ACCOUNTABILITY CHALLENGES OF THIRD PARTY GOVERNANCE

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The past 60 years have marked an unprecedented expansion of the role of government, particularly the federal government, in our nation's domestic life. One reason for this may be our increasing reliance on indirect governmental tools and a wide range of third parties to participate in national programs. As Lester Salamon has noted, most of the federal budget in fact is devoted to funding programs and operations featuring a critical role for third parties – states, local governments, private contractors, nonprofits and other entities. A wide range of governmental tools is deployed to engage these actors in national initiatives – contracts, grants, regulation, loans, tax expenditures are among the instruments that are relied upon by national actors to pursue national goals. Indeed, it is difficult to find many major federal mission areas that do not rely heavily on third parties for program delivery and even goal definition. Even the function of defending the nation’s borders has become a matter dependent on other actors beyond the Pentagon, whether it be defense contractors or local fire departments and other first responders who have become the line of first defense in the event of a terrorist attack.

The reliance on third parties reflects an underlying ambivalence in our culture over the role of the federal government in general and bureaucracy in particular. As the agenda of national policy issues has become more expansive, the national government has become compelled to extend its reach in areas where it has no direct role or legitimacy. As these national issues increasingly skipped traditional boundaries of federal roles and responsibilities, national policymakers improvised by designing policy initiatives appearing to minimize direct federal roles by attempting to leverage, cajole, entice, mandate and otherwise engage the resources of independent actors in a highly pluralistic society. Robert Stoker has aptly suggested that the tools of third party government, while advertised for their ostensible decentralizing bias, in fact were an enabler permitting the federal government to gain access to authorities, resources and political consent that it would never have been able to do on its own.
Despite the growth of such tools, our understanding of how to think about the resulting governance patterns and strategies remain underdeveloped. Paul Light has shown how impoverished our metrics are about the size and scope of the federal government by revealing how limited the numbers of direct federal employees are as a gauge of federal activity. Light’s research in fact suggests that the true size of the federal workforce is not 1.8 million as the federal government’s figures portray, but rather nearly 17 million when the various private and public employee are counted who work on federal programs in other sectors.  

Most importantly, the concept of accountability for the results of third party programs remains underdeveloped. Most scholarly treatments of accountability do not address issues associated with third party governance. As one analyst put it,

"We do not know how best to maximize the quantity and quality of governmental product when the point of finance is split and often two or even three levels removed from the point of final output."

Third parties provide important advantages to the federal government – they enhance the legitimacy of the federal presence, share the costs, provide critical skills and authorities not available to the federal government, and help adapt federal programs to unique local conditions and needs. However, they also complicate the projection of national goals and raise unique accountability challenges. It may be no coincidence that the period of growing national program responsibilities coincided with a broad sweeping indictment of the capacity of government to deliver on those expectations.

Our management reform legislation and debates at the federal level have not yet caught up with practice to provide criteria or models to address the accountability challenges in third party government. The management reforms at the federal level in the 1990’s – the Chief Financial Officers Act, the Clinger-Cohen legislation on information management and the Government Performance and Results Act – were all premised on improving the management of stand alone bureaucracies at the federal level. Certainly improved management and information in federal
agencies are important predicates to managing third party relationships. To date, these reforms largely stop at the boundaries of federal agencies and have largely not yet been used to address third party relationships and programs. Although accountability procedures exist in all federal agencies that govern third party relationships, the federal government has not yet subjected these relationships to the kind of systematic scrutiny and reform undertaken for direct agency operations.

Much of the debate over management reform at the federal level has not taken full account of this fundamental shift in the form of public action reflected in third party governance. For instance, the reinventing government movement, championed by such writers as Osborne and Gaebler and reflected in Vice President Gore’s National Performance Review, appeared to embody the spirit of third party governance by calling for greater delegation, decentralization and devolution of authority to managers and to states and localities, among other third parties. However, its prescription for federal employees to shift from a rowing, i.e. direct service provision, to a steering strategy, i.e. guiding and financing others, failed to acknowledge that the federal agencies had largely become steerers, rather than rowers. The central challenge had shifted long ago within the federal establishment from how to deliver direct programs more efficiently and responsively to how to steer or influence independent actors to provide the services themselves.

Theoretical perspectives on public management also have not yet been helpful in understanding this new environment for public management. Traditional public administration with its focus on managing large organizations does not speak directly to the design and management of tools engaging actors across governmental and sectoral boundaries in common forms of public action. The implementation literature discovered this reality many years ago when it noted the many factors in the third party environment that served to frustrate the attainment of national goals using intergovernmental actors. Pressman and Wildavsky’s classic study of Oakland characterized how great expectations in Washington can be dashed in the field when multiple actors play a role in goal achievement. However, these early implementation studies were premised on a top down view and often failed to recognize the legitimacy of joint goal determination by the multiple actors in third party environments. Some perceived the implementation research to have reached a “dead end” that had failed to generate useful hypotheses. Other scholars argued that the implementation field had
not achieved conceptual clarity and argued for a shift to the study of policy design. In fact, important implementation research continues and offers useful findings that could potentially be useful in understanding accountability issues.

Network theory also offers potentially useful insights on accountability in third party governance arrangements. Instead of a governmental steering model, policy networks spanning organizational, governmental and public-private boundaries are viewed as the drivers of public goal setting and implementation. In this view, the ex ante goals or policies of one of the participants, i.e. government, is not the yardstick for accountability. Rather, goals emerge from the interaction of actors in the network. Implementation and performance are evaluated based on the capacity to cooperate and solve problems within networks. The focus is not on goal achievement but on whether conditions encourage the formation and sustainability of positive interactions across the network. Criteria for network management include creating win-win situations which make nonparticipation less attractive, limiting interaction costs, promoting transparency, and securing commitment to joint undertakings.

In this literature, the government's role is not to impose unilateral goals - these would not be effective if they are perceived as being illegitimate by networks. Rather, its role is to work with networks to define goals and to gain cooperation for full implementation. It is acknowledged that government can also serve as a network manager and facilitator, creating or sustaining conditions for full and open participation.

Network theory provides significant insights about the conditions for legitimate public action. It usefully suggests that policy networks of like-minded actors are a meaningful unit of analysis. It also reminds us that effective and workable networks are not an act of nature, but require sustenance and nurturing by network participants and government alike. In essence, networks help define the capacity to act publicly in an era where public action can no longer be contained within vertical hierarchies but necessarily engages horizontal relationships across institutional and sectoral boundaries.
Nonetheless, network theory has limitations in speaking to the unique accountability issues facing federal policymakers and bureaucrats. Networks can become self-referential and not fully useful to pursue broader public goals that either transcend their boundaries or encompass other interests not represented in the network. Constraining governments to act solely within the boundaries of established networks needlessly limits the scope of public policy to those actions endorsed by what might become highly insular and insulated networks. Government, thus, still has a special role - one that might very well be achieved through existing networks, or as we have said above, through a variety of other strategies, including the empowerment of new networks.

This paper seeks to examine what we have learned about these unique accountability challenges for third party governance settings. It seeks to establish a framework for thinking about these accountability issues that builds on existing theory and policy guidance to offer a lexicon and some general conclusions about the kinds of options available for policymakers and bureaucrats. To do so, it first examines what we mean by accountability, then identifies the sources of the accountability problems of third-party government, and finally considers some strategies for addressing these challenges.

Defining Accountability

Accountability is a multi-faceted concept fraught with ambiguity. Traditionally, accountability controls were envisioned as a way to prevent the arbitrary exercise of power by leaders. Clearly the touchstone in any democratic society, this concept has been recast more broadly for the modern administrative state to encompass the activities that help government programs meet expectations for performance held by their various publics. In this sense accountability includes not only the traditional management controls and reviews undertaken during the implementation process, but also the more fundamental choices over the design and use of certain tools and implementation networks – often third parties – to address public expectations for program results. All stages of the policymaking process, thus, are implicated in accountability for public programs.
As the foregoing illustrates, there are several important questions that should be addressed when discussing accountability for what and to whom. Accountability has its origins as a financial concept, derived from the Latin, "to compute". In this early application, it was associated with the proper accounting and legal expenditure of public funds. Although many would subscribe to this definition, they wouldn't stop there. A federal program manager would likely expand the definition to include oversight mechanisms necessary to ensure that the goals set forth in statutes and regulations are in fact being achieved. A federal budget official might add procedures to ensure that federal funds are spent in the most efficient manner possible. An interest group advocate might add that what is most important is that the broad outcomes are being promoted in the most effective and equitable manner. A state official responsible for implementing the program would work to promote accountability of the program to the state's political community and would want to ensure that federal programs support, not distort, state priorities.

Determining the locus for accountability - accountability to whom - will largely determine which political interests will frame the debate over the program as well as its objectives. Building on principal agent theory, there are a variety of principals and agents with a stake in government performance in a pluralistic democratic system.\textsuperscript{16} Federal programs are accountable not only to a multitude of elected officials, but also to a plethora of interested groups, clientele, media and other actors participating in the programs' policy issue network.\textsuperscript{17} As Barbara Romzek observes, most public sector employees face “multiple legitimate masters” to whom they must answer.\textsuperscript{18} Norton Long's classic formulation of federal bureaucracies is relevant here: goals are necessarily ambiguous and conflict because the political system is fragmented and conflicted.\textsuperscript{19}

As challenging as accountability for government bureaucracies is, the issues and dilemmas are even more daunting for programs using third-party tools. Agencies that deliver services directly with their own employees have certain accountability advantages: transactions are internalized within hierarchies that are more cohesive and responsive to central leadership.\textsuperscript{20} Obvious challenges are presented when the federal government must use independent actors it does not fully control to achieve its goals, especially since, as Don Kettl has noted, transferring who does the work does not relieve the federal government of responsibility for the performance.\textsuperscript{21}
Central to the accountability challenge of third-party government, is the multiplicity of legitimate perspectives it brings to the designation of program goals and purposes. By inviting third parties in to the design and implementation of these programs, an expectation is often created, intentionally or not, that some level of program accountability to non-federal perspectives is legitimate as well. In contrast to principal agent theory, third party government multiplies not only agents but the range of principals as stakeholders with legitimate voice in determining program goals at the outset. The consequence is an ambivalent accountability where programs are influenced by interests and values prevailing at many levels throughout the system.

Sources of Accountability Challenges

The major challenge posed by third-party government stems from the diffuse political authority embedded in third party relationships. Third party providers have independent bases of political power and potentially conflicting goals and interests. Fundamentally, tool relationships are consequently best characterized as bargaining relationships in which the third party partners often have the upper hand in both policy formulation and implementation. This is particularly true in view of the fact that at the outset of third party relationships, federal managers are focused on gaining the participation of third parties to build support for the program throughout the nation. As Ingram notes, participation is initially more critical to program survival than promoting compliance with goals, with the hope that goal congruence and compliance can emerge over time.22

This solicitation of third parties’ support may reflect the relative weakness of national political support for many programs reliant on third parties at their inception. Philip Moneypenny argued many years ago that the federal government resorts to grants when program advocates cannot muster sufficient political support to sustain fully federal financed and operated activities.23 Schneider and Ingram similarly argue that the federal government chooses more direct tools of policy intervention when delivering benefits to advantaged groups and utilizes indirect tools when delivering benefits to deviant or powerless interests.24
Third party tools of government are often justified as a way to decentralize federal initiatives and align them better with local values and interests. Flexibility in implementation permits third parties to experiment with innovative approaches and test out alternative program models when national leaders have limited foresight or political cohesion. The welfare reform block grant, for instance, followed several years of state experimentation with work programs which served as models for the time when Congress and president achieved sufficient political consensus to enact a new framework. Accordingly, these tools invite third-party agents to adapt federal programs to the goals and needs of their own clientele and constituencies.

However, while decentralizing, third party governance also can be viewed as centralizing since the approach is often essential to legitimize federal programs in the first place. Rather than a zero sum game where extensive third party chains are viewed as a threat, third parties could be viewed as an enabler for an expanded federal role. In this view, most powerfully argued by Robert Stoker, third parties actually expand federal power to act on issues outside the realm of national authority in a federal, mixed market system. Indeed, given the nation's historic resistance to large national bureaucracies, it is difficult to imagine gaining support for such programs as special education, interstate highways, or substance abuse if legions of federal civil servants were deployed to fan out throughout the nation to deliver them. From a functional perspective, the federal government simply does not have access to the policy levers needed to pursue many emerging national goals. The new national interest in education, for instance, must be pursued by tools engaging an educational system that is largely controlled by state and local governments. Federal air pollution standards rely on the inspection of motor vehicles to reduce emissions, which involves tools to engage the support of state motor vehicles laws and bureaus in enforcing periodic inspections. From this perspective, the goal diversion and fiscal windfalls accruing from these tools might be viewed as the price to be paid for expanding the federal role and capacity to govern in new arenas. As Ingram has said, the federal government gains the opportunity to bargain with third party entities.

Specific features empower third parties with leverage in these relationships and these have
wide ranging implications for accountability for third party programs.

**Political Resources**

In the first place, third-party providers, whether they be states, nonprofits, universities or defense contractors, have influence that affects both the setting of goals and the implementation of these goals as well. Richard Nathan has argued that any successful federal program must have the support of a horizontal coalition of program advocates and beneficiaries as well as a vertical coalition of providers.\(^{27}\) Part of the influence of providers is attributable to their control over program resources and their ability to passively or actively withdraw from program participation.

In addition to this exit option, providers enjoy an influential voice in the policymaking process. James Wilson has argued that groups gaining or losing concentrated and narrow public benefits will enjoy disproportionate leverage over those groups with broader and less intense interests.\(^{28}\) Providers are likely to enjoy disproportionate influence, since they are often well organized and financed and pursue a set of narrow and intensely felt interests. Providers such as states and large contractors, moreover, are able to mobilize support within Congressional delegations due to the concentration of economic and political resources in specific states. Consequently, states can have significant influence in setting program goals for grant programs, as well as in reformulating those goals during implementation.

**Voluntary Participation**

For most tools, the participation of third parties and beneficiaries alike is voluntary. Whether it be a grant, a loan or a tax credit, third parties can, at least in theory, take it or leave it. Even for regulatory tools, some programs give third parties leverage by permitting them the choice of participating in the program as an enforcer of regulations meeting minimum federal standards - what has come to be known as the partial preemption strategy.\(^{29}\) For some programs and tools, like procurement and project grants for research, voluntaristic participation may in fact confer an advantage to the federal government, for it ensures that only providers with sufficient interest
participate. However, many federal programs have more universalistic ambitions. In fact, the rationale for many programs is to nationalize programs that are already underway in a number of communities and states and provide a minimum floor of benefits throughout the nation. It is here that providers have the greatest leverage to, in effect, engage in bargaining over the program's design and implementation features and affect outcomes through their own unilateral decisions.

Nathan shows how stricter federal eligibility requirements for CETA public service jobs in 1978 caused many local governments to withdraw from participation, an action which ultimately undermined the support for the program and prompted its termination. The goals of other programs can be undermined when subsidies and incentives fail to prompt third parties to provide sufficient levels of benefits or services. For instance, Congressional tightening of reimbursement rates for HMO’s participating in the Medicare program in 1997 precipitated the widespread termination of coverage for seniors by these plans. Even though analysts with the General Accounting Office and others at the federal level continued to note that these plans were reaping a financial windfall from the Medicare program, Congress enriched the payments to these plans in the 2003 prescription drug bill to entice these insurers to once again enroll seniors.

It might be objected that although tools may legally not require participation, it is very difficult for most providers to turn down the offer to participate in federal programs. This is no doubt the case; it is big news when a state turns down a major federal grant. However, this proves the point - most programs have to provide sufficiently rich packages of incentives to induce participation by providers. From an accountability and management perspective, we need to be concerned about what tradeoffs have to made in the design and implementation process to gain this full participation. For instance, recently, the federal interest subsidy for the guaranteed student loan program had to be increased when the nation's banks threatened to stop participating in the program. Although successful in finally obtaining the banks' involvement, federal subsidy costs increased to finance this extra incentive.

Monopolies
Complicating matters is the fact that providers often have monopolies over the means of program production and beneficiaries, which gives them further leverage in bargaining with the federal government in program formulation and implementation. States and local governments for example, are the only vehicle for program implementation in many cases. This makes it hard to invoke the ultimate weapon in the accountability arsenal of federal grant overseers to penalize noncompliance -- the cutoff of federal aid -- since such actions would ultimately hurt beneficiaries themselves. One Urban Institute study found that federal sanctions on state welfare programs were announced in 24 cases, but withdrawn in 23. In the homeland security area, the federal government has to take fire departments and other first responders as it finds them and hope it can influence them to work toward national preparedness goals. The cutoff of federal funds would deprive national leaders of the opportunity to bargain and influence these critical national homeland defense resources. Similarly, regulatory agencies have been shown to be reluctant to impose sanctions on critical industries, such as automobile manufacturers, that would jeopardize production and jobs.

In other tools, federal program actions help spur the development of provider monopolies. In the area of contracts, competition can be limited when a single provider has a monopoly on expertise or production resources that are critical for the program. Certain defense contractors, for instance, enjoy leverage owing to their past production of particular weapons systems, which can put them in an indispensable position for subsequent competitions. In the regulatory arena, professional associations are given licensing authority by states, giving them monopolistic powers to regulate entry and define performance. Federal recognition of accrediting associations for certifying higher education institutions, medical networks for determining rules for organ transplants, and the financial accounting standards board as the authority regulating financial reporting for corporations constitute other examples where monopolistic authority is, in effect, delegated to associations of third parties. In fairness, there are cases where federal tools are deployed to introduce new provider networks and competition to formerly closed systems, and these will be discussed in a later section of this paper.

Information Asymmetries
Principal-agent theory tells us that agents enjoy influence by virtue of their inside knowledge about their own behaviors and motivations. Third parties gain important leverage in bargaining with federal principals as a result. First, they have inside knowledge about their own prospective responses to federal program incentives and sanctions - a key advantage in bargaining. For instance, it is critically important for policymakers to know whether a new tax expenditure for higher education tuition or day care will, in fact, stimulate behavior changes by inducing more parents to send their children to college, and by prompting universities to raise their tuition. Similarly, in designing a grant, it would be important to know whether an increase in program funds will prompt increased spending by the states or a substitution of federal for state funds. For the most part, prospective information about responses to these kinds of program interventions is only known by recipients and providers, and even they may not be entirely sure how they will behave.

Equally critical is knowledge of the impacts of reducing or terminating subsidies or regulatory programs. Providers generally oppose such actions by proclaiming that their subsidized behavior would stop, with great harm to the national community. However, it is often unclear what their actual responses might be. For instance, when over 80 categorical federal grants were cut by 25 percent and consolidated in 1981, dire predictions from states and local providers rained down on Washington decisionmakers. However, field research confirmed that states largely replaced most of the cuts in health and social services programs in the following several years - a response that surprised officialdom in Washington. Similarly, proposed cuts in federal insurance for foreign investment in high risk nations has prompted an outcry by defenders of the Overseas Private Investment Corporation who warn of a pullback in investment by American corporations. Some, however, suggest that corporations will continue their overseas investments, pointing to the growth of an international private insurance market and to corporate investment in nations like China that have been off limits for OPIC subsidies.

Information on the retrospective performance of third parties is also difficult to ascertain. Agents have incentives to intentionally hide unfavorable information from principals. Although monitoring and reporting can help disclose key data, audits and field monitoring are often necessary
to validate information on performance. This can be expensive for federal agencies, particularly where thousands of providers are involved. Data are often recorded in different categories, serving the needs of providers but complicating the ability of federal agencies to obtain uniform perspectives on performance.

Complex Implementation Chains

One of the leading misconceptions that federal officials make is that individual programs can be managed and evaluated in isolation from other federal, state, local or private initiatives. In fact, the performance of any one program is influenced by a rich environment of collateral tools and programs at federal, state, local and nongovernmental levels. Whether it be child care, early childhood education, or substance abuse, most major domestic problems have numerous federal categorical grants directed at them with little evidence of coordination or rationalization.\(^{36}\) Even when resources from a variety of federal, state and local funds are combined to fund common services, other problems arise making it difficult to track the activities supported by specific federal programs. As one observer puts it:

"The state gathers all of the requests for funds from the other state agencies, local governments, subdivisions, and private agencies and eventually funds the requests from the various pots of federal and state monies. There is no segregation of federal funds...the state pool of money is made up of state and federal monies from a variety of sources."\(^{37}\)

Complicating matters further, there are often a variety of other federal tools addressing similar problems as well. For instance, a GAO evaluation of the low income housing tax credit found that the credit was accompanied by other grants, rental vouchers, loans and insurance for most of the subsidized units.\(^{38}\) Tax expenditures comprise a significant share of federal activity in other major program areas as well. For instance, tax expenditures comprise over 30 percent of total federal spending for health care (excluding Medicare) and nearly 60 percent for business subsidies. What is important is not that different tools are used but that they generally are not developed as part of a concerted strategy. Rather they emerge ad hoc, often from different congressional committees and
agencies with differing agendas and interests. There has been little effort to harmonize or coordinate these disparate initiatives.\(^{39}\)

Adding to the complexity, federal programs are delivered through long implementation chains that are often difficult to understand, let alone influence. Grants that reach the states, for instance, are only the first stop in a lengthy and complex delivery network featuring a variety of tools and agents. For example, child care block grants provided to states are subsequently subgranted to counties. The counties in turn often contract directly with private providers for actual services as well as issue vouchers directly to families to purchase child care services.\(^{40}\) Accountability can become diffused and confused in such an environment, which really constitutes fourth-, or fifth-, party governance.

Homeland security offers a good case in point. Grants are most often funneled through the states to local governments. Given the urgency of the threat facing the nation, strong national interest exists in upgrading the preparedness of communities as expeditiously as possible. However, states have been reportedly taking considerable time to develop strategic plans and accountability systems prior to the allocation of their funds down to local governments, prompting the Conference of Mayors to issue a statement alleging that states were blocking funds vital to preparing cities for terrorist attack. Recent audit reports have noted that states have in fact allocated the funds down to local governments – to the county level. However, in many states, counties are yet another intermediary level of government between the federal government and the ultimate targets of potential attacks – larger cities. The complex and lengthy nature of the implementation network for these grants and the variance across states surprised many at the federal level who were unaware of the nature of the delivery systems that are acknowledged to be the essential vehicles for national preparedness.

These practices prompt some to argue that only a "bottoms-up" view of implementation can provide a valid picture of program delivery.\(^{41}\) Indeed, to some the complexities of implementation appear to be impenetrable to systematic understanding.\(^{42}\)
Consequences of Accountability Challenges

These accountability challenges of third-party tools generate a unique set of performance problems which potentially undermine the effectiveness and efficiency of national programs while at the same time limiting accountability options available to resolve these issues. Of particular interest here are the accountability problems that arise from the perspectives of the national government although third party perspectives on these relationships are also important, as will be discussed later. It is important to recognize that these problems vary somewhat depending on the third-party tool being used and the specific design features embodied in the particular version of the tool. Broadly speaking, however, five generic problems can be identified.

Goal Diversion

Perhaps the major accountability problem posed for the national government by third-party government is goal diversion. Independent implementers can use federal program resources to pursue goals and objectives that differ from those envisioned for the federal program. The implementation literature has long taught us that national policy goals can become recast or even unwound as third parties redefine programs in the crucible of their own backyards.\textsuperscript{43} Paul Peterson argues that state and local governments are particularly likely to undermine the achievement of federal goals for redistributive programs where they have strong economic incentives to avoid becoming magnets for lower income people.\textsuperscript{44} Studies of environmental programs show that goal conflicts vary considerably among states, with differences in capacity and interest key variables predicting differential state conformance with environmental goals.\textsuperscript{45}

Goal conflict can be expressed in several ways. In some cases, third parties avoid or sidestep federal policies. Western states, for instance, addressed the federal 55 mile per hour speed limit mandate by handing out warnings to violators, not tickets, sending a clear signal that exceeding the limit was tolerated. In the early 1990's, states used artful reimbursement strategies under the open-ended Medicaid program to bill all sorts of extra costs to the federal government.\textsuperscript{46} In other cases, third parties actively resist federal goals, either by court actions or by taking their case to the
Congress. For instance, former Governor Allen of Virginia forestalled an EPA mandate to conduct stricter vehicle emissions tests by appealing to a newly conservative Congress. California lobbied to prevent a federal welfare fund cutoff due to its failure to implement an effective child support collection system.\(^{47}\)

At times, goals are compromised to bring about goal congruence, essentially by defining down deviance. Federal regulatory programs have been observed to be vulnerable to considerable goal slippage, as regulated entities seek to reopen the initial decision through active co-optation of federal regulators or passive resistance. In one model, the politics of speculative augmentation, federal policymakers are initially prompted to enact bold policy which is subsequently temporized and modified as the costs of reform become more salient and third parties become more sensitized to these costs.\(^{48}\) As we will discuss later, goal congruence also occurs over time as the preferences of third parties become nationalized as a result of participating in federal programs.

**Fiscal Windfalls**

A second type of accountability problem takes the form of provider use of federal subsidies for their own spending priorities. Whether it be tax expenditures to hire welfare recipients or grants to educate disadvantaged children, federal subsidies often do not succeed in changing behavior and causing additional services to be provided. Instead they are used to supplant funds that the recipient would have spent anyway. A recent meta-analysis of econometric studies of grants found that for every dollar of federal aid to state and local governments, about 60 cents was used to supplant state and local funds that would otherwise have been provided for the aided activity.\(^{49}\) In effect, substitution transforms categorical grant programs into a form of revenue sharing.

Tax expenditures are highly vulnerable to substitution as well. Tax expenditures to encourage the hiring of former welfare recipients have been found largely to subsidize employers who would have hired these people anyway. Tax-exemption of mortgage bonds for lower income first-time home buyers have been found to aid people who could have qualified for conventional mortgages. Tuition tax credits have been claimed to be designed primarily to help parents who
would have sent their children to college anyway, thereby providing little additional boost for college enrollments. Since universities will likely raise their tuition rates in response, they and not the parents would ultimately reap the windfall of this new tax credit.\textsuperscript{50}

**Moral Hazards**

Thirdly, tools that indemnify third parties for risks may undermine program purposes by encouraging third parties or recipients to engage in behavior that exacerbates the risks and undermines program goals.\textsuperscript{51} Federal insurance and loan guarantee programs such as pension insurance, deposit insurance and flood insurance are particularly vulnerable to this problem as the paper on insurance has shown. Federalizing these risks by shifting the costs to the nation’s taxpayers, however necessary from a social or political standpoint, nonetheless removes financial incentives to discipline economic decisions.

