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When the Private Sector Competes

Private firms and nonprofit agencies are delivering more and more of the nation's public services, especially in programs designed to help families and children living in poverty. This fundamental shift in the delivery of services for the nation's most vulnerable citizens has raised serious concerns about the conditions under which the private sector carries out important public functions. This paper explores these developments through an examination of the 1996 welfare reform law and the delivery of related services at the local level.

The popular debate over the incursion of the private sector into the public sphere centers mainly on questions of whether the private sector actually provides services more efficiently and less expensively. However, case studies in four jurisdictions–Houston, Milwaukee, New York City, and San Diego County–identified several other questions that are critical to understanding the long-term impact of welfare reform. Will the financial strength of large for-profits crowd out nonprofits, which represent much of the civic infrastructure in low-income communities, leaving welfare recipients vulnerable if market forces later drive these businesses into other arenas? Will local governments' capacity to manage contracts be threatened as private and nonprofit organizations drain their talent pool? Can existing contract designs and resource commitments for oversight ensure accountability for vulnerable clients?

The 1996 Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA), and the Temporary Assistance for Needy Families program (TANF) that it created, gave states the leading role in charting welfare policy. But there were strings attached. The legislation required states to place 25 percent of their welfare recipients in jobs or work-related activities by 1997, and 50 percent by 2002, or risk losing federal welfare funding.

The simultaneous loosening of many federal constraints on welfare-related programs and strengthening of mandates to increase job placement and reduce welfare caseloads prompted states and localities to reorganize their delivery of services to welfare recipients. Many jurisdictions sought to reduce costs and encourage innovation by outsourcing program functions

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Providing Services to the Poor

to for-profit and nonprofit service providers. Public pressure to reduce the size of government and improve its efficiency provided additional incentives for organizing new service delivery systems under private contract, thereby circumventing public employee unions. The Bush administration's proposal to channel more money to religious social service groups could bring additional service delivery agents into this rapidly changing environment.

This issue of Reform Watch presents findings from case studies in New York City, Milwaukee, San Diego County, and Houston, all of which have introduced competition into their restructured welfare service delivery systems (see figure 1). Using semi-structured survey instruments, contractors, subcontractors, public officials, and opinion leaders were interviewed at each site from 2000 to 2001. The case studies provide a lens for observing the continuing challenges that face state and local governments and nonprofit organizations when they compete with for-profit corporations.

Scaling Up, Increasing Capacity

The employment mandates in the 1996 welfare reform law have created extraordinary pressures on the service capacity of existing public agencies to find jobs for large numbers of clients or place them in employment-related activities. Many jurisdictions have had to provide intensive and extensive services for two to three times more clients. Moreover, as the easier-to-place clients have moved off welfare, the challenges of reaching required placement targets for a caseload with multiple barriers to employment become even more significant.

The pressure to quickly engage large numbers of their caseload in work activities, coupled with concerns about public employee unions' willingness to accept new performance incentives, motivated some jurisdictions to contract with large, experienced, well-capitalized organizations. Contracting allows local governments to avoid the continuing costs of new public employees if demand for services declines over time. Contracting also provides an opportunity to harness market forces to provide services in a manner that some public officials believe is cheaper and more efficient.

In three of the four sites visited for this study, contractors had economic incentives to provide required services at lower cost. Thus, they gain if a client is placed sooner, eschewing longer and more expensive services. Agency officials argue that these performance-based contracts create incentives to provide stable, well-paid jobs for clients, since contractors receive increased payments per placement after a client can be certified to have worked for sixty or ninety days. Most public officials interviewed said that

