvania, two judges received \$2.6 million over seven years from Pennsylvania Child Care LLC, a private company that operated a juvenile detention center, in return for helping to secure the company a twenty-year, \$58 million contract with the county.¹⁸³ The judges were charged with aggressively sentencing children for minor infractions to ensure that the detention center remained at capacity.¹⁸⁴ In early 2009, the two judges were charged with racketeering, extortion, bribery, money laundering, and fraud, among other crimes.¹⁸⁵ Also in 2009, a county commission president in Alabama was convicted of taking bribes to steer government business to J.P. Morgan.¹⁸⁶

Simply put, corruption may also blunt the impact of actions meant to control agency costs.¹⁸⁷ A party that knows it will win a contract renewal on the basis of bribes rather than performance will not be incentivized to deliver better performance.¹⁸⁸

E. Studies Demonstrate Problems with Traditional Approach

Theory aside, some preliminary empirical studies have now shown that in certain types of public-private contracting, highly detailed and specific contractual requirements do not positively correlate with

182. See Schlesinger et al., *supra* note 181, at 253 (explaining that the difficulty in prespecifying a task, such as mental health care, lessens the incentive to perform as required, i.e., to produce more efficient care).

183. *Pennsylvania “Kids for Cash” Conspiracy*, IN PUB. INT., <http://www.inthepublicinterest.org/case/pennsylvania-kids-cash-conspiracy> (last visited Oct. 22, 2014).

184. Stephanie Chen, *Pennsylvania Rocked by “Jailing Kids for Cash” Scandal*, CNN (Feb. 24, 2009, 10:14 AM), <http://www.cnn.com/2009/CRIME/02/23/pennsylvania.corrupt.judges>.

185. *Id.*

186. Mary Williams Walsh, *J.P. Morgan Settles Alabama Bribery Case*, N.Y. TIMES (Nov. 4, 2009), <http://www.nytimes.com/2009/11/05/business/05derivatives.html>.

187. In part for this reason, sanctions are used infrequently and inconsistently.

188. It is unclear whether drafting less detailed contracts more effectively curbs corruption. This is an area requiring more study.

better contractor performance.¹⁸⁹ For instance, one study was conducted on a dataset of 450 local government contracts from throughout the country obtained by a mail survey.¹⁹⁰ It noted that there is a common set of variables in the literature thought to determine contract performance.¹⁹¹ Included in those variables are contract specificity and contract monitoring scope and intensity, among others.¹⁹² The study author hypothesized that these variables would be positively correlated with the dependent variable.¹⁹³ On the contrary, though, the study found that “developing highly detailed and specific contractual requirements [to] have little if any effect on contracting performance,” and that “the discovery of performance problems through monitoring by itself does little to improve contracting performance.”¹⁹⁴ It also found that the use of legal sanctions did not discourage poor performance.¹⁹⁵ Nor did “including financial incentives . . . in the contractual agreement appear[] to have . . . [an] effect on contracting performance”¹⁹⁶

More work in this area is merited. But, at the very least, there is strong reason to doubt that the default approach specifying tasks in detail, monitoring to ensure compliance, and tying success to financial incentives—is the best approach. The next Part details an alternative suggested by work in behavioral economics.

III. SUGGESTING A DIFFERENT APPROACH

The standard approach to principal-agent problems is predicated on the assumption of fully rational and selfish individuals looking for opportunities to shirk.¹⁹⁷ Viewed in this way, agents need to be controlled or need to be given incentives so that their rational, profit-

189. Sergio Fernandez, *Accounting for Performance in Contracting for Services: Are Successful Contractual Relationships Controlled or Managed?* 10–11 (Sept. 2005) (unpublished manuscript), available at http://localgov.fsu.edu/readings_papers/Service%20Delivery/Fernandez_Accounting_for_Performance_in_Contracting_Services.doc.

190. *Id.* at 14–15.

191. *Id.* at 6.

192. *Id.*

193. *Id.*

194. *Id.* at 17–18.

195. *Id.* at 18.

196. *Id.* at 19; see also Ernst Fehr & Armin Falk, *Psychological Foundations of Incentives I* (Inst. for the Study of Labor, Discussion Paper No. 507, 2002), available at <http://www.econstor.eu/bitstream/10419/21434/1/dp507.pdf> (finding that monetary incentives can “backfire and reduce the performance of agents or their compliance with rules”). As discussed in Part III.B *infra*, other studies have affirmatively shown a *negative* effect from the use of incentives.

197. See *supra* Part I.C.1 (discussing how agency theory assumes that agents are rational, selfish actors).

maximizing interests align with the principal's interests. But this is not necessarily always an accurate view of individual behavior. Indeed, it has now been over thirty years since Daniel Kahneman and Amos Tversky,¹⁹⁸ Richard Thaler,¹⁹⁹ and others first described a variety of contract-relevant behavioral anomalies.

In particular, the positive reciprocity norm—meaning that people reward kind actions—has been shown to often constrain actors' behavior, resulting in deviations from what the rational actor model would predict.²⁰⁰ Research has demonstrated that because of the inclination towards reciprocity, less complete contracts that do not highly specify tasks or do not use incentive-based compensation actually induce higher agent effort levels and better constrain opportunistic impulses than more explicit contracts.²⁰¹ Therefore, exclusive reliance on the rational actor model in designing contracts to mitigate agency costs may be misplaced. This Part suggests that particularly where traditional detailed contracts are ineffective, governments should instead consider drafting contracts that trade on the positive reciprocity value, and are accordingly less-detailed.²⁰²

198. See, e.g., Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 *ECONOMETRICA* 263, 263 (1979) (presenting problems in which preferences violate the expected outcome); Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 *SCI.* 453, 453 (1981) (finding shifts of preferences from the predicted outcome when the problem is framed in a different way).

199. See Richard Thaler, *Toward a Positive Theory of Consumer Choice*, 1 *J. ECON. BEHAV. & ORG.* 39, 57–58 (1980) (arguing that in certain situations consumers act in a way inconsistent with economic theory).

