

Privatization and the Reagan Administration: Ideology and Application

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Ronald Reagan arrived at the White House in 1981 armed with a quixotic strategy for reducing the size and scope of the federal government and for closing the budget deficit. The President's strategy required a massive reduction in taxes and, simultaneously, even greater reductions in expenditures. But by 1984, President Reagan had failed to translate his commitment to minimalist government into reality.¹ Although President Reagan sought and achieved large tax reductions in 1981, his budget proposals, due to sustained real growth in defense expenditures, actually increased gross federal spending.

The Reagan Administration's initial approach failed, in part, because it ignored the strength of coalitions of beneficiaries, service providers, activists, and members of Congress, all of whom had definite interests in the preservation and expansion of particular programs.² Members of the Reagan Administration erroneously had assumed that an arithmetical imperative would constrain federal expenditures once the President was successful in choking off the revenue sources that finance federal programs.³ Despite the failure of its earlier efforts, the Administration did not give up its hope of somehow reducing the size and the scope of the federal sector. In

1. During President Reagan's first term, federal spending consumed an average of 23.4% of the gross national product (GNP), a proportion significantly greater than the 19% figure the Administration thought it could achieve when it first took office. Executive Office of the President, Office of Management and Budget [hereinafter collectively OMB], Historical Tables Budget of the United States Government, Fiscal Year 1987, Table 1.2(2) (1986). In setting the 19% target, the Administration assumed that it could roll back domestic spending to 1970 levels. D. Stockman, *The Triumph of Politics* 148 (1986). The President's plan to eliminate the deficit fared no better than his plan to curb spending. In 1980, the federal deficit was \$74 billion, but by 1984, the deficit had more than doubled to \$185 billion. OMB, Historical Tables, *supra*, at Table 1.1(2).

2. Privatization theorists, such as Stuart Butler, have criticized the President's "supply side view of the budget process." As noted by Butler, the flaw in Reagan's first term approach was that it "ignore[d] the demand side of the political equation. It overlook[ed] the subtle process by which government programs grow and the fact that they are sustained by powerful coalitions." S. Butler, *Privatizing Federal Spending: A Strategy to Eliminate the Budget Deficit* 9 (1985).

3. See D. Stockman, *supra* note 1, at 147.

President Reagan's second term,⁴ the Administration embraced "privatization" as a new, supplementary⁵ strategy for minimalist government and deficit reduction.

"Privatization" defies easy definition; advocates do not agree on a single definition, nor do they agree on the practical limitations of privatization as a policy.⁶ However, privatization advocates share a common assumption, whether grounded in ideology or in economics, that the public sector is too large and that it engages in activities more properly or more efficiently performed by the private sector. This belief is echoed in the Administration's own definition of privatization. It defines privatization as:

a strategy to shift the production of goods and services from the Government to the private sector in order to reduce Government expenditures and to take advantage of the efficiencies that normally result when services are provided through the competitive marketplace.⁷

From this simple definition, it would appear that privatization avoids the political hazards of expenditure reductions. The ostensible goal of privatization is not necessarily to deny consumers the

4. The Reagan Administration proposed a number of specific privatization measures during its first term. Those measures included: the Justice Department's proposal to privatize the federal prison system, the Department of Interior's efforts to sell federal lands, and the Department of Housing and Urban Development's housing voucher plan. The Reagan Administration, however, first articulated "privatization" as a general, unified strategy for reducing the size and scope of the federal government in its fiscal year (FY) 1987 budget proposal. OMB, