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Third-Party Opportunism and the (In)Efficiency of Public Contracts

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Preface & Acknowledgements

Welcome to our Ninth Annual Acquisition Research Symposium! This event is the highlight of the year for the Acquisition Research Program (ARP) here at the Naval Postgraduate School (NPS) because it showcases the findings of recently completed research projects—and that research activity has been prolific! Since the ARP's founding in 2003, over 800 original research reports have been added to the acquisition body of knowledge. We continue to add to that library, located online at www.acquisitionresearch.net, at a rate of roughly 140 reports per year. This activity has engaged researchers at over 60 universities and other institutions, greatly enhancing the diversity of thought brought to bear on the business activities of the DoD.

We generate this level of activity in three ways. First, we solicit research topics from academia and other institutions through an annual Broad Agency Announcement, sponsored by the USD(AT&L). Second, we issue an annual internal call for proposals to seek NPS faculty research supporting the interests of our program sponsors. Finally, we serve as a “broker” to market specific research topics identified by our sponsors to NPS graduate students. This three-pronged approach provides for a rich and broad diversity of scholarly rigor mixed with a good blend of practitioner experience in the field of acquisition. We are grateful to those of you who have contributed to our research program in the past and hope this symposium will spark even more participation.

We encourage you to be active participants at the symposium. Indeed, active participation has been the hallmark of previous symposia. We purposely limit attendance to 350 people to encourage just that. In addition, this forum is unique in its effort to bring scholars and practitioners together around acquisition research that is both relevant in application and rigorous in method. Seldom will you get the opportunity to interact with so many top DoD acquisition officials and acquisition researchers. We encourage dialogue both in the formal panel sessions and in the many opportunities we make available at meals, breaks, and the day-ending socials. Many of our researchers use these occasions to establish new teaming arrangements for future research work. In the words of one senior government official, “I would not miss this symposium for the world as it is the best forum I've found for catching up on acquisition issues and learning from the great presenters.”

We expect affordability to be a major focus at this year's event. It is a central tenet of the DoD's Better Buying Power initiatives, and budget projections indicate it will continue to be important as the nation works its way out of the recession. This suggests that research with a focus on affordability will be of great interest to the DoD leadership in the year to come. Whether you're a practitioner or scholar, we invite you to participate in that research.

We gratefully acknowledge the ongoing support and leadership of our sponsors, whose foresight and vision have assured the continuing success of the ARP:

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James B. Greene Jr.
Rear Admiral, U.S. Navy (Ret.)

Keith F. Snider, PhD
Associate Professor



Panel 9. Opportunism in Defense Contracting

Wednesday, May 16, 2012	
1:45 p.m. – 3:15 p.m.	Chair: Dr. Fred Thompson, Professor, Atkinson Graduate School of Management, Willamette University <i>Third-Party Opportunism and the (In)Efficiency of Public Contracts</i> Marian Moszoro, <i>IESE Business School, Barcelona</i> Pablo T. Spiller, <i>University of California, Berkeley</i> <i>Business Models for Cost Sharing and Capability Sustainment</i> Michael Pryce, <i>Manchester Business School</i> <i>Endogenous Split Awards for Protest Management</i> Peter Coughlan, <i>Naval Postgraduate School</i>

Fred Thompson—Dr. Thompson is the Grace and Elmer Goudy Professor of Public Management and Policy Analysis at the Atkinson Graduate School of Management, Willamette University. Dr. Thompson is a specialist in the field of tax policy and regulation.

Dr. Thompson is co-editor of the Handbook of Public Finance. He was the founding editor of the International Public Management Journal and is currently associate editor of the Journal of Comparative Policy Analysis. He has been published in numerous scholarly journals, including the American Political Science Review, Public Administration Review, Public Choice, and Journal of Economic Behavior and Organization.

In 2000 Dr. Thompson received the Distinguished Research Award of the National Association of Schools of Public Affairs and Administration and the American Society for Public Administration. In 2005 he received the Aaron B. Wildavsky Award for Outstanding Lifetime Scholarly Achievement in the field of public budgeting and financial management of the Association for Budgeting and Financial Management. In 2006 he served on the United Nations Development Program's Blue Ribbon Commission on Macedonia.

Dr. Thompson earned his Bachelor of Arts in economics and history from Pomona College and his PhD from the Center for Politics and Economics, Claremont Graduate University.



Third-Party Opportunism and the (In)Efficiency of Public Contracts¹

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Pablo T. Spiller—Spiller is a Jeffrey A. Jacobs Distinguished Professor of business and technology at the Haas School of Business, University of California, Berkeley, CA. He is a visiting professor of law at Columbia University, and a research associate at the National Bureau of Economic Research. Professor Spiller earned his PhD in economics from the University of Chicago.