200. See, e.g., Fehr & Gächter, *Fairness and Retaliation*, *supra* note 28, at 164, 176–77. Not all actors will behave reciprocally. Fehr et al. have found that 60–75% of subjects will behave reciprocally, while 15–25% of subjects will act in line with the rational actor model. Fehr et al., *Reciprocity as a Contract Enforcement Device*, *supra* note 28, at 840 n.7.

201. See Fehr & Gächter, *Fairness and Retaliation*, *supra* note 28, at 173 (explaining that with incomplete contracts, workers can punish the employer by working less until the worker receives a wage increase).

202. *But see*, Scott Baker & Kimberly D. Krawiec, *Incomplete Contracts in a Complete Contract World*, 33 *FLA. ST. U. L. REV.* 725, 732 n.17 (2006) (pointing out that vertical integration is often the suggested solution when more complete contracting is not possible). However, for a variety of reasons both economic and political, governments often cannot practically take these services back “in-house.” Governments may lack the resources and expertise to directly provide these services. Once a service has been outsourced, there may be political consequences to admitting the fault in that decision. Accordingly, this section looks for solutions aside from vertical integration.

A. *The Reciprocity Norm in General*

Reciprocity in the behavioral economics literature²⁰³ refers to responding in kind. If you are treated kindly, you will respond with kind actions. If you are treated poorly, you will reciprocate with negative actions. Reciprocity is different from “cooperative” or “retaliatory” behavior because it does not turn on a calculus as to future benefits. As such, it is different from relational principals that largely focus on the development of trust through long-term interactions. The games that define the parameters of reciprocal behavior are generally one-shot games with no repeat interaction.²⁰⁴ A reciprocal actor reacts without expectation of future material gains.²⁰⁵

There are three seminal social dilemma games that are particularly relevant to the theory of reciprocity: the Ultimatum Game, the Trust Game, and the Public Goods Game.²⁰⁶ The Ultimatum Game requires two participants to decide how to split a fixed sum of money.²⁰⁷ The first party makes a proposal of how to split the sum, and the second party either accepts the proposal or rejects it. If the second party accepts the proposal, each leaves with their portion of the total. If the second party rejects the proposal, both parties walk away with nothing. If the parties acted in a purely rational, self-interested manner, one would predict that the first party should make a very low offer and the second party should accept it. The second party is better off walking away with any amount that is not zero. The evidence shows, however, that if the first party proposes anything less than 20% of the total amount, the second party will reject the offer more than 50% of the time.²⁰⁸ In other words, people react to the perceived fairness of the offer, and not as the rational actor model would predict.²⁰⁹

203. The term reciprocity is used across many different disciplines. Here, I am focused on reciprocity in the behavioral sense as a form of voluntary cooperation.

204. Scott, *supra* note 28, at 1665. This is important for the application of reciprocity to government service contracting where markets are often thin. While trust that develops over time may certainly be important in this context, and many contracts may indeed be long-term and involve repeat interaction, I am concerned that repeat interaction games count on reputational sanctions in a well-functioning market to constrain bad behavior.

205. Reciprocity is also different from altruism, which is unconditional kindness unrelated to others' actions.

206. Mark F. Schultz, *Fear and Norms and Rock & Roll: What Jambands Can Teach Us About Persuading People to Obey Copyright Law*, 21 BERKELEY TECH. L.J. 651, 700 (2006).

207. *Id.* at 706–07.

208. Scott, *supra* note 28, at 1663.

209. See *id.* at 1664 (explaining that responders do not behave as the self-interested hypothesis predicts because “[t]hey are prepared to reject offers they perceive as unfair even at a cost to themselves”).

The Trust Game is an extension of the classical Dictator Game.²¹⁰ In the Trust Game, one player (the allocator) decides on his or her own how to split up a pot of money with a second player.²¹¹ The amount the allocator gives to the recipient is then multiplied by some value greater than one and the recipient chooses what amount, if any, to give back to the allocator. The game is played only once. A rational allocator will assign no part of the pot to the recipient, and a rational recipient will make no payment back to the allocator.²¹² A 2009 meta-analysis of 84 trust game studies revealed that the allocator gave an average of about 51% and that the receiver returned an average of 37%.²¹³

Finally, in the Public Goods Game, each player is asked to secretly contribute some amount of their money into a public pot.²¹⁴ The total amount of money is then multiplied by some “payoff” number (i.e., a multiplier) and divided equally among the group. Subjects are allowed to keep the money they do not contribute. Self-interested, rational actors would contribute nothing to the pot because they free ride off of others’ contributions regardless of whether they individually contribute. In reality, though, people do tend to contribute to the pot at some non-negligible percentage. Studies confirm that three-quarters of participants will contribute and that half of those who do so understand that they would be economically better off not contributing.²¹⁵

A host of empirical studies of real-world behavior have also confirmed the functioning of the reciprocity value in practice. For instance, the decisions to give to charity, to not litter, and to wait your turn in line have all been studied as examples of reciprocity in action.²¹⁶ In other words, people reciprocate the dispositions of

210. *Id.* at 1663 n.95; see Schultz, *supra* note 206, at 708 (explaining that, in the Dictator Game, the proposer decides how much money to give to an anonymous person, who receives the money and cannot respond).

211. Noel D. Johnson & Alexandra Mislin, *Cultures of Kindness: A Meta-Analysis of Trust Game Experiments* 4 (May 18, 2009) (unpublished manuscript), available at <http://mercatus.org/sites/default/files/Cultures-of-Kindness—A-Meta-Analysis-of-Trust-Game-Experiments-pdf>.

212. See Scott, *supra* note 28, at 1661 (defining rational choice theory as a theory that assumes individuals will make decisions based on self-interest).

213. Johnson & Mislin, *supra* note 211, at 10–11, 40 tbl.1.

214. Schultz, *supra* note 206, at 702–03.

215. Brian Netter, *Avoiding the Shameful Backlash: Social Repercussions for the Increased Use of Alternative Sanctions*, 96 J. CRIM. L. & CRIMINOLOGY 187, 204 (2005). In a 2001 study, Fischbacher et al., observed average contributions of 33.5%. Urs Fischbacher et al., *Are People Conditionally Cooperative? Evidence from a Public Goods Experiment*, 71 ECON. LETTERS 397, 401 (2001).

216. See ELLIOT ARONSON, *THE SOCIAL ANIMAL* 29 (7th ed. 1995) (discussing how people tend to do what they see others doing and comply with social norms, for instance in not littering); ROBERT B. CIALDINI, *INFLUENCE: SCIENCE AND PRACTICE* 96–

others; they engage in certain behavior because others are also willing to do so, and it seems fair to comply with behavioral norms.

The games and their real-world counterparts demonstrate reciprocal social behavior that deviates from rational actor expectations. The games focus on how behavior is affected in light of the perceived intentions of other actors. If another actor treats you fairly, you are more likely to treat him or her fairly in return. The actual fairness of distribution is not as relevant as the perceived kindness or fairness of actions.²¹⁷

The identification of the reciprocity norm may suggest that contracting mechanisms relying purely on material self-interest are incomplete because they are missing important behavioral motivations. The next Section explores whether contract design has the potential to prompt reciprocal behavior.

B. *Reciprocity and Specificity in Contracting*

Reciprocity is now firmly established in experimental settings and can be reliably elicited.²¹⁸ The next question, then, is how the reciprocity norm manifests in the contracting context (if at all).

As discussed in Part II.E, one might predict that a less specified contract that does not tie performance to compensation would make it more difficult for a principal to control an agent. If contracts are not well specified, then rational, self-interested parties might take advantage of ambiguities in the contract and shirk. In addition, the traditional view of specificity in contract design is that specificity is an enabling factor for monitoring. The agent cannot be successful in implementing the will of the principal unless it knows precisely what the principal wants it to do. It is generally thought that specifying

97 (3d ed. 1993) (explaining that people have a tendency to give more to charity if they think others also give to charity); Robert B. Cialdini et al., *A Focus Theory of Normative Conduct: Recycling the Concept of Norms to Reduce Littering in Public Places*, 58 J. PERSONALITY & SOC. PSYCHOL. 1015, 1015–16 (1990); Stanley Milgram et al., *Response to Intrusion into Waiting Lines*, 51 J. PERSONALITY & SOC. PSYCHOL. 683, 683 (1986) (analyzing the line as an example of society's effort to create equity); Peter H. Reingen, *Test of a List Procedure for Inducing Compliance with a Request to Donate Money*, 67 J. APPLIED PSYCHOL. 110, 110 (1982) (discussing the impact of social influence on people contributing to charity).

217. Stefan Magen, *Fairness and Reciprocity in Contract Governance* 5 (Max Planck Inst. for Research on Collective Goods Preprint, Working paper No. 2013/21, 2013), available at <https://www.econstor.eu/dspace/bitstream/10419/84986/1/769720838.pdf>.

218. Fehr & Gächter, *Fairness and Retaliation*, *supra* note 28, at 162–63; *see also* Jody S. Kraus & Robert E. Scott, *Contract Design and the Structure of Contractual Intent*, 84 N.Y.U. L. REV. 1023, 1091 n.245 (2009) (“The observed preference for reciprocity is heterogeneous . . . ‘where some people exhibit reciprocal behavior and others are selfish.’”).

tasks *ex ante* is less costly than litigating a vague contract *ex post*, taking into consideration the probability that litigation will result.²¹⁹

This is all what traditional law and economics suggests. But, experiments tying the reciprocity norm to contracting behavior belie much of this traditional view.²²⁰ Ernst Fehr and Simon Gächter, among others, have studied the question of whether changing contract design can cultivate social norms, in particular reciprocal responses, and have answered in the affirmative.²²¹

In one study, Fehr et al. hypothesized that “reciprocal motivations and interactions could potentially ease incentive compatibility constraints” in contracts.²²² They tested their theory in an experiment that simulated firms and workers.²²³ They designed two treatments, a weak reciprocity treatment and a strong reciprocity treatment.²²⁴ In the weak treatment, workers could respond reciprocally to firms’ actions, but the firms could not respond to the workers.²²⁵ On the other hand, in the strong treatment, both the firm and the workers could respond reciprocally to each other.²²⁶ The study found large efficiency gains in the strong reciprocity treatment.²²⁷ Workers shirked less, and firms enforced effort levels far above the incentive compatible level.²²⁸

In another study, Fehr and Gächter tested how explicit material incentives to abide by the terms of the contract interact with motivations of fairness and reciprocity.²²⁹ There, the study compared implicit and explicit contracts.²³⁰ The implicit contract specified a fixed wage and a desired effort level, but made no incentive-based

219. See Magen, *supra* note 217, at 15–16 (discussing the efficiencies of *ex ante* and *ex post* negotiations).

220. See *id.* at 14 (“With *homo reciprocans* contracting, contracts will be accompanied by expectations of fairness. These fairness expectations might not be recognised by the law as relevant, but it is safe to assume that they influence the formation and execution of the contract by the parties and should hence be taken into account by Contract Governance.” (footnote omitted)).

221. In more recent years, others have also studied whether contract choices “may signal information about the actions of other agents and thus create indirect effects on behavior.” Anastasia Danilov & Dirk Sliwka, *Can Contracts Signal Social Norms? Experimental Evidence* 3 (Inst. for the Study of Labor, Discussion Paper No. 7477, 2013) (citing the economic models generated by Sliwka (2007), Friebe and Schmedler (2011), van der Weele (2012), and Bénabou and Tirole (2012)).

222. Fehr et al., *Reciprocity as a Contract Enforcement Device*, *supra* note 28, at 834.

223. *Id.* at 835.

224. *Id.*

225. *Id.*

226. *Id.*

227. *Id.* at 835, 856.

228. *Id.* at 856.

229. Fehr & Gächter, *Fairness and Retaliation*, *supra* note 28, at 176.

230. *Id.* at 176–78.

commitments.²³¹ The principal was obligated to pay the wage regardless of the agent's actual output level.²³² The explicit contract also specified a wage and a desired output; however, it included an additional term whereby the principal could fine the agent in the case of shirking.²³³ The game had three stages.²³⁴ Principals chose contracts (explicit or implicit), agents agreed to contracts, and then agents chose an effort level.²³⁵

The results were informative. Principals who chose the explicit contract lost on average nine tokens per contract, compared to a profit of 26 tokens per implicit contract.²³⁶ The difference was attributable to effort levels.²³⁷ The agent's effort level in the implicit contract was 5.2 on average (out of ten), while the effort level in the explicit contract was 2.1 on average.²³⁸ Similar results have been confirmed by other studies.²³⁹

Why would it be the case that less explicit contracts prompt better agent performance? Most experiments do little to answer this question.²⁴⁰ The prevailing theory is that less-specific contracts give

231. Although it made no commitment to do so, the principal had the option of paying a bonus after observing the agent's effort level. *Id.* at 176.

232. *Id.*

233. *Id.*

234. *Id.*

235. *Id.* at 176–77.

236. *Id.* at 177.

237. *Id.*

238. Fehr & Gächter dismiss the possibility that the punishment versus reward distinction explains the result based on the results of further experiments. *Id.* at 177.

239. See, e.g., Bohnet et al., *supra* note 24, at 141 (asserting that lower levels of contract enforcement increase trustworthiness between contracting parties while economic incentives do not have the same effect); Fehr & Gächter, *Crowd Out*, *supra* note 33, at 26 (observing that voluntary cooperation may be crowded out by incentive contracts); Frey & Jegen, *supra* note 33, at 606 (finding empirical evidence for the idea that incentives and punishments crowd out intrinsic motivation); Kessler & Leider, *supra* note 33, at 76 (describing a laboratory experiment finding unenforceable “handshake” agreements to be most effective); Lubell & Scholz, *supra* note 33, at 167 (discovering that incentives created by institutions do not “counterbalance the temptation to free ride”); see also Scott, *supra* note 28, at 1644–45 (speculating that parties write “deliberately incomplete contracts that rely on self-enforcement” between strangers, which is a “more efficient . . . alternative . . . [than] more complete, legally enforceable agreements”). *But cf.* Rigdon, *supra* note 33, at 102–03 (finding no evidence to support a hypothesis that motivating a worker with trust alone is more effective than incentives or punishments). Put simply, these studies suggest that less specified contracts may prompt better performance than more explicit contracts that utilize incentive-based compensation even though higher effort levels are not in the agent's rational self-interest. Scott, *supra* note 28, at 1663 (“[E]xperimental evidence suggests that incompletely specified contracts that leave space for reciprocation can achieve higher levels of efficiency than more explicit, legally enforceable contracts. These fairness values appear to interact with and complement the self-interest motivation of economic actors.”).

240. Behavioral economics tries to predict responses but does not in general seek to answer the question of “why.”

agents more autonomy than more-specific ones and boost intrinsic motivation.²⁴¹ Specificity in contracts, on the other hand, gives the agent the impression of lack of trust on the part of the principal. This theory is strengthened by other work.²⁴² For instance, an experiment allowed a principal to either set a lower limit for production to bind an agent, or to give discretion to an agent to set a production amount.²⁴³ It then tested production amounts chosen by agents.²⁴⁴ The results indicated higher levels of production with the ambiguous instruction than with the lower limit.²⁴⁵ When the agents were questioned, most indicated perceiving the lower limit as a signal of distrust and hence behaved less cooperatively.²⁴⁶

One possibility is that less-specific contracts frame the relationship from the outset as a cooperative one. The so-called “Wall Street Game” or “Community Game,” demonstrated that simply changing the name of the social dilemma game significantly changed the results.²⁴⁷ In this experiment, American college students, Israeli pilots, and their flying instructors played a Prisoner’s Dilemma-type game where the participants chose to compete or cooperate in a number of stages.²⁴⁸ Those who were told they were playing “the Community Game” were found to be much more cooperative throughout the stages of the game than those who were told they were playing “the Wall Street Game.”²⁴⁹ Similarly, the tone set during contracting may persist for the duration of the parties’ relationship.

241. Chou et al., *supra* note 24, at 17–18 (asserting that less-specific contracts benefit both employees and employers); *see also* Edward L. Deci et al., *Facilitating Internalization: The Self-Determination Theory Perspective*, 62 J. PERSONALITY 119, 140 (1994) (extolling the benefits of self-determination: enhanced creativity, productivity, and work satisfaction); Wendy S. Grolnick & Richard M. Ryan, *Parent Styles Associated with Children’s Self-Regulation and Competence in School*, 81 J. EDUC. PSYCHOL. 143, 152 (1989) (finding that children are more successful when parents support the child’s autonomy); Richard M. Ryan & Edward L. Deci, *Self-Determination Theory and the Facilitation of Intrinsic Motivation, Social Development, and Well-Being*, 55 AM. PSYCHOL. 68, 76 (2000) (explaining that autonomy encourages intrinsic motivation, while controlled conditions undermine it).

242. Armin Falk & Michael Kosfeld, *The Hidden Costs of Control*, 96 AM. ECON. REV. 1611 (2006).

243. *Id.* at 1611.

244. *Id.*

245. *Id.* at 1612.

246. *Id.* at 1611–12.

247. Varda Liberman et al., *The Name of the Game: Predictive Power of Reputations Versus Situational Labels in Determining Prisoner’s Dilemma Game Moves*, 30 PERSONALITY & SOC. PSYCHOL. BULL. 1175, 1182 (2004).

248. *Id.* at 1176, 1178.

249. *Id.* at 1177 (finding that when playing the “Community Game,” more nominees cooperated, while when playing the “Wall Street Game,” only one-third of the same nominees cooperated).

Less specified contracts set a more positive tone than more highly detailed, control-based contracts.²⁵⁰

Other studies have shown that strict enforcement, incentives, and sanctions can also harm cooperation.²⁵¹ In general, much work has now suggested that intrinsic motivations can be crowded out by extrinsic ones.²⁵² Fehr in particular has found that when people attribute their behavior to external rewards, they discount their other (social) incentives for behavior.²⁵³

It is not only specificity that can crowd out intrinsic motivation. Studies have shown that the use of tangible rewards or sanctions undermines motivation for a range of activities.²⁵⁴ Use of incentives, such as incentive-based compensation (the so-called carrots and sticks), can damage self-esteem and harm the norms of professionalism, thus crowding out intrinsic motivation.²⁵⁵ Also, monitoring at a certain level decreases work effort.²⁵⁶ Monitoring and specificity together have been shown to be particularly problematic.²⁵⁷

250. See David Hess, *A Business Ethics Perspective on Sarbanes-Oxley and the Organizational Sentencing Guidelines*, 105 MICH. L. REV. 1781, 1796–97 (2007) (noting in the context of firm behavior that “negative attitudes toward cooperative behavior are always lurking in the background and must be proactively managed”).

251. See Ann E. Tenbrunsel & David M. Messick, *Sanctioning Systems, Decision Frames, and Cooperation*, 44 ADMIN. SCI. Q. 684, 704 (1999) (suggesting that sanctioning systems decrease cooperation and cause subjects to value economic incentives over moral ones).

252. Bohnet et al., *supra* note 24, at 132 (“At intermediate levels [of enforcement], honesty is crowded out; more second movers breach, and resources are wasted in trials.”); Deci et al., *Extrinsic Rewards*, *supra* note 24, at 659 (“[R]eward contingencies undermine people’s taking responsibility for motivating or regulating themselves.”); Fehr & Gächter, *Crowd Out*, *supra* note 33, at 26 (describing their finding “that reciprocity-driven voluntary cooperation may indeed be crowded out by incentive contracts”); Uri Gneezy & Aldo Rustichini, *A Fine Is a Price*, 29 J. LEGAL STUD. 1, 3 (2000) (arguing that “the introduction of the fine changes the perception of people regarding the environment in which they operate,” but does not necessarily reduce penalized behavior); Daniel Houser et al., *When Punishment Fails: Research on Sanctions, Intentions and Non-Cooperation*, 62 GAMES & ECON. BEHAV. 509, 522 (2008) (“Credible threats of sanctions often failed to produce cooperative behavior, and our evidence is that incentives, not intentions, underlie this effect.”); Chou et al., *supra* note 24, at 16.

253. See, e.g., Fehr & Gächter, *Crowd Out*, *supra* note 33, at 26 (concluding that “reciprocity-driven voluntary cooperation” has been crowded out by incentive contracts); see also John Rappaport, *Second-Order Regulation of Law Enforcement*, CALIF. L. REV. (forthcoming 2015) (manuscript at 32) (on file with author) (citing the work of Tom Tyler to show that law enforcement officers’ perceptions of legitimacy are shaped by their feelings about procedural fairness).

254. See generally EDWARD DECI & RICHARD RYAN, *INTRINSIC MOTIVATION AND SELF-DETERMINATION IN HUMAN BEHAVIOR* (1985) (describing how psychological needs, specifically self-determination and competence, drive human motivation).

255. See Gilson et al., *Braiding*, *supra* note 30, at 1400 (finding that paradoxically, introduction of formal enforcement increases shirking).

256. See David Dickinson & Marie-Claire Villeval, *Does Monitoring Decrease Work Effort? The Complementarity Between Agency and Crowding-Out Theories*, 63 GAMES & ECON. BEHAV. 56, 70 (2008) (finding that productivity is reduced when subjects are

Evidence on crowding out, however, is far from conclusive or without controversy.²⁵⁸ Some scholars have deemed it “thin.”²⁵⁹ The body of work is growing, but should nonetheless continue to be studied and confirmed.

C. Support from Other Contexts

While it may seem counter-intuitive that less is more in terms of motivating agents, there are interesting real-world examples of companies very successfully motivating their employees through *less*-specific direction.²⁶⁰ For instance, Zappos grew a million-dollar business built on customer service without telling its call center employees what to say—an unheard of approach in the industry.²⁶¹ The approach resulted in a corporate culture that considered the highest level of customer service crucial to the company’s business model.²⁶² This focus on customer service seems to have worked. Nordstrom, one of the most profitable retailers in the United States, took a similar approach for many years. Their employment contract simply stated: “Use best judgment in all situations. There will be no additional rules.”²⁶³ In general, old models of motivation driven by

more heavily monitored); *see also* Margit Osterloh & Bruno S. Frey, *Motivation Governance*, in *HANDBOOK OF ECONOMIC ORGANIZATION: INTEGRATING ECONOMIC AND ORGANIZATION THEORY* 26, 28 (Anna Grandori ed., 2013) (arguing that monetary incentives can negatively impact performance and reduce the joy a person feels from completing a task).

257. “According to these theories, over time, the accuracy of measurement decreases as people concentrate their effort strictly on the measured components of an activity, resulting in a decline in the overall quality of their performance. Therefore, specificity combined with monitoring that focuses only on given measurable components (the letter of the law) seems to produce a straightforward effect of crowding out intrinsic motivation and decreasing overall performance.” Constantine Boussalis et al., *An Experimental Analysis of the Effect of Specificity on Compliance and Performance* 7 (2013) (unpublished manuscript) (on file with author).

258. Several studies do not find crowding out but rather see complementarity, including Sergio G. Lazzarini et al., *Order with Some Law: Complementarity Versus Substitution of Formal and Informal Arrangements*, 20 *J.L. ECON. & ORG.* 261, 290 (2004), and Rigdon, *supra* note 33, at 93, 102.

259. Eric A. Posner, Book Note, 101 *AM. J. INT’L L.* 509, 510 n.1 (2007) (reviewing ROBERT E. SCOTT & PAUL B. STEPHAN, *THE LIMITS OF LEVIATHAN: CONTRACT THEORY AND THE ENFORCEMENT OF INTERNATIONAL LAW* (2006), and criticizing the limited availability of cognitive psychology evidence for crowding-out theory); *see also* Yuval Feldman, *The Complexity of Disentangling Intrinsic and Extrinsic Compliance Motivations: Theoretical and Empirical Insights from the Behavioral Analysis of Law*, 35 *WASH. U. J.L. & POL’Y* 11, 23 (2011) (observing that alternative paradigms using different theoretical structures can produce similar results to those produced by the crowding-out theory).

260. DANIEL H. PINK, *DRIVE: THE SURPRISING TRUTH ABOUT WHAT MOTIVATES US* 103 (2009).

261. *Id.* at 103.

262. *Id.*

263. Chou et al., *supra* note 24, at 2.

carrots and sticks are passé. Human motivation is largely intrinsic, and that impulse should be fostered.²⁶⁴

The regulatory context provides additional real world support for the proposition that less specificity prompts higher levels of effort and innovation. John Braithwaite famously studied nursing home regulations in Australia.²⁶⁵ He found that a standards-based regime resulted in higher quality service than a strict rules-based regime.²⁶⁶ For instance, when nursing homes were told how many pieces of artwork to hang on the wall, they tore pages out of magazines and taped them to wall, complying with the letter of the requirement but certainly not its spirit.²⁶⁷ On the other hand, when nursing homes were told to create a home-like environment, they did a much better job complying with the spirit of the regulation.²⁶⁸

A comparative study of the greening of the car industry in Japan and the United States is also instructive.²⁶⁹ Japan used a more standards-based approach, whereas the United States highly detailed its regulations.²⁷⁰ A study determined that the United States' formalism undermined affirmative motivations.²⁷¹ Results were significantly better under the Japanese approach.²⁷² In general, the regulatory sphere has seen a move away from the traditional, formalist, command-and-control type regulation in the past decade.²⁷³

The concept of providing less specification in privatization contracts is similar. Privatization is designed to foster innovation, but contracting through detailed specification, monitoring, and incentive-based compensation crowds out the intrinsic motivation

264. PINK, *supra* note 260, at 9.

265. John Braithwaite, *supra* note 34, at 61.

266. See, e.g., *id.* at 75; John Braithwaite & Valerie Braithwaite, *The Politics of Legalism: Rules Versus Standards in Nursing-Home Regulation*, 4 SOC. & LEGAL STUD. 307, 336 (1995); Marilyn J. Rantz et al., *Field Testing, Refinement, and Psychometric Evaluation of a New Measure of Nursing Home Care Quality*, 14 J. NURSING MEASUREMENT 129, 144 (2006).

267. Braithwaite, *supra* note 34, at 61.

268. *Id.*

269. MIKLER, *supra* note 34, at 2.

270. *Id.* at 98, 101.

271. *Id.* at 101.

272. *Id.*; see also Kenneth A. Bamberger, *Regulation as Delegation: Private Firms, Decisionmaking, and Accountability in the Administrative State*, 56 DUKE L.J. 377, 461 (2006) (arguing that regulation of private firms should be more principal based and the specifics of how to achieve them should be delegated to the agent, especially for complex regulations).

273. See, e.g., David J. Barron & Todd D. Rakoff, *In Defense of Big Waiver*, 113 COLUM. L. REV. 265, 299–301 (2013) (noting the “[w]aning [a]ppeal of [c]ommand and [c]ontrol [r]egulation”).

required for innovation.²⁷⁴ Accordingly, governments should reconsider what has become the default approach.

D. The Proposal: Less-Specified Contracts

The proposal this Article advances is a nuanced one. Where mitigating agency cost through detailed contracts is unlikely to be effective for the reasons detailed in Part II, governments should try a less-specified contract design without use of incentive-based compensation. Contracting parties are sensitive to intentions conveyed by contract language. This Article suggests that governments might be better served by conveying positive intentions to the other party to a bilateral agreement—as in the Community Game/Wall Street Game experiments, framing the relationship as one based on collaboration rather than competition. I focus on this particular problem in the government outsourcing context because it is an area of pressing need where current solutions are clearly not working. But I leave open for another day the possibility that this proposal might have broader application.

There is a spectrum along which contracts might specify tasks. At one end, one could conceive of a contract that tries to detail every step, no matter how small, that an employee must take in processing an application for Medicaid benefits. At the other end, one might imagine a contract that simply says “process applications for benefits.” This Article merely assumes that government service contracts are closer to the detailed pole than they should be. But it does not suggest that contracts be drafted that are entirely devoid of guidance for the contractors. Indeed, studies have found that when faced with ambiguity and the absence of goals, ambiguity will be used to justify moral hazard behavior.²⁷⁵ Subjects given distal and proximal goals do better than those simply instructed to “do [their] best.”²⁷⁶

To invoke the reciprocity norm, contracts should specify goals, but also create room for contractor discretion and innovation.²⁷⁷ Based

274. See Roland Bénabou & Jean Tirole, *Intrinsic and Extrinsic Motivation*, 70 REV. ECON. STUD. 489, 503 (2003) (finding that explicit incentive schemes can backfire, reducing motivation in the long term); see also Rappaport, *supra* note 253, at 32 (discussing studies of police officers and concluding that officers who are treated fairly are motivated to be good organizational citizens).

275. See Jason Dana et al., *Exploiting Moral Wiggle Room: Experiments Demonstrating an Illusory Preference for Fairness*, 33 ECON. THEORY 67, 78 (2007) (finding that reduced transparency encouraged study participants to act in in their self-interest).

276. Gary P. Latham & Gerard H. Seijts, *The Effects of Proximal and Distal Goals on Performance on a Moderately Complex Task*, 20 J. ORG. BEHAV. 421, 426 (1999).

277. See *id.* (finding superior performance when goals combine with feelings of self-efficacy).

on study results, contractors are likely to react positively to the trust put in them to deliver quality service and to ascertain the best method of delivering that service and accomplishing the defined goal.²⁷⁸ This type of contracting device might reduce the possibility of opportunistic behavior by the agent rather than encouraging opportunism through vagueness.

In the welfare benefits example, a less-detailed contract would establish price and contract duration.²⁷⁹ But, instead of specifying tasks, outcome measures, and incentives, it would set only broader parameters and goals to guide the relationship. It would function essentially like a simple employment agreement, which sets compensation and defines the parameters of a role, but generally does not impose sanctions tied to specific tasks. Similarly, a less detailed public-private contract would not specify particular tasks and exacting success metrics *ex ante*. Rather, it would be more fluid, allowing the parties to chart the best, most flexible course during the term of the contract.²⁸⁰

E. Possible Limitations and Future Study

Despite the promise inherent in this new approach, it is difficult to argue that reciprocity norm experiments have any *direct* application to public-private contracting. This Section flags some limitations in the approach and suggests areas where future study would bolster the preliminary conclusions of this Article.

The most common critique of reciprocity is that it is a figment of lab work that does not translate to the real world.²⁸¹ Actors in experiments might behave differently than they would in real work environments. For instance, they might behave in a manner that they believe will please the experimenter. The stakes may be artificially

278. Chou et al., *supra* note 24, at 3 (defining “less-specific contracts” as those that describe basic roles and rules and “more-specific contracts” as those that describe roles, rules, and contingencies in more elaborate detail).

279. Note that the contracts would still have to have the necessary requirements to be enforced by a court. *See, e.g.*, Scott, *supra* note 28, at 1643 (discussing a category of contracts that are so incomplete that courts refuse to enforce them pursuant to traditional contracts doctrine). It may be more difficult to prove breach based on a low quality service provision absent explicit performance requirements.

280. *See* Macneil, *supra* note 36, at 900 (advocating for planned flexibility in complicated contractual relationships, because these relationships will become dysfunctional if too tightly controlled).

281. *See, e.g.*, Francesco Guala, *Reciprocity: Weak or Strong? What Punishment Experiments Do (and Do Not) Demonstrate*, 35 *BEHAV. & BRAIN SCI.* 1, 1 (2012) (using reciprocity theory to explain the willingness of experimental subjects to punish uncooperative free-riders at personal cost); Scott, *supra* note 28, at 1672 (noting that reciprocity theory has not yet been tested seriously in real world contexts, though it is predictive in experimental settings).

low, leading to distortions in behavior. On the other hand, they may be asked to put themselves in situations that are foreign and for which they have no expertise.

Experimenters have tried to address some of these critiques by increasing the stakes in experiments and by using a diversity of test subjects, not just university students.²⁸² Results in other studies are similar. The possibility of trying to please the experimenter may indeed cause distortions, but the critique carries less weight against the backdrop of heterogeneous results where decision subjects make different choices.²⁸³ It is true that lab results must be taken with a grain of salt. The real world case studies and regulatory context referenced above are helpful, but certainly the conclusions in this Article could be bolstered by additional work evaluating real world responses to less-detailed contracts, particularly in the government setting.

Another concern is that the studies of reciprocity in contracting generally test an employment relationship, where a single individual must decide how to react to contract language. In the context of government service contracting, the government contracts with a large private firm. It is difficult to know the extent to which a junior-level employee conducting work pursuant to the contract knows what the language of the contract requires, or can be influenced by contract language choices. Put more generally, the transferability of these results to firm-level behavior is somewhat attenuated.²⁸⁴ For incomplete contracts to have the desired effect, the reciprocity inclinations of firm leadership would have to be displayed by firm workers.

There is reason to be optimistic, however, that the results are relevant to firm-firm interactions. Even in firm-firm contracting, performance decisions are ultimately made by individuals. For instance, one can look to the example of prisons making the decision to cut security or welfare administrators giving direction to cream applications. In both cases, senior executives made the decisions and set the tone for those beneath them in the hierarchy. Senior executives are individuals making decisions capable of being

282. See Fehr & Gächter, *Fairness and Retaliation*, *supra* note 28, at 161–62 (providing examples of studies that found that higher monetary stakes either did not change the results or led to only minor impacts in negative reciprocity ultimatum games); Liberman et al., *supra* note 247, at 1182.

283. See Scott, *supra* note 28, at 1648 (discussing the real-world challenges that economic actors confront, and noting that these externalities may influence contracting behavior).

284. See Fehr & Gächter, *Fairness and Retaliation*, *supra* note 28, at 162–63 (concluding that while experiments have shown that reciprocity is a common behavioral response for some people in certain circumstances, the extent to which it impacts individual interactions in firms, government, and markets is unclear).

influenced by contract language just as the individuals in the experimental literature.²⁸⁵ In the USIS example, executive leadership allegedly passed down the order to flush applications.²⁸⁶ It is easy to imagine that executive level leadership, in that case influenced by contractual provisions linking pay to completed background checks, could be influenced by changing the contract structure. If USIS leadership took a different approach, that approach would influence more junior level employees.²⁸⁷

Another concern is that these studies do not truly test how clarity of objective (i.e. specifying tasks rather than simply broad standards) plays into performance quality.²⁸⁸ One reason that scholars advocate for task specification is that clarity is thought to mitigate conflict.²⁸⁹ Agents with a clear sense of purpose are thought to better meet their objectives. Contractors given unconstrained discretion might innovate and deliver quality service, *or* they might jump at the “hole” in task definition and act opportunistically.²⁹⁰ Contract incompleteness in some literature has been equated with a risk of increased litigation for precisely these reasons.²⁹¹

285. See, e.g., Ronald J. Gilson et al., *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 COLUM. L. REV. 431, 487 n.144 (2009) (explaining that while the experiments cited describe individual behavior and not the behavior of firms, the findings should be relevant to those institutions because the individuals in the simulated collaborative process are personally invested in the success of the project); see also Van Slyke, *Agents or Stewards*, *supra* note 51, at 164 (defining stewardship theory as situations in which managers act as “stewards” who put the objectives of their principles before their own individual goals).

286. See *supra* notes 8–16 and accompanying text.

287. A recent study looked at a related issue, evaluating the extent to which an individual breaching a contract is seen as having committed a moral transgression, whereas a firm breaching is viewed as having made a legitimate business decision. Uriel Haran, *A Person—Organization Discontinuity in Contract Perception: Why Corporations Can Get Away with Breaking Contracts But Individuals Cannot*, 59 MGMT. SCI. 2837, 2839, 2844, 2851 (2013). The study found that “some actions are equally regarded as moral transgressions when committed by either individuals or organizations.” *Id.* at 2844. As such, “the formation of an explicit association between the contract and a promise—accomplished by phrasing organizational contractual obligations in promise terms—can eliminate the discrepancies between people’s reactions to contract breaches by organizations versus those by individuals.” *Id.* at 2839. The study looks at perception of behavior rather than impact on actual behavior, but the results suggest phrasing contracts in terms of promise may affect results. *Id.* at 2851.

288. Gilson et al., *Braiding*, *supra* note 30, at 1390.

289. *Id.* at 1391 (addressing the choices that parties must make regarding renegotiation of contractual rights when formal contract enforcement breaks down); see also Boussalis et al., *supra* note 257, at 6–7 (suggesting “that when specificity helps provide clear instructions . . . it is superior to ambiguous standards or instructions”).

290. Work has shown, for instance, that parties are more likely to act opportunistically when they can rationalize that the contract was ambiguous. Boussalis et al., *supra* note 257, at 6–7.

291. See Scott, *supra* note 28, at 1643 (analyzing a sample of incomplete contracts and noting “a surprisingly high volume of litigation”).

Although this criticism is valid because the reciprocity studies do not address the role of task specification in performance, they do demonstrate that agents who could have acted opportunistically by exerting minimal levels of effort did not so. In theory, if agents are satisfied with the contracting relationship and the discretion to meet high-level objectives, they may ultimately perform better and perhaps innovate to save costs rather than decrease quality of service. These issues require further testing.

A related issue has to do with monitoring. Monitoring is dependent, so the argument goes, on knowing what the monitors are looking for (i.e. task specification). The idea, however, is that monitoring will be less necessary because the agent will be intrinsically motivated.²⁹² Also, monitoring may be more successful without strict and detailed contract language because it will be more collaborative and cooperative in nature. The idea that monitoring is more successful with an underlying detailed contract is a fallacy, as discussed above.

Another argument for specification over reciprocity is that specification is beneficial if litigation does result. It would be both more costly and more difficult to litigate a breach of contract action where the contract is less specific. Also, it may be hard to imagine a lawyer who, anticipating potential litigation *ex post*, would counsel a client to make his or contract *less* detailed.

These, too, are valid concerns, although at base, they harken back to the basic standards versus rules debate. Courts are frequently tasked with adjudicating standards. It might be more costly to adjudicate a contract that is more standard-like than rule-like,²⁹³ but that tradeoff might be worthwhile in a cost-benefit analysis if a more standard-like contract is also less likely to result in litigation because the principal will be happier with the agent's effort level compared to a rule-like regime.²⁹⁴ Also important to consider is that less-detailed contracts are less costly to draft *ex ante*.

As mentioned earlier, there are additional reasons that parties might prefer specificity. For instance, politicians might prefer more

292. See Rappaport, *supra* note 253, at 32 (observing that "voluntary deference yields good behavior even when officers know they are not being watched").

293. However, there are lots of shades of grey in this question. In cases where contracts seem to be detailed and clear, the modern approach is to nonetheless allow parties to introduce extrinsic evidence.

294. See, e.g., George Triantis, *Exploring the Limits of Contract Design in Debt Financing*, 161 U. PA. L. REV. 2041, 2045–46 (2013) (arguing that standards like good faith that convey discretion to the court can be effective tools if the reason for contract incompleteness is cost of specification *ex ante* but this introduces the risk of high cost litigation and judicial error).

detailed contracts for reasons of public accountability or to have benchmarks to prove success. These mechanisms are only effective though if the public is attuned to these contracts and if benchmarks are easy to discern, which is often not the case.

Contractors too might want more detailed contracts so that they have better information on which to base their bids. Without a detailed contract, some might worry about preventing corruption²⁹⁵ or a race to the bottom based on price.

The problem, again, is that detailed contracts have not proven to be particularly effective at mitigating these concerns. This is particularly true where there is a thin market for services. Many of the examples cited in this paper are ones where there was only one bidder for the work.

Reciprocity-based contracting may not solve every problem inherent in government contracting. But it holds much promise and the government should experiment with this new method.

CONCLUSION

Contracts for complex government services only continue to grow in use. That such contracts often result in cost reduction at the sacrifice of service quality is a dire problem, particularly when governments are outsourcing services such as national security, prison and public benefits administration, and education.

Private service providers engage in opportunistic behavior that reduces service quality because of misaligned incentives and unconstrained agency costs. The private service provider is interested in maximizing profit while the government is interested in the agent providing quality service. Agency theory suggests that the way to mitigate such costs is to align incentives. The traditional method for aligning incentives in similar scenarios is to detail tasks, monitor to ensure compliance, and reward (or punish) compliance with financial incentives.

However, the traditional method is ill-suited to mitigate agency costs for certain types of contracts for government service. For many of these contracts, it is difficult and costly both to specify tasks and to monitor performance. A thin market also cuts against use of the traditional method, as does the prevalence of corruption.

This Article suggested that the traditional approach is based on an assumption that agents are rational actors looking for opportunities to shirk and this may be a misunderstanding of human nature.

295. Corruption is a problem that neither model adequately solves.

Governments should instead look to research on the reciprocity norm in contracting and draft less-detailed contracts. At the very least, we should consider a solution that fosters the collaborative rather than the competitive instincts of private service providers. Studies have shown that less-detailed contracts where agents are left more discretion and more room to innovate generate better agent performance than more detailed contracts. The studies are not without limitation, but contracting parties would be remiss to continue to function as if *increasing* contract specification is the clear choice.