in the Wake of Welfare Reform

Figure 1: Overview of Contract Characteristics by City

City	Placement of TANF	Numbers of Contractors and Sites per Provider	Sector Breakdown By Contract Value	Level of Sub-Contracting	Bidding Process	Services Provided TANF Clients	Contract Structure and Measurement Parameters
Houston	Assigned to 1 of 30 centers by ZIP code	6 with multiple sites	For-Profit: 17% County: 16% Nonprofit: 67%[1]	Relatively little	Request for Proposal	Case management, assessment, employment planning, job readiness, job search	Cost reimbursement
Milwaukee	Assigned to 1 of 6 geographic regions, each with a sole provider	5 total 4 with 1 & 1 with 2	For-Profit 32% Nonprofit 68%[2]	Extensive	Request for Proposal	Eligibility determination and all services through training and placement	Pay for performance
New York	Referred by Human Resource Administration to 1 of 5 contractors[3], then (if needed) to 1 of 12 (ESP) providers	5 for Skills Assessment and Job Placement (SAP) 12 for Employment Services and Job Placement (ESP)	SAP For-Profit: 67%[3]* Nonprofit: 33% ESP For-Profit: 70%** Nonprofit: 30%	Very little for SAP Extensive for ESP	Negotiated Acquisition	Skills Assessment and Job Placement (SAP): Skills assessment, and services through preliminary job placement centers Employment Services and Job Placement (ESP): Intensive employment	Pay for performance
San Diego	Assigned to 1 of 6 geographic regions, each with a sole provider	2 with 1 site 2 with 2 sites (Lockheed Martin IMS and SD County)	For-Profit: 84%[4] Nonprofit 16%***	Very little	Request for Proposal	Case management, appraisal, assessment, job search training. If client does not succeed, referred to separate work placement network	Pay for performance

* The city initially awarded $56.6 million to Maximus for SAP, but has since withdrawn the contract. The amount is still pending.
** The city initally awarded $47.8 million for ESP to MAXIMUS but has since withdrawn the contract. The Amount is still pending.
*** County amount not reflected.

1 Contract information provided by the Houston Department of Human Services, Gulf Coast Workforce Board
2 Contract information received from Wisconsin Department of Workforce Development
3 Contract information received from Office of Contracts, NYC Controllers Office
4 Information provided by the County of San Diego, Contract Operations

the new financial incentives resulted in managerial, technological, and service innovations.

Critics in all sites, however, argue that this need to base service decisions on cost induces fewer and lower quality services and encourages contractors to select easier-to-place clients over those who are more difficult (and more expensive) to serve. Since the bulk of payments accrue at placement, contractors may determine that the economics favor getting clients into any job regardless of their longer-term economic prospects.

Load Shedding and Reducing Administrative Burdens

Welfare reform increased the motivation and opportunity to experiment with different service delivery models, but most jurisdictions have had some history of contracting for employment and training services from nonprofit and private vendors—especially under the Department of Labor's previous programs, which were part of the Job Training Partnership Act (JTPA). Many of these experiences had placed the public agency in the role of contract manager for a multitude of small community-based organizations and sometimes, for-profit providers. Managing these contracts was onerous and considerable evidence suggests that local governments have not always been smart buyers or good contract managers. Desires to reduce administrative burdens associated both with direct service from welfare agencies and contracting to large numbers of small nonprofits have recently led many local jurisdictions to select fewer but larger, well-capitalized contractors—either nonprofit organizations or for-profit corporations. The use of a few large contractors in each site creates a system of managed competition, not unlike that found in the health care sector. Managing a few large contracts, as the prime contractors themselves manage the subcontractors, adapts a growing model used in government contracts for large capital projects. This form of contracting has many virtues, but managing and insuring the performance of large vendors also poses new managerial burdens and challenges.

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New York, for example, has been notoriously poor at monitoring the hundreds of contracts with nonprofits providing employment and training services. The current effort to contract out initial assessment and placement for welfare recipients—and separately, employment training and job placement functions—resulted in a dramatic change in contract management. Instead of managing hundreds of small contracts, only 17 multi-million dollar prime contracts with 13 providers were authorized for the city's new delivery system under TANF.

Many of the new providers will depend on dozens of subcontractors to meet the demands of their service commitments, but now it will be their role to negotiate the terms of these contracts, and monitor and ensure reporting compliance from their subcontractors. The result, from the city's point of view, is a vast "load shedding"—a shifting of reporting and monitoring functions to their contractors. This, New York City officials argue, will result in significant cost savings and shifts in the roles and responsibilities of scores of city employees.

The risks for accountability loom large, however. New York, in effect, relinquished much of its authority and responsibility for oversight to third parties when it selected contractors whose role now included insuring the performance of their subcontractors. There is little evidence that public officials in New York and elsewhere have improved their oversight or increased their personnel commitments to ensure that prime contractors perform these functions well. Further, the design of performance-based contracts does not specify the dimensions of quality necessary to ensure the long-term well-being of clients. Recent legislative audits in Milwaukee have revealed misuse of public funds by private contractors not previously exposed by existing systems of oversight. They also revealed a failure by contractors to inform clients about entitlements and supportive services for which they were eligible. In response the state has awarded a $5 million contract to Milwaukee county workers to take over the initial needs assessments and referrals of clients seeking assistance to ensure that those clients are not denied available or needed services.

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Playing the Game, Maintaining the Mission

Interviews with nonprofit executives, public officials, and opinion leaders in the four sites have painted a decidedly mixed picture about the virtues of the market-driven arrangements to place welfare recipients in jobs. All of these organizational changes are recent, so there is insufficient evidence to judge the relative effectiveness and efficiency gains associated with a more competitive environment and with the increasing use of performance-based contracts. Other important impacts are emerging, however.

Many organizations that succeeded in the various bidding processes in the four cities visited were experienced service providers with a history of contracting with government and with missions focused on disadvantaged populations. Many, but not all, had provided case management, employability assessment, job placement, and/or training services under a wide range of government funding streams and/or private philanthropic resources. Many had some degree of skepticism about the future under a competitive contract process with for-profit organizations. But most were motivated to participate by a commitment to serve low-income populations consistent with their missions.

The nonprofit response to the changing environment is clearly a marriage of pragmatism and social mission. There is recognition that the welfare reform law is the only game in town—a game where the players are eligible for far more resources than most have ever had in a single contract. But most of those interviewed also affirmed that this is the business they are in, and held a mission-driven belief that they can do it better than for-profit companies. Many even claimed to welcome the competition from the private sector because the competitive pressures make them function better managerially, while the financial structure of their operations and their long experience in the community in dealing with disadvantaged clients and employers gives them a comparative advantage.

Most of the nonprofits interviewed were relatively well capitalized and have been in the business for a long time. Still, asset levels, even for large nonprofits, are often low compared to the size of contracts they are taking on. For example, United Migrant Opportunity Services (UMOS), of Milwaukee, won a $37 million contract for 2000-2002 with only $20.3 million in assets.

A major dilemma for the large, stable nonprofits is whether they will compromise their missions of putting the client first and meeting individuals' needs. Performance-based contracts and current payment levels favor rapid placement of clients and few specialized services. The diversified funding streams that characterize many of these larger nonprofits (like foundation and private fundraising sources) can allow for cross-subsidy and cost-sharing among different programs, enabling them to pay for services clients may need but for which current contract amounts do not provide. The economic incentives go in the opposite direction, however.

The Struggle to Stay Solvent

Many nonprofits in the employment and training business are facing an insecure future in this changing environment. Large, stable nonprofits with strong and diversified funding streams appear relatively secure and in many ways resemble their for-profit competitors more than they do leaner, less business-oriented, small nonprofit providers. Many of the latter are struggling with thin budgets and small cash reserves to sustain themselves in a performance-based environment. They have been forced to adapt to new ways of doing business. Some of the medium-sized and smaller organizations are regrouping. These efforts to survive combine a search for new sources of both government and private funding, development of new areas of program growth, and investments in improved management to achieve cost savings. Some are embracing private market techniques through for-profit subsidiaries. Catholic Charities in San Diego, for example, underwent significant management reorganization and recruitment of more professional management personnel and systems. An ability to compete and manage their new county contracts required the introduction of a new generation of technology, human resource, and information systems.

Innovative collaborations have allowed some community-based organizations (CBOs) and small nonprofits that had been successful providers under previous contractual arrangements with state and local governments to survive even though they lack the size, capital, and management capacity to compete individually under the new arrangements. SEEDCO, a medium-sized intermediary in New York, has built a collaborative with nine community-based organizations. SEEDCO gives the organizations technical assistance while helping them to provide employment training and job placement to TANF recipients under a $7.4 million city contract structured as a limited liability corporation (LLC) called EarnFair. As an LLC, EarnFair can operate as a temporary employment agency and syndicate and sell tax credits to subsidize increased and more intensive services to the clients they serve. Their ability to provide these services depends on additional funding from a diverse set of resources, including philanthropic and other public funds.

SEEDCO is a management service entity, with the key service provision provided through CBOs. EarnFair provides information systems, capacity, financial assistance, and technical programmatic supports. SEEDCO views the CBOs as partners rather than subcontractors, but even these competent CBOs would most likely have been closed out of these contracts had they not been able to come under the umbrella of a well-managed, fiscally sound prime contractor.

The need to increase staff quickly to meet the expected client referrals has created a strain for nonprofits and for-profits that have survived the current challenges of competition. In many markets, both private and nonprofit firms are competing for the same managers and job developers.

Many other traditional employment and training contractors are scrambling to stay in business, however, and view the payment levels and schedules as unrealistically low under these contracts. Rachel Miller, an executive at the Women's Housing and Economic Development Corporation, said "Our reimbursement as a sub[contractor] won't cover our costs. We'll have to fundraise to cover costs. But our key advantage is our diversified funding. We see government contracts as defraying costs, not covering [all of] them."

Nancy Liu, executive director of the Chinese Community Center in Houston, agreed, saying that "if you (as a local CBO) rely totally on government money, it is almost impossible for you to survive."

The contracts provide no incentive for long-term investment, and for the subcontractors who must relinquish overhead to the prime contractors, current payment schedules may pay only a fraction of the true costs of serving a disadvantaged client. But accepting these subcontracts allows for financial piggybacking and economies of scale for multiple program cost-sharing. For small nonprofits, whose financial solvency depends upon their performance, reasonable numbers, quality referrals, and timely payment for performance—the last of which depends upon the administrative performance of both the county or city and the prime contractor—the financial risks are clearly high.

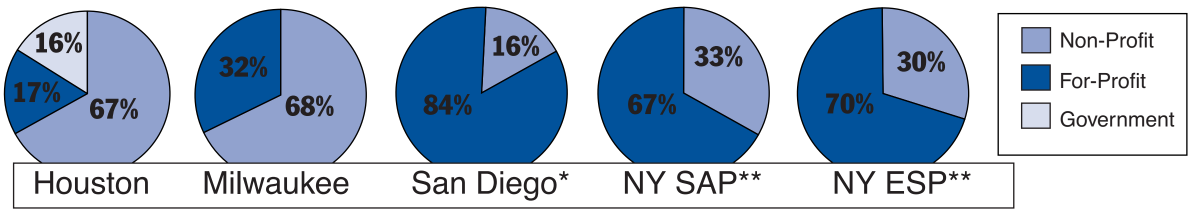
The current strategy of the four municipalities studied has been to find a few experienced contractors with good track records and sufficient technological and managerial expertise to provide the services and information systems necessary to ensure full participation and job placement of all eligible clients. Federal mandates and the terms of performance-based contracts require information systems to track and verify the progress of all clients in the system, and these demands often require sophisticated technology and management systems.

For-profit providers have considerable advantages in providing these systems. In New York and Milwaukee, many nonprofit providers have had a long history and good record of providing employment and training services, yet lack the necessary technological and managerial systems to oversee performance-based contracts. Further, because the timing of payments depends on performance in Milwaukee, New York, and San Diego, which in turn requires systems to verify placements, considerable initial capital is necessary to undertake these contracts. The for-profits can sustain operations in anticipation of future payment streams, since they have access to investment capital. Only a fraction of the nonprofits historically operating in the employment and training business have the working capital to stay the course while they wait for payment.

Living on the Brink

Smaller, more community-based nonprofits that have historically provided employment and training services to low-income populations represent a large and diverse group nationwide. Prior to the 1998 Department of Labor legislation under the Workforce Investment Act (WIA, Public Law 105-220), there were 163 federal programs that funded employment and training. Thousands of nonprofit and for-profit organizations have received contracts and grants under these titles. In New York City alone, more than 115 individual providers had one or more employment and training contracts under federal titles prior to the newly awarded TANF contracts and the commencement of the WIA programs. Their capacity and ability to succeed in a more competitive and performance-based environment varies enormously. Most of the organizations interviewed believed they would survive in the short run. Few small organizations had the

Figure 2: Dividing up Total Contract Dollars in Four Cities:
Contracts by Contractor type



Sources: Contract Information provided by the Houston Department of Human Services, Gulf Coast Workforce Board, Wisconsin Department of Workforce Development, Office of Contracts, NYC Controllers Office, and by the County of San Diego, Contract Operations

* Government amount not reflected

** $56.6 million of for-profit is MAXIMUS contract still pending.

*** $47.8 million of for-profit is MAXIMUS contract still pending.

ability to bid on TANF contracts, given the scale and organizational capacity requirements. In New York, where the bidding process was known as negotiated acquisition, organizations were invited to bid, and many small, historic nonprofit contractors were closed out.

Because of the scale of these efforts, however, most of the prime contractors in Milwaukee and New York by necessity have solicited or responded to CBOs' requests to act as subcontractors or link with these organizations to provide training and social service support for clients with special needs. In this process, many historic providers will continue to serve portions of the caseload, albeit in limited roles. In the short run, many of the national for-profit providers (and large local nonprofits), like Lockheed Martin IMS[1] and MAXIMUS, have selected community-based organizations as subcontractors. Contracting with CBOs has a number of valuable practical and political payoffs as for-profits and nonprofits enter new markets. CBOs may have a better understanding of particular client needs and connections to the resources in the community that can provide prime contractors with needed local expertise as well as protection against political backlash in the communities where they have won contracts.

William Grinker, a former New York City welfare commissioner and SEEDCO's president, believes that many CBOs will survive as subcontractors in the near term but will disappear over the long run, as the for-profits develop capacity in the community and have financial incentives to save the overhead devoted to managing them. Moreover, the for-profits may ultimately need less of the political protection they now enjoy through their connection with popular CBOs serving as their subcontractors.

[1] Lockheed Martin recently completed the sale of its IMS unit to Affiliated Computer Services, a Dallas-based outsourcing company.

This winnowing out will have a mixed impact on the quality and range of available services. Many small providers serve special populations with particular needs. Whether current contracting and referral arrangements can preserve the services that may be critical to special needs populations, like ex-offenders, immigrants, and drug-addicted clients, is questionable. There is concern that these special-needs groups will fall through the cracks of the system. Some observers also fear the civic and economic consequences of the loss of critical social capital in low-income communities when CBOs are forced to close their doors. Others view the possible thinning of the provider ranks as healthy because it eliminates weaker and less able providers.

The Increasing Dominance of National Firms

While many nonprofits, especially community-based providers, face serious threats to their missions, the large for-profits are thriving (see figure 2). The current welfare-to-work contracts have been an increasing profit center to large corporate entities with a foothold in serving state and local governments in technology-related human service areas. Using large contracts, such as the management of child support enforcement systems, as an opening to branch out to other areas, companies such as Lockheed Martin IMS and MAXIMUS have been increasing the size and numbers of their contracts with state and local governments. Their strategies have been to concentrate on large welfare reform markets in jurisdictions with large caseloads.

The increasing dominance of the for-profits in this business signals potential problems, however. Dramatic declines in welfare caseloads in recent years leave them little growth potential in these markets. Indeed, for-profit corporations gain their comparative advantage from achieving economies of scale and standardization of the product they deliver across markets. With smaller caseloads and an increasing preponderance of the harder and more expensive clients to place, large, private companies may simply leave the market, moving to areas where their virtues earn larger profits. A swift exit of these providers would wreak havoc on many local systems. If the public agencies have been drained of expertise and institutional memory, and the bulk of smaller nonprofits have been weakened or refocused on other service areas, remaining providers may not have the financial or organizational capacity to fill the gap.

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A focus on the bottom line may induce the firms that remain to shortchange clients with multiple needs, since eschewing special services avoids higher cost investments associated with providing them. While the incentives for these decisions may be inherent to the current performance-based contracts, their consequences may not be immediately obvious. Many critics fear serious and long-term repercussions for vulnerable clients whose multiple barriers to employment may require deeper and longer-term investments. Public organizations responsible for monitoring are often ill equipped or underinvested in the means or measurement capacity to uncover lapses in quality. Nonprofits are also potentially at risk of capitulating to the financial incentives to sacrifice quality for financial gain, but they generally place a high value on their social mission.

"Brain Drain" and Public Capacity

The need to increase staff quickly to meet the expected client referrals has created a strain for nonprofits and for-profits that have survived the current challenges of competition. Attracting and motivating key executive and managerial personnel has been difficult. In many markets, both private and nonprofit firms are competing for the same managers and job developers. In some jurisdictions, including San Diego and Houston, nonprofits and for-profits are hiring county workers.

Many of the for-profits interviewed believe they offer public service-oriented managers greater autonomy than the public sector and therefore, attract former government employees as well as newly minted public policy graduates. Some of the smaller nonprofits, especially those who did not use monetary incentives to attract talent, felt their values, missions, and the quality of their operations gave them a comparative advantage in hiring over private sector organizations. Thus, both types of private contractors are draining talent from the public sector. This "brain drain" may weaken the capacity of government to be smart buyers and sophisticated contract managers, or reduce their ability to reclaim many of these functions, should contracting arrangements prove unsatisfactory.

Conclusion

The dramatic changes taking place in the systems that deliver employment and training services to welfare recipients—especially the entrance of the for-profit sector into policy arenas that have historically been dominated by the public and nonprofit sectors—pose both risks and rewards. There are several conclusions that we can draw.

First, market incentives generated by the increasing popularity of performance-based contracts are inducing innovation and desirable management changes in many nonprofit providers. But they are also producing distortions of contractual intent by motivating both nonprofit and private contractors to make service delivery choices that may compromise the well-being of clients in order to minimize costs. Minimizing cost may inadvertently be threatening service quality and ultimately, client outcomes.

Second, the future of mission-driven nonprofits is uncertain and worrisome. While systems of managed competition with the private sector are clearly improving the manage-

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ment, capacity, and performance of many fiscally sound nonprofits, many others are in danger of losing their distinctive public service missions. Still others living on the brink are in danger of extinction.

Third, market forces alone are likely to drive the large national for-profits to arenas where their comparative advantages make them dominant. When caseloads decline and easier-to-place clients are scarce, they are likely to move on to other human service areas where they can increase their market share, economies, and profits. The reduced capacity of public agencies and the declining participation of CBOs pose threats to a healthy service sector and to meeting the needs of a diverse client base.

Finally, the competition for talent in stronger nonprofits and private organizations gearing up for large new contracts threatens to leave government organizations bereft of talent. Increasingly, institutional memory and capacity for resuming service functions are declining. Should the availability of competent and high performing contractors decline, or shift to alternative service areas, this "brain drain" threatens the public ability to provide quality services to vulnerable clients.

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