Abstract

The lack of flexibility in public procurement design and implementation is a political risk adaptation by which public agents limit hazards from opportunistic third parties—political opponents, competitors, and interest groups—and externalize the associated adaptation costs to the public at large. Public agents endogenize the likelihood of opportunistic challenge, lowering third parties' expected gains and increasing litigation costs. We provide a comprehensible theoretical framework with empirically testable predictions: Scrutiny increases public contracting efficiency in costly litigation environments, concentrated (politically) contestable markets, and with upwardly biased beliefs about benefits of challenge.

Executive Summary²

In contrast to private contracts, public contracts are open to challenge by third parties. The whiff of corruption and the concern for misuse of other people's monies make challenging public contracts feasible. Even though the enactment and performance of a contract may be honest and legal, public agents may fear politically motivated challenges, and hence will *ex ante* adjust the nature of the contracts so as to limit those features whose probity may be questioned. These adjustments imply more contract specificity in design and rigidity in implementation. Such contractual adaptation, however, is not costless. Contractors' perception of specificity and rigidity translates into *ex ante* higher prices, as well as the enactment of stronger compensating clauses. The contractual complexity and adaptation required to limit the potential for third-party challenges, whether opportunistic or not, make public contracting look "inefficient."

The higher level of contract specificity and rigidity in public contracting can be understood, then, as a political risk adaptation by public agents. It is not that civic-oriented legislation limits public agents' discretionary actions with "red tape," but rather that public agents limit the risk of third parties' challenges through contract formalities and rigidities, externalizing the associated costs to the public at large.

This paper provides an operationalization of Spiller's (2008) third-party opportunism (TPO) towards an understanding of the organizational foundations of pricing, specificity, and rigidity—the outer features—of public contracts. Spiller's theory of public organization is rooted in a transaction cost-*cum*-positive political theory, where the nature of the organizational adaptation of public contracts results from their inherent hazards. Spiller's framework follows Williamson's (1999) four cornerstones of the economics of governance—namely, governance, transaction costs, adaptation, and interdisciplinary social science—and introduces third-party opportunism as the quintessential hazard of public transactions.

¹ JEL Classification: D23, D72, D73, D78, H57.

² Full paper downloadable at: <http://ssrn.com/abstract=1969105>



Prior Literature

Third-party opportunism relates to a threefold literature on public contracting: industrial organization, public administration, and political economy.

In the industrial organization literature, public-contract pricing is fundamentally determined by informational costs arising from informational asymmetries, the extent of verifiability of information, and the presence of repeated interactions (Bajari & Tadelis, 2001; Laffont & Tirole, 1993; Loeb & Surysekar, 1994; Macaulay, 1963). It is, however, the nature of the hazards involved in public-private relations that determines the fundamental features of public procurement and contracting. Not only is “the nature of the agreement . . . carefully delimited, and the more formal features govern when . . . terms are contested,” but the potential for a contest from an excluded seller is what impacts the nature of the agreement (Marshall, Meurer, & Richard 1994a).

Whereas the parties in private-private relations adapt to new information as it becomes available in order to save litigation costs, and courts are used rather to terminate disputes, public contracts appear bureaucratic and over-monitoring in situations in which it is not needed (Prendergast, 2003, pp. 932–933). According to the public administration view, contracting inefficiencies are associated with the large number of formal processes that appear to be essential to ensure the public sector’s functions, as well as with “red tape,” that is, costly and compulsory rules, regulations, and procedures with no efficacy for their functional object (Bozeman, 1993, p. 274). Bureaucrats are used only for “hard” agency problems, where consumers cannot be trusted (Prendergast, 2003, p. 933). Extensive rules and regulations arise from dividing authority among the separate branches of government (executive, legislative, and judicial), which were designed to prevent abuses of power, protect people’s rights (Baldwin, 1990, pp. 10–11), and reflect equity values not necessarily present in private firms, including educational, health-related, legal, and environmental values (Forrer et al., 2010, p. 480). Red tape regulations are intended to decrease public employees’ uncertainty about how they should behave (Kurland & Egan, 1999, p. 440). Both formalities and red tape are the instruments by which bureaucracies restrict public agents’ discretion (Boyne, 2002; Lan & Rainey, 1992) and “overcome the temptation to capitulate to consumers simply to avoid complaints” (Prendergast, 2003, p. 932).