For instance, federal pension insurance enacted in 1974 provided employees assurance about the reliability of promised private pension programs. However,\textsuperscript{52} absent effective federal regulatory controls and incentives, it potentially can give employers and employee bargaining groups alike incentives to underfund benefits to free up funds for other urgent uses, such as wage increases or capital investment, with the knowledge that the government would bail out the pension plan in the end. Pension insurance also can distort investment choices by giving employers incentives to undertake risky investment strategies with plan assets, comforted in the knowledge that they will reap all the gains while the government will bear all the losses.\textsuperscript{52} Similarly, as paper 6 noted, the design and management of federal deposit insurance played a major role in the financial crisis affecting the nation's savings and loans in the 1980's and early 1990's.\textsuperscript{53}

Although the savings and loan crisis is perhaps the most notable example of the counterproductive consequences of federal subsidies, other kind of subsidies also induce a form of moral hazard where well intentioned subsidies induce effects that prompt offsetting reductions in program investment elsewhere in the economy. For instance, the 1997 federal grant to states to expand the numbers of lower income children with health insurance may very well prompt some
employers to drop coverage for children newly eligible for this program. Similarly, research has shown that increases in the size of Pell grants are offset by a decline in institutional aid offered by universities to eligible students.\textsuperscript{54}

**Perverse Fiscal Incentives**

Closely related to moral hazard, third parties may not have sufficient incentives to promote efficient programs when they have no responsibility for raising the funds which they spend. The potential incentive consequences were perhaps best captured by Adam Smith when discussing private corporations:

"The directors of such companies, however, being the managers rather of other peoples' money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own... Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company."\textsuperscript{55}

When federal grant recipients have little or no fiscal stake in a program, an essential disciplinary constraint on efficiency is removed. Federally funded programs with little or no cost sharing do not tend to benefit from the levels of political or management oversight normally provided by state, local or private parties for their own funds. Federal categorical grants to states, for instance, received less real attention by state legislatures than state funded programs, reflecting both the lack of financial payoff and relatively limited discretion available for narrowly drawn categorical programs. Although limited oversight by state elected officials may not be welcomed by some program advocates, such programs can become isolated within states, cut off from vital political, legal and financial resources that may be critical for successful program outcomes.

Depending on their design, grants or other subsidies have the potential to discourage initiatives by third parties to reduce costs and enhance efficiency. Savings from program or
management reforms generally accrue to the federal government alone. For instance, a recent GAO study of the food stamp program found that while states' management commitment was critical to reducing overpayments, states faced a disincentive because savings accrued entirely to the federal government since food stamp benefits are entirely federally financed. Of course, many factors affect performance and efficiency besides federal incentives, but one study of local libraries found that efficiency, as measured by circulation and other outputs, was inversely related to libraries' dependence on intergovernmental grants.

Federally funded grants for mass transit and flood control have been accused of supporting unproductive and inefficient projects due to the absence of meaningful local cost-sharing requirements. Mass transit projects with little ridership were financed with 80 percent federal grants even though the benefits largely accrued to the residents of those cities. Critics argue that the relatively minor local cost share did not prompt the kind of review and screening that might have either prevented these projects from being started or perhaps prompted their modification to better address local needs. For flood control, projects were often started at the behest of congressional delegations with little or no cost sharing by local taxpayers. When the local cost sharing requirement was increased in 1986, the projects underwent more local scrutiny and the projects selected were more often defensible on economic grounds.

Loan and loan guarantee programs can also suffer when lenders have no shared costs and face no risks from lending decisions. As noted earlier in this paper, banks faced insufficient incentives to screen recipients of federally guaranteed student loans or institute timely collections because they faced no financial risk from the transaction. Similarly, lenders who hold and service HUD-insured multifamily mortgage loans bear little or no financial risk of default, and it is no surprise that they become "passive" in their oversight of borrowers. OMB guidance on loans suggests that financial institutions participating in federal guaranteed loan programs should bear at least 20 percent of the loss from any default.

Similar fiscal incentive issues have surfaced with the contracting tool. Cost plus contracts which reimburse costs plus profit appeared to be the standard for many years. However, such
contracts failed to provide savings incentives during performance. The fixed price contract does provide incentives - contractors are responsible for delivering prescribed outputs at a fixed cost and they reap the full benefit if they deliver at lower cost but also must absorb any costs exceeding the fixed price. Potentially, this device offers powerful incentives to monitor program efficiency. However, contractors will not bid on fixed price contracts where products or costs are uncertain, and reportedly federal agency officials are reluctant to force contractors to absorb excess costs over the agreed price when this threatens the solvency or competitiveness of major suppliers.\textsuperscript{59}

Attraction of Opportunistic Partners

Finally, third-party subsidies can encourage the emergence of third parties whose primary goal is to profit from the subsidy rather than address the program's goals. Examples here include the rise of proprietary trade schools formed to obtain student loans and the exploitation of Medicaid by providers obtaining reimbursement for services not actually provided or medically necessary. In the case of proprietary schools, many were attracted to the field by the income that could be earned from subsidized students, but then provided training that did not prepare these students for the job market. Developers of low income housing are enticed by rich subsidies as well, which may be the only way to prompt development of these units. Yet, their commitment to maintain and sustain these units over the long term is highly uncertain.

At the root of this problem are subsidies that entice participation without sufficient risk- or cost-sharing or screening to ensure commitment to the program. Tools like formula grants and tax expenditures provide rich subsidies to ensure universal participation, but typically involve little or no cost sharing or risk sharing. Accordingly, such tools are likely at least at the outset to include third parties with only a weak commitment to the goals of the program.

Rent seeking is a closely related phenomenon where governmental tools confer substantial incomes to third parties. The “rents” that providers gain represent income conferred not by markets but by their status as providers of government programs. Examples here include payments to hospitals under Medicare, farmers under food stamps, or housing developers under numerous federal
housing subsidies.

Whether these incomes are excessive or essential to stimulate sufficient supply of the aided benefit is a focus of considerable debate. For instance, under the "risk contract program," Medicare pays health maintenance organizations (HMOs) a fixed amount for each beneficiary enrolled. This amount is now based on the experience of the fee-for-service Medicare program adjusted for the relatively healthier status of seniors choosing the HMO option. While GAO and others have argued that managed care companies are receiving windfall profits from the contract formula, HMO's have been dropping out of the program when the federal agency seeks to reduce this alleged profit, claiming that their costs are not sufficiently reimbursed. Debates over the alleged profits of government contractors similarly reflect the challenges facing principals in reviewing the claims submitted by their agents for these kinds of programs.

Even when provider incomes are kept within appropriate bounds, goal displacement nonetheless can occur as the income provided by the tool can become more politically salient than the ostensible programmatic objectives. While goal displacement occurs within bureaucracies as well, the use of third parties increases the stakes associated with the income effects of public programs by multiplying the stakeholders whose economic interests are bound to the programs. As a program evolves, the incomes provided to third parties can become a progressively more important influence on program decisions, eclipsing in some cases the underlying program goals themselves. The dependence of third parties on public subsidies can become an important constraint on public decisions in both overseeing program compliance and in choosing more promising providers or projects. Thus, for instance, the political choices associated with federal weapons or space projects become influenced not only by national security and scientific goals but by the major stakes involved for large contractors and thousands of their employees and stockholders.

Strategies for Responding to Accountability Challenges

The foregoing suggests that the performance problems associated with third party
government are significant and vexing indeed. Yet, these problems, while endemic to these relationships, are by no means immutable. Most programs, in fact, incorporate various features to head off the kinds of policy fiascos that analysts seem prone to highlight. As deLeon says, “things” do get implemented and carried out on a regular basis, although sometimes it takes programs a number of years to finally get it right.61

The case of guaranteed student loans in Text Box 1 illustrates the daunting performance and accountability challenges posed by third party governance, yet it also illustrates that these challenges are not insurmountable when policymakers act with insight to address complex tool design and accountability issues.

Text Box 1

Guaranteed Student Loan Program

The federal government has offered guarantees for student loans from private banks for some years. By the early 1990's, over 20 percent of these loans were in default for over three years, necessitating expensive federal payments to the lending institutions holding these loans. Apparently, the 100 percent federal guarantee caused banks to be less than vigilant in their management of these loans. In addition, guarantees were extended to students in a wide range of proprietary trade schools which often failed to provide their students with the education necessary to find viable jobs to pay back the loans.

Perceptive federal policymakers took action in the 1990's to correct these problems and default rates dropped below 10 percent by the end of the decade. First, banks were given a financial stake to screen and monitor loans by being held responsible for a portion of defaulted loans. State guarantee agencies were provided grants to help prevent defaults and the Department of Education was given new authority to take back and manage defaulted loan portfolios from the states. More effective screening of proprietary schools was instituted as well, with thresholds established based on prior default records experienced by their students. Over 1000 schools have been terminated from the program as a result. New incentives and sanctions were applied directly to defaulting students, including an offset of federal tax refunds and a garnishment of wages. Finally, the Department of Education instituted a direct loan program during this period as well. This set a competitive incentive in place for banks to demonstrate to universities the efficacy of their loans over the new instruments available.
Overall, accountability strategies attempt to achieve program objectives by pursuing two tasks: enhancing the capacities of third party implementers and/or assuring a more appropriate alignment of third party interests with national policy goals. When interests are aligned, public goods may still be underproduced when third parties lack sufficient capacity or awareness of their joint interests. The function of federal leadership here is to lower the costs of cooperation through such approaches as fiscal, technical or information assistance. In the more obvious cases where interests or goals are in conflict, strategies can center on either changing internal preferences within the provider community or shifting provider networks themselves. A broad array of devices can be deployed to bring about what is essentially a reframing of the policy agendas and attentions of networks of third parties to support national goals.

These tasks are pursued through specific oversight and accountability strategies that go well beyond the traditional audit and reporting commonly believed to constitute accountability. Rather, strategies to address third party performance problems embrace such fundamental program formulation and design issues as initial tool selection, tool design, provider selection, network transformation, oversight and information feedback mechanisms. These strategies are interdependent – a potential problem prompted by a poor match between the tool and a program goal can complicate subsequent oversight but can also be ameliorated by appropriate provider selection and administrative oversight approaches.

**Tool Selection**

Some performance and management problems are built in at the outset by a mismatch of tools with goals and problems. Some instruments are better suited to certain policy tasks than others. As Lester Salamon has observed, each tool has a distinct political economy – a bundle of incentives, sanctions, rules and processes that tend to have reasonably predictable performance and accountability consequences. As Salamon also notes, however, in the policymaking process, tools are first and foremost strategies of political mobilization, and only secondarily analytic categories.
against which to evaluate the appropriateness of public policy proposals. It is not surprising, then, that tools are selected because they happen to fit with a particular mood or political perspective, not necessarily because they are the right instrument for the job at hand.

Block grants, for instance, have become a tool used to legitimize new federal initiatives during a conservative political era. While championing devolution during the policy formulation stage, many federal policymakers grow frustrated over time when they learn that the limitations placed on federal oversight and rules by this tool subsequently limit their ability to deliver on national policy goals and promises. Introduction of categorical requirements and the nationalization of reporting mechanisms often follow several years in the wake of initial passage.\(^6^5\)

A number of other mismatches with real performance consequences have also been noted. Donahue, for instance, concludes that contracting is often overextended to cover duties that are difficult to specify in advance and inherently judgmental and governmental in nature.\(^6^6\) Paul Light has noted some leading areas where federal agencies have used contracts for inherently governmental functions due to restrictions on the hiring of federal employees.\(^6^7\) Tax expenditures have also come under criticism when advertised as a way to provide benefits to low or moderate income taxpayers who get little or no gain from these provisions due to their zero or low initial income tax liability.\(^6^8\) Partly due to the favorable and “businesslike” connotation attached to credit compared with more explicit subsidies, loans and loan guarantees have also been used in areas where other tools, such as grants, are perhaps more appropriate.

Table 1 offers an approach for guiding the selection of tools to match generic policy purposes. This table shows how federal tool choices can be sorted against two dimensions: the universality of participation desired for the program and the federal tolerance for performance differences among third parties. The table suggests tool choices should flow from overarching policy decisions regarding the tolerance for policy differences across third parties and the scope of participation desired from the universe of third parties. Thus, regulation would be appropriate when the federal government wants both universal participation or applicability and has low tolerance for performance variations. Loans, on the other hand, would be appropriate when federal tolerance for
Tools can fall into several of these categories depending on their design. Thus, for instance, for the grant tool, a categorical formula grant could be characterized as calling for universal participation and relatively low tolerance for state or local differences from federal standards, thus falling into the upper left hand quadrant of Table 1. A discretionary basic research grant, on the other hand, would be characterized by selective participation and could provide for high flexibility for researchers to pursue promising discoveries, thus falling into the bottom right hand quadrant of Table 1.
Table 1
Criteria for Tool Selection

<table>
<thead>
<tr>
<th>Participation Policy</th>
<th>Federal Tolerance for Diversity</th>
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<tr>
<td>Low</td>
<td>High</td>
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<tr>
<td>Universal</td>
<td>Regulation</td>
</tr>
<tr>
<td>Selective</td>
<td>Contract</td>
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This kind of framework can help us diagnose mismatches between tool choices and policy purposes. For instance, when looking at the criteria reflected in Table 1, we can see that loans are an instrument to use when we want recipients to self select based on their prospective capacity to pay the loan off when it comes due. However, federal loans have sometimes been selected when national leaders have more universalistic participation in mind, including participation by lower income recipients without the wherewithal to pay back loans received. Thus, loans to farmers come to resemble grants because during farming recessions, farmer defaults are greeted by forbearance and the issuance of new credit, not collections. From this perspective, loans can also prove to be an ineffective tool to reach the universe of lower income students needing access to higher education.

Most programs ideally call for a synergistic combination of tools to promote effective performance, and problems can occur when policymakers are not alert to this dimension. For instance, the savings and loan crisis was in part prompted by broadening the scope of bank lending activities at the same time that federal regulatory oversight was curbed. The implicit moral hazard associated with a more liberalized deposit insurance program required a combination of strong oversight and public accountability. The federal crop insurance program was undermined over many years when farmers realized they could wait for federal disaster grant payments during natural disasters in lieu of paying insurance premiums; this was reversed in the mid-1990’s when Congress required insurance participation as a condition for disaster payments.

**Tool Design**

Appropriate design of tools can also fend off management and performance problems. Linder and Peters observed that improper design condemns some programs to be "crippled at birth", a malady which the best public bureaucracies cannot overcome. By design, I mean the combination of incentives, sanctions and rules built in to the program at the outset. Design can compensate for potential performance problems posed by individual tools. For instance, the moral hazard potential associated with insurance can at least be tempered with risk sharing requirements such as coinsurance requirements, risk adjusted premiums, and expanded capital requirements. Similarly, the fiscal windfall potential of grants can be addressed with effective maintenance of effort and
matching requirements.

Tool incentives and sanctions can be conceived of as programmatic, participative and managerial. **Programmatic features** are intended to promote the effectiveness of the program in achieving its program objectives. For instance, sanctions penalizing welfare recipients for not working and states for failing to meet thresholds of work participation for their welfare clients have a programmatic thrust to reinforce the underlying goals of the TANF block grant itself. Programmatic decisions concerning which activities and recipients are eligible for funding can have a significant bearing on some of the performance problems discussed above. For instance, fiscal substitution may be prompted when federal subsidies are extended for services and goods that have low externalities, i.e. services that local governments or taxpayers already have ample incentives to provide on their own without federal aid. Thus, if policymakers were concerned about protecting against substitution, care could be taken to concentrate federal subsidies on new or emerging activities with high externalities which nonfederal providers are least likely to undertake on their own. Similarly, targeting subsidies to lower income taxpayers, businesses or governments may also yield lower substitution because these recipients are less likely to have the capacity to fund activities from their own resources prior to the federal subsidy. Some tax expenditures are already targeted in this way, such as the child care credit which has an income ceiling.

**Participative features** define, mandate or entice participation in the program in the first place. Although participation is mandated for coercive tools like regulations, for most tools participation is voluntary and must be induced by a package of financial incentives and appeals to broader values. As Ingram has noted, participation is the first and foremost political task for federal program survival, with compliance and goal congruence the goals only over the longer term. Universal participation is also the rationale for many programs whose primary purpose in fact is to ensure a minimum level of services, protection or rights throughout the nation.

**Managerial features** are those provisions intended to boost responsibility and stewardship of the program by third parties. Grants and contracts include a plethora of financial accounting, reporting and inspection requirements levied on third parties which attempt to enforce compliance
and accountability for specific federal objectives, but other strategies are also pursued which seek to
instill responsibility for proper stewardship for both federal funds and goals on the part of third
parties. Matching, risk sharing, and maintenance of effort can help ensure the kind of fiscal interest
necessary to prompt ownership and responsibility on the part of recipients. Research on grants, for
instance, suggests that if nonfederal matching rates are high enough and if they require new cash, as
opposed to inkind, investment, these requirements can provide the kind of fiscal stake to prompt
managerial interest in federally assisted programs by third parties, all other things being equal.70
Similarly, risk sharing, risk adjusted premiums and expanded capital requirements are among the
incentives that can help overcome moral hazard in insurance by fostering greater fiscal responsibility
for fiscal consequences of decisions by recipients. Funding incentives rewarding or penalizing third
parties based on performance are another example of managerial features that can help prompt
ownership and efficient management or programs. Thus, several federal grant programs are
beginning to offer performance incentives to motivate more improved performance. States now can
receive bonus payments if they reduce their food stamp error rates, and this seems to have prompted
increased commitment in the states.71

Many of the management and performance problems discussed earlier can in fact be
attributed to incipient conflicts between participative, managerial and programmatic incentives.
Although managerial incentives promise to foster the kind of stewardship that could mitigate or
prevent the unique third party performance problems discussed above, these provisions are often
overshadowed and negated by the universality imperative when such provisions threaten to impede
full participation in the program. Notwithstanding the benefits to be gained from greater risk and
cost sharing, these provisions are often viewed as working too well to screen out partners and
clientele deemed vital to the goals of the program. Thus, for instance, matching provisions might
prompt some jurisdictions to opt out of federal grant programs and thereby jeopardize the goals of
providing uniform service levels across the country. After all, the original rationale for most federal
programs is to inspire a greater level of program activity than third parties had been providing in the
absence of federal tools. Reflecting this, there has been a trend in recent years to lower or eliminate
matching for federal grants. Half of all grants had no matching requirement at all in 1995 and those
that did were too weak to provide the kinds of efficiency incentives necessary. Thus, in some ways,
the performance problems characteristic of third party government are in fact often designed in to programs at the outset.

**Provider Selection**

The selection of third parties who can be depended upon to be active and responsible supporters of the program is critical to program success. Philip Pettit argues that selection of supportive providers can avoid the need for onerous and conflictual sanctions on performance.72

Some tools, like contracts and discretionary project grants, permit the federal government to select its providers using criteria that help ensure the selection of providers committed to the program goals. Consideration of past performance and the desire of providers to maintain long term relationships can provide information to guide the selection process and promote incentives for program compliance.73 As noted above, the Department of Education is now screening prospective trade schools more rigorously before they qualify for student loans. HUD's housing programs require a long term commitment from developers to maintain housing units for low income families as a condition for obtaining these subsidies in the first place. Regulatory tools sometimes use an analogous strategy to gain upfront control over third parties - licensing of participants using criteria promoting policy goals. The Agriculture Department, for instance, requires states to inspect and certify all food vendors for participation in the food stamp program to screen out providers likely to commit fraudulent transactions

Competition against specific criteria helps screen in providers who have the greatest potential to meet effectiveness and efficiency goals. Prospective performance can be at least partly judged based on past performance, reputation, organizational and personnel capacity, skills and resources and other indicators. Notwithstanding these advantages, we know these approaches are not an ironclad guarantee of quality - contractors' bids have a tendency to be deliberately undercosted and overpromised, contractors and grantees with sunk costs in a project have an inside track in obtaining follow-up assistance, and agencies sometimes are not good judges of quality. Competition presumes...
the existence of a vigorous market of suppliers, which often is not the case particularly when projects require unique expertise or capacity. As Don Kettl argues, market imperfections make it more difficult for the federal government to become a "smart buyer". Government, not the market, must define the product, determine reasonable prices and set standards of quality in the absence of the signals that competitive markets provide. The principal agent issues become correspondingly more consequential, as government principals must rely on agents who have exclusive knowledge of their own qualifications as well as price-quality tradeoffs, technical feasibility and other key issues defining the contractual relationship. Defining appropriate incentives and standards, monitoring performance and leveraging contractors’ performance become far more complex where competition is limited or nonexistent.

Other tools do not provide for the screening and pre-selection of providers. Whether it be grants, tax expenditures, regulations and most loans, many programs are obligated to deal with all eligible providers and accept the provider world as it is. Lacking a strong screening mechanism, these tools often seek to shift the priorities and values of established provider networks from within – obviously not an easy task and one that may be achieved only over the longer term.

Federal programs build support within state and local governments, for instance, by establishing what researchers call a "picket fence" of program specialists and advocates within these governments disposed by professional training and values to support the federal program. Reinforced by federal personnel qualifications, single state agency requirements and detailed citizen participation provisions, programs form coalitions between federal and state or local specialists across governmental and sectoral boundaries, often in opposition to the interests of these officials' nominal central government superiors. Peterson and others have articulated a maturation model where third parties grow over time to adopt the goals of federal policy, due in part to the growth of like-minded professional networks and groups representing program clientele. Program design can nurture these networks by prescribing qualifications for personnel working on aided programs and by institutionalizing roles and rights for beneficiary groups at the provider level. For instance, federal programs often define requirements for advisory boards to be appointed by providers, with exacting criteria for membership.
Having energized like-minded bureaucrats, these programs also seek to activate recipients or clientele by granting such groups appeal rights and court access. Such provisions, called "fire alarm oversight" by two observers, essentially can generate new interest groups within state or local government that can ultimately work to transform state or local priorities. Studies suggest that such initiatives have succeeded in internalizing federal program priorities and interests within these governments over several decades. Although such programs were initially sources of intergovernmental conflict, over time states grew to become senior fiscal partners, replacing federal cuts in many cases in the 1980's. There appears to be some evidence that comparable internalization occurs over time with federal regulatory goals. Corporations make investments in compliance and gain an interest in championing program goals which could give them an edge over new entrants or other competitors.

In the past, the federal government has also created entirely new types of providers to deliver services when it felt that existing delivery networks were not responsive to federal programs. The Community Action Agencies and the Head Start program both were premised on the need to create alternative service delivery networks to compete with established state and local systems. Although these networks have now become institutionalized within state and local governments, other federal initiatives to change the structure of third party delivery systems have had a more mixed record. Federal planning requirements in the 1960's and 1970's, for instance, sought to promote regional planning and coordination of services throughout metropolitan areas. Notwithstanding some limited progress, for the most part federally inspired regional planning bodies did not take root as important drivers of priorities or policy.

Federally inspired networks can not only become the agents of the federal government for service delivery, but also help to reframe the debate within established third-party networks by introducing new interests and forcing these networks to reckon with new actors and interests. For instance, transportation planning at the state and local levels has changed in recent years partly due to linkages articulated by federal regulation between compliance with federal clean air goals and transportation initiatives. Not only can noncompliance with environmental standards prompt a
cutoff of federal highway funds, but EPA rules force states to address land use and transportation plans in their clean air attainment plans. Federal and state environmental networks are now relevant to state transportation networks as a result of the federally enforced linkage.

One potentially transformational initiative receiving considerable attention is the use of vouchers to deliver public services. Such an approach could very well transform service delivery systems by breaking apart monopolistic providers within local areas and placing more leverage in the hands of clientele. Several major federal programs, such as HUD’s Section 8 housing program and the new Child Care Development Block Grant, have encouraged widespread use of vouchers. Existing provider networks are beginning to experience significant new competition and pressures as a result.\textsuperscript{80} \textsuperscript{81}

**Administrative Oversight**

Oversight can also clearly make a difference to program performance and management. The process, capacity, skill and interest of administrators has a clear impact and can overcome potential problems inherited from tool selection and design stages. One study of federal education grants, for instance, showed that strong congressional interest and aggressive oversight by the federal agency was able to transform the federal compensatory education grant program into a stimulant of greater state compensatory education spending, notwithstanding program design features that would have been expected to promote fiscal substitution.\textsuperscript{82}

Federal oversight and accountability can be characterized as being ex ante or ex post, or some combination of the two. Generally, ex ante accountability concentrates oversight and control at the front end of the relationship. The burden of proof is on the third party to show how they will comply with federal requirements. Goals are negotiated interactively and federal expectations are documented in specific, often measurable terms. Typically, recipient plans and proposals are reviewed extensively at the front end and approved prior to the flow of funds. Federal agencies can use this prior approval to enhance their leverage in at least two distinct ways - first by selecting providers evidencing strong commitments to federal goals, and second by establishing terms and
conditions promoting program outputs or outcomes. In Salamon’s framework, the ex ante approach is similar to the direct model featuring active administrative control over program performance at the front end of the relationship.\(^8^3\)

For most tools, the federal government relies on ex post oversight strategies. Tools such as formula grants, tax expenditures, loans and loan guarantees and most regulatory initiatives have only limited front end administrative controls in setting goals or reviewing providers. There is a presumption of compliance, and compliance is certified without rigorous up front examination. Bargaining occurs, as was noted earlier, but at a distance and through complex signaling and political processes. Changes to plans and budgets are generally adjusted at the third party level without approval of each transaction from federal agencies - begging for forgiveness, not permission, is the hallmark of the ex post approach. Compliance is generally validated following the completion of performance through ex post audit. Monitoring during performance generally occurs on an exception basis when, for instance, complaints are brought to the federal agencies. The burden of proof shifts to federal agencies to demonstrate noncompliance or other performance issues. Federal influence can be limited at this stage due to the difficulties in recovering funds already spent. For these kinds of programs, program design and provider network commitment become more critical as strategies to promote accountability for federal goals.

Table 2 illustrates the differences between these two approaches. The distinctions drawn are for heuristic purposes, and many programs reflect a mix of the two. For instance, many categorical grant programs call on federal agencies to approve plans submitted by grantees and require approval for significant deviation in planned budgetary allocations during the performance period. Procurement represents the purest form of ex ante oversight, and block grants and tax expenditures reflect the ex post approach most faithfully.
### Table 2

**Characteristic Oversight Features**

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<thead>
<tr>
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<th>Ex ante</th>
<th>Ex post</th>
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<tbody>
<tr>
<td>Goal setting</td>
<td>Negotiation</td>
<td>Statute</td>
</tr>
<tr>
<td>Provider selection</td>
<td>Competition</td>
<td>Formulaic</td>
</tr>
<tr>
<td>Front end compliance</td>
<td>Prior approval</td>
<td>Certification</td>
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<tr>
<td>Performance monitoring</td>
<td>Transactional approval</td>
<td>Exception based</td>
</tr>
<tr>
<td>Validation</td>
<td>Periodic monitoring</td>
<td>Post audit</td>
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Notwithstanding the advantages accruing to the federal government from the ex ante approach, there are compelling reasons for reliance on the more passive oversight strategy implied by the ex post approach. Christopher Hood suggests generally that the larger the clientele, the more government will switch from active to passive oversight strategies as a way to reduce bureaucratic burdens. Differences in the federal role and the specificity and prescriptiveness of federal goals may also explain the reliance on ex ante versus ex post approaches.

As a general proposition, government oversight of implementation is constrained by the limited resources available to check on the thousands of providers often participating in public programs. For instance, individual contract officers at federal EPA and the Labor Department on average each handle 26,000 contract actions a year. Even for federal regulatory programs with a strong federal role and objectives it is acknowledged that federal agencies must rely on voluntary compliance and certifications by regulated entities in large part.

Ironically, perennial constraints on the size of the federal workforce, reinforced by budgetary ceilings on federal personnel, have both contributed to the federal reliance on third parties as well as limited the scope of its ex post oversight. Moreover, longstanding human capital problems within the federal workforce can serve to limit oversight capacity as well. Don Kettl discusses the unique skills challenges prompted by third party governance, as managers must bridge gaps between organizations and weave together the networks producing services. GAO has noted that these complex public management roles in overseeing work of contractors and grantees are proving to be increasingly challenging to the federal workforce. In programs such as the Environmental Protection Agency’s Superfund and the Department of Energy’s nuclear waste, federal officials themselves expressed concerns over their capacity to review the reasonableness and accuracy of cost estimates and performance reports from contractors and grantees. GAO also observes that staff are not well deployed in some agencies to monitor the wide range of third parties whose performance is critical to agency objectives. For instance, the Department of Housing and Urban Development has experienced widespread problems in monitoring real estate contractors, appraisers, lenders, local housing authorities and landlords; for instance, HUD conducted on-site monitoring of only 4 of the 3700 lenders participating in the department’s home improvement loan insurance program in 1997.
Perhaps to compensate for inherent resource constraints, the federal government has sought to delegate oversight for many tools to third parties as well. The audit of grants, for instance, now must be arranged by grant recipients themselves, either using their own auditors or contracting with accounting firms. Federal audit staffs play a role in following up on these reports and doing selected studies of their own. Many federal regulatory programs have reached out to engage states as regulatory partners, often in partial preemption programs under which the states receive partial federal funding and permission to exceed federal standards in certain cases. Even tax expenditures have come to use state agencies to select projects in certain cases, most notably the low income housing tax credit and private activity bonds, where states allocate limited tax expenditures among developers and other entities within the state. The so-called direct federal loan programs actually use private collection agencies to process delinquent loans while the guaranteed student loan program uses state guarantee agencies as key players. The Medicare program uses a diverse array of nonfederal entities to provide accountability for the program. Private insurance contractors are engaged to process and approve claims and separate contract staffs review claims paid for potential fraud.

While a delegated, ex post oversight process may cover salient instances of third party noncompliance, it would be unrealistic to expect this process to ensure that programs are responsibly and efficiently managed. Federal agencies' staffing and political constraints prevent them from becoming on-site auditors and overseers at third-party offices. This suggests that instilling appropriate third-party responsibility at the outset through the design of effective incentives is essential to good stewardship and accountability.

Tracking Money and Outcomes

Notwithstanding the devolution of active oversight, the federal government retains responsibility for obtaining information on program spending and performance. Even for such programs as block grants, third-party programs must provide national data to compete in annual congressional appropriations processes. However, obtaining national information on third-party environments is often fraught with political controversy. Third parties maintain data on spending and
program outputs in categories meaningful to their own accountability stakeholders and it is accordingly difficult for federal officials to establish uniform information needed to gain national perspectives on program implementation.

At the very least, principals want financial information revealing the activities for which the funds were spent. This permits members of Congress to take credit for supporting discrete services and provides some accountability for how funds were spent. Tracking how federal dollars were spent appears straightforward enough, but this too becomes complex in third party environments. The more that federal programs have broader goals in areas where third parties have significant investment, the more it will be difficult to isolate and track spending for federal initiatives separately. Federal funds and programs tend to be commingled with state and local funds and results are reported for an integrated set of initiatives – a result which many would applaud as an efficient outcome. In fact, at some point, federal funds become "fungible". In these cases, it is impossible to definitively establish and track the specific uses of federal funds for particular clientele, services or activities.91

Fungibility has real consequences for the enforceability of specific federal fiscal prohibitions and restrictions. Federal restrictions on the use of funds for such items as administration or construction can easily be evaded by third parties who can simply shift their own funds to support the prohibited activity and use the federal money for activities previously financed with nonfederal funds. The real "impact" of federal funds in this case would be to free up nonfederal funds to support the prohibited activity. This kind of "multipocket budgeting" enables third parties to juggle federal and nonfederal funding sources to escape real accountability.92

A more promising approach to accountability in fungible funding environments is the performance results perspective. Widespread reform initiatives to shift the focus of accountability from inputs and processes to outputs and outcomes have taken root around the world. In the United States, such initiatives were piloted by localities and states, then given new life at the federal level by the 1993 Government Performance and Results Act. Federal agencies are required to prepare performance plans delineating objectives and indicators that address the outcomes of their programs.
This outcome approach to accountability is potentially promising for third-party programs because it cuts across all entities working toward common performance objectives, encouraging them to view themselves as a single results-oriented partnership. It also carries a promise to deregulate third party transactions, giving third parties more flexibility in deciding how to spend federal money and manage these programs in return for heightened focus on achieving results. Performance-based accountability has been introduced in grants under the rubric of performance partnerships, in procurement as performance contracting, and in regulation as performance-based standards.

As promising as these initiatives appear, they raise some critical accountability issues of their own which are just now being revealed as the federal experience with GPRA unfolds. As Don Kettl has noted, outcome reporting, although capturing a unified perspective, does not permit each participating public or private entity to identify its unique contributions to the overall program results. New Zealand’s performance management system clarifies accountability by holding public managers accountable for discrete outputs directly connected with government programs, not the broader outcomes or results to which these contribute. John Donahue has observed that even output based accountability in the procurement area breaks down when the bond between payment and ultimate results is severed.

In some respects, performance based agreements exacerbate principal-agent problems. Input and level of effort are more easily assessed and tracked by principals. By contrast, the link between a given level of funding and prospective or actual performance is often more uncertain and difficult for principals to ascertain independent of agents' representations. For instance, it is relatively easy to track the number of children served in a feeding program – agency projections can be compared with past levels achieved and actual numbers of children served can be validated by independent audit and evaluation. However, it is far more difficult for principals to assess agency claims that the feeding program will improve health outcomes by a specific amount. Absent definitive models on the linkage between the feeding program and health outcomes, which are usually lacking, principals
must either accept agents’ claims or search for some reasonable alternative model for this linkage. Actual health outcomes can be ascertained eventually, but it is difficult to audit or evaluate the production function linking the specific program intervention, e.g. numbers of children fed, to the outcome. Moreover, it often takes years for the outcomes of public interventions to be realized and measured. Of course, the dilemma is that accountability for outputs alone may not provide sufficient incentives for third parties to reach for the broader outcomes and results the public expects from public programs.

Performance based agreements also presuppose a level of agreement on objectives that is often more apparent than real. Vague or conflicting objectives do not provide a firm basis for performance accountability at any level. Under these conditions, it becomes difficult for federal agencies to hold states or contractors accountable for performance shortfalls. Performance partnerships in the area of grants may be the most difficult to implement where they arguably can have the greatest impact on public services - in major programs – because agreement on objectives and measures may be most difficult to achieve here. Donahue similarly argues that contracts work best for the government when tasks are discrete and measurable, but when tasks are vague and ambiguous, too much discretion and leverage are provided to contractors to define or redefine public objectives.95

A GAO report on EPA’s performance partnership initiative for grant and regulatory programs illustrates the challenges. In 1998, nearly all states negotiated agreements with EPA giving them greater flexibility over spending federal funds and running operations in return for more specific accountability for achieving specific environmental goals. GAO noted some real advantages in improved communication between EPA and the states and providing greater flexibility for states to shift resources to meet unique state conditions. However, it also identified obstacles including disagreements over performance levels and types of measures and difficulties in linking state activities to environmental results.96

Moreover, the outcome approach raises sensitive political questions about who defines the outcomes. The assertion of outcome goals for entire program areas by federal agencies challenges prevailing federalism norms, particularly for areas like education where the federal funds comprise
only a minor share of the entire intergovernmental effort. If not done in full partnership with third parties, such initiatives can generate fears of excessive centralization of policy leadership in many domestic policy areas.97

Relating Accountability Mechanisms to Tools and Purposes

This paper has defined some key performance issues and accountability challenges facing third party tools in general. It goes without saying, however, that the challenges are not uniform across all tools and types of third parties. Nor can or should a single accountability strategy apply to all tools and third-party relationships. Indeed, we know that even for a single tool like federal grants, different accountability schemes are appropriate for categorical versus block grants to reflect the differential federal roles contemplated under each.

Among the factors likely to determine the appropriate choice or tools and accountability strategies are the nature of the federal role intended by policymakers, the nature of the tool itself, the congruence between federal and third party goals, the fiscal role undergirding the tool, and the relative weight placed on universal participation. Considerable additional research is needed to understand the systematic relationship between some of these key dimensions and performance outcomes. But several suggestive propositions can be offered here.

First, the foregoing section on conflicting accountability expectations suggests that the nature of the federal role should be crucial in determining the type of tool that is appropriate, the performance challenges that exist, and the accountability strategies to be followed. Three broad models can be posited, as shown in Table 3.

- Federal - programs where specific federal goals define performance expectations and implementation. Here the federal government would be expected to set specific and prescriptive goals and uses coercive and centralizing tools like contracts and regulation. Third parties are
placed in classic agent roles. To the extent possible, federal agencies would exercise up front control over provider selection and will maximize opportunities for front end review and approval of third party plans and actions.

- **Partnerships** – programs where goals are set through bargaining relationships between the federal government and third parties. Where the federal role is defined in partnership terms, programs would be expected to define goals in broader terms and use such tools as categorical grants or partial preemption regulatory mechanisms that permit some third party discretion and flexibility within federally set parameters. Under this scenario, federal agencies most likely would have little control over selecting third party providers and must use established networks, but would seek to influence values and priorities of established providers through fire alarm and picket fence mobilization strategies. Oversight would be ex post for the most part and may be performance based as well, with indicators and measures jointly agreed to by federal and third party officials.

- **Third Party** – programs where goals are set primarily by third parties themselves and the federal role is defined as supporting third parties to implement their own goals. Principal accountability for these programs is to constituencies at the third party level who assume roles as truly independent actors. Typically, block grants or tax expenditures best lend themselves to this purpose. Federal agencies under this scenario would take providers as they find them, with oversight constrained to ex post reviews of funds and performance, most likely delegated to third party institutions, such as state or local auditors or legislative oversight hearings.

These models define theoretical constructs and actual programs and tools will probably constitute a mixture of these types.
Table 3

Different Accountability Models

<table>
<thead>
<tr>
<th>Nature of Federal Role</th>
<th>Federal</th>
<th>Partnership</th>
<th>Third Party</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Goals</strong></td>
<td>Federal prescriptive</td>
<td>Bargained</td>
<td>Third Party</td>
</tr>
<tr>
<td><strong>3rd Party role</strong></td>
<td>Agent</td>
<td>Partner</td>
<td>Independent</td>
</tr>
<tr>
<td><strong>Tool choice</strong></td>
<td>Contract/Regulation</td>
<td>Categorical grant</td>
<td>Block grant</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Tax expenditure</td>
</tr>
<tr>
<td><strong>Provider selection</strong></td>
<td>Competition/Create new</td>
<td>All eligible/Influence focus of All eligible</td>
<td></td>
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<tr>
<td></td>
<td>networks</td>
<td>networks</td>
<td>networks</td>
</tr>
<tr>
<td><strong>Oversight</strong></td>
<td>Ex ante</td>
<td>Ex post w/federal agency reviews Ex post w/delegation to providers</td>
<td></td>
</tr>
</tbody>
</table>
These models might suggest an evaluative framework that could define mismatches between overall federal roles, program goals and the tools and accountability arrangements supporting those arrangements. Thus, for instance, a mismatch could be identified when a federal program with specific and compelling national performance goals uses tools such as tax expenditures and strategies such as ex post oversight more suited for less centralized federal roles.

In addition to the federal role, other variables can systematically affect the performance and accountability challenges faced in third party governance settings. The nature of the tool itself can independently condition subsequent performance in important ways. As discussed above, tools relying on more direct federal administrative reviews and approvals ex ante are likely to enjoy greater leverage over third party behavior than tools relying more on ex post reviews. This is particularly the case for such tools as contracts and discretionary grants that can choose their providers based on some performance related criteria. Tools relying on ex post reviews must usually take providers as they find them and seek to influence behavior through a mix of incentives and sanctions with more uncertain results. As Salamon has observed, tools relying on automatic as opposed to administered processes tend to be more vulnerable to the fiscal windfall and goal diversion problems discussed above. Of course, this dimension is somewhat correlated with the federal role factor discussed just above, since the choice of more direct tools relying on ex ante administration is likely to be most appropriate where the federal role is highly centralized at the outset and program goals are fairly discrete and specific.

The congruence between federal and third party values and interests is another important dimension affecting performance from these third party programs. Kettl posits congruence as the critical variable affecting successful implementation in third party programs. Goal diversion and fiscal windfalls are but two manifestations of this problem and federal agencies often have little leverage in the short term except to tolerate conflict or actually to modify federal goals to become more congruent with third party capacities or interests. Research has identified the importance of this dimension for tool choice and performance. Congruence should not be expected to exist at the outset of the program, for there would be little rationale for a national program if third parties already had the capacity and interest required. Ellmore has suggested that areas with low congruence
should adopt more coercive tools such as mandates since the gap between federal goals and behavior is relatively high. Other research has suggested, however, that coercive tools are perhaps least likely to be adopted when conflicts between values of federal and third parties are highest, since third parties will use their political influence to thwart these approaches. Ironically, as goals and interests converge, coercive tools become more politically feasible as third party providers acquire an interest in collaborating with federal officials to promote common goals and punish deviants. Research has indeed shown that many federal programs over time succeed in bringing about congruence through the gradual internalization of national program norms and values by third parties.

The demand for the aided service by third parties also important implications for performance and accountability. Some federal subsidies are provided for services characterized by high externalities, i.e. where benefits accrue largely to publics outside particular state or local communities. Accordingly, these communities are likely to have little incentive to provide significant investments of their own funds in these areas, thereby limiting the potential for fiscal substitution and windfalls when federal subsidies enter the picture. Conversely, when federal subsidies are provided for services that third parties already have ample incentive to invest in on their own, i.e. services with low externalities where benefits largely accrue to taxpayers within those communities, different consequences can be expected. These types of subsidies are more vulnerable to fiscal substitution, as third parties would be more tempted to replace their own funds with the subsidy. Moreover, it is more difficult to track the specific uses of federal dollars as their relative contribution to total program financing drops, giving rise to fungibility.

The relative weight given to obtaining universal participation is also a factor which can have important consequences for the management of third party programs. As discussed above, tools and programs seeking universal participation generally deprive federal programs of the leverage of selecting third party providers up front and they also tend to be loathe to sanction providers once problems are discovered. Moreover, the participation imperative can limit the use of risk sharing, cost sharing and other managerial provisions designed to foster responsibility within third parties.
Conclusions

Early in this paper, we defined accountability to mean addressing the public's expectations for governmental performance. The foregoing suggests this is not easily done in any setting, but particularly in third party environments. Much remains to be known about how best to promote performance and accountability in these relationships, but we do know that the conditions facilitating accountability for federal goals are often lacking in federal programs. Goals are frequently vague and conflicted, third parties have much to say about what the goals are and how they are applied, agencies have little leverage over selecting or deselecting providers, and oversight is often deliberately constrained. Perhaps part of the problem is a lack of knowledge about how to make these relationships work to promote performance levels most of us expect.

Yet, perhaps a larger part of the accountability dilemma has to do with the traditional definition of accountability discussed at the outset of this paper – preventing the exercise of arbitrary power by leaders. While programs engaging third parties raise public expectations for effective national performance, third parties are valued also for promoting other values including decentralization, diversity, and innovation. And most importantly they respond to a rampant mistrust of government, particularly central government, that has characterized our political culture through its history. Accordingly, while national levels of performance may be compromised or limited, we achieve other important political values in the process.

Those of us in the accountability and research communities need to more explicitly acknowledge the multiple goals served by these arrangements and the multiple principals that are served. While the achievement of national goals is clearly at stake, the pursuit of these goals can at the same time limit the capacity and responsiveness of the system to address other diverse interests and constituencies in the system. In fact, a paradox can occur - while engaging third parties helps decentralize federal programs, it simultaneously limits the responsiveness of third parties to their own constituencies. In effect, a convergence may occur between federal and local interests, but to no one’s satisfaction – federal programs come to be more decentralized but the priorities of
nonfederal agents are themselves "federalized." This centralization of third party priorities occurs across a range of tools – federal grants and mandates have centralizing effects on state and local priorities; tax expenditures have collective and negative consequences for economic efficiency by distorting private economic decisions best left to the market; large contractors become dependent on federal procurement to the point where they lose their competitive edge, which is the source of the efficiency they potentially bring to government.

Ultimately, third party governance reflects the ambivalence most Americans feel toward government. We want effective government services but don't trust traditional bureaucratic and central government to do the job alone. Some would lament the limits placed on federal influence to implement national goals. However, given the very real political, cultural and administrative limits on central power in our system, it is also true that third party roles are often essential to legitimize federal programs in the first place. From a political perspective, the involvement of third parties has probably served to enhance the legitimacy and political acceptability of the growth of the federal role in domestic policy over the past 50 years.

Recognizing the inevitability of third party government for our system, the question becomes not whether to use third parties but how to do so in a way that promotes the high but potentially conflicting expectations held by federal and third party actors for these programs. Much research needs to be done to enable policymakers and administrators to make more informed choices of tools, design options and oversight mechanisms. The stakes are indeed high. Prompted by a healthy suspicion of government and contemporary ambivalence, do third party governance tools at the same time lay the groundwork for even more frustration and disaffection with government by promising more than we can deliver through these mechanisms? And by pursuing both national programs and local control, it would be ironic indeed if we ended up with ineffective national programs and the nationalization of local third parties conscripted or enticed to serve as the new implementers of national policy.
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26. Ingram, “Policy Implementation Through Bargaining”
32. Grant McConnell, *Private Power and American Democracy*
35. U.S. General Accounting Office, *Overseas Private Investment Corporation*
48. Charles O. Jones, Clean Air: The Policy and Politics of Pollution Control (Pittsburgh, Pa.: University of Pittsburgh Press, 1975). Anthony Downs has referred to this process as the issue attention cycle in "Up and Down with Ecology-The Issue Attention Cycle", Public Interest (Summer, 1972)
61 Peter deLeon, “The Missing Link Revisited: contemporary implementation Research”
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98. Salamon, *Beyond Privatization* 46
100. Richard Ellmore, (cite needed)
102. Peterson, Rabe, and Wong *Making Federalism Work*
105. Howard, *The Hidden Welfare State*
106. Donahue, *The Privatization Decision*