The political economy profession has long been divided into advocates of public interest theory (in line with the public sector motivation literature) and “capture” or interest group theory of government intervention in industries, seeded by Buchanan (1965) and Olson (1965) and elaborated by Stigler (1971). This positive approach, both in its Chicago school (Becker, 1983; Peltzman, 1976; Stigler, 1971) and Virginia school (Buchanan, 1975; Buchanan, Tollison, & Tullock, 1980) modalities, concentrates on the demand-side, “black-boxing” the supply-side of political decision-making (Laffont & Tirole, 1993, pp. 475–476). On the other hand, positive political theory scholars, led by Riker (1963), focused on the supply-side of political decision-making, studying how politics/legislative procedures, administrative procedures, and bureaucratic oversight affects legislative, judicial, and regulatory behavior. Positive political scholars have also studied the use of interested parties (McCubbins & Schwartz, 1984; de Figueiredo, Spiller, & Urbiztondo, 1999) and consumers (Prendergast, 2003) as instruments of oversight.

Laffont and Tirole (1993) emphasized that the link

between procurement and regulation and the associated administrative and political constraints is still unknown to us or is still in a state of conjecture. . . . Institutions are endogenous and should as much as possible be explained by primitive considerations.



This paper is an attempt to rationalize the basic features of public contracting from its primitive considerations: its fundamental hazards.

A Model of Third-Party Opportunism

Signaling Process: Hazards into Rigidity

We focus our analysis on the public agent's perspective. Furthermore, we ignore sunk costs to abstract from governmental opportunism and to make the argument on TPO straightforward.

There are four agents explicitly and implicitly involved in public contracting:

1. the incumbent public agent;
2. the private contractor;
3. third-party challengers (i.e., political opponents to the incumbent public agent, competitors to the contractor, and interest groups); and
4. the public at large (i.e., voters and courts).

The signaling process starts before the contract is signed. The public agent receives project features and the budget to contract for goods and services. The public agent perceives the threat of potential third-party challenges and tries to minimize political risks and maintain political support. The private contractor may not be directly aware of the hazards faced by the public agent but observes contract specificity and rigidity. Specificity and rigidity equal less adaptability, higher contracting and implementation costs, and hence higher final prices charged to the public agent. Third parties privately perceive the benefits from challenge. Contract features affect third parties' strategies, thereby affecting political outcomes. If a public contract does not meet the public's expectations, political consequences may include weakened chances of re-election for incumbent public agents (Forrer et al., 2010, p. 480).

Conceptualizing Contract Specificity and Rigidity

Contract specificity refers to *ex ante* complexity of subject, completeness of clauses, technical provisions, and processing costs (Laffont & Tirole, 1993, p. 307). Contract rigidity refers to *ex post* enforcement, penalties, hardness, and intolerance to adaptation of contracts, and normally correlates with contract specificity: The more specific the contract is, the more rigid its implementation and enforcement is expected to be. Otherwise, if the contract is specific and then the parties agree to deviate, third parties can accuse the contracting parties of collusion.

Complex public contracts have more contractual rigidities than simpler contracts. The cost of *ex post* enforcement increases in complexity. Because the public sector has more ambiguous objectives than private organizations (Boyne, 2002), and because it is difficult to assess to what extent these objectives are achieved (Lan & Rainey, 1992), public high specificity and rigidity mitigate ambiguity and problematic evaluation. For example, the U.S. Department of Defense directives specify in great detail source selection policies, including the development of objective technical, cost, schedule, manufacturing, performance, risk criteria, auction techniques, the organization of the selection committee, and the pertinence of contacts with contractors. Public agents must also follow imposed standards of evidence and may be constrained to formulate standards and follow their own rules to avoid discriminating between distinct situations on the basis of non-verifiable information (Laffont & Tirole, 1993, p. 5).



Concluding Remarks

TPO theory combines political hazards and transaction costs to explain apparent inefficiencies in public contracts. High *ex ante* payment volatility or *ex post* exibility in implementation may trigger drawbacks, leading to contract failure or costly adaptation by the public official, whether in terms of time or political career. A paramount conclusion of our analysis is that public contracts cannot be directly compared to private contracts. Instead, they can be compared only to analogous public contracts and should pass Williamson's (1999) "remediableness criterion," which holds that "an extant mode of organization for which no superior *feasible* alternative can be described and *implemented* with expected net gains is *presumed* to be efficient" (p. 316) to attest to their efficiency.

The fact that public contracting is more expensive and rigid than private contracting, however, does not mean that transferring those activities to the public sector would reduce political risks and hence make them more efficient. Public procurement is used for "hard" agency problems where consumers cannot be trusted and "when bureaucracies work poorly, [but] consumer choice works worse" (Prendergast, 2003, pp. 930–933). Not only, as Williamson (1999, p. 320) discusses, do certain transactions have special needs for probity and require the security of the State, but the privatization of public functions itself involves TPO hazards, making them less preferable for public agents than public contracting itself.

In this paper, we analyzed public procurement in a variety of environments to show that much of its outer features can be understood as political adaptations to the fundamental hazard of third-party opportunism prevalent in public contracting.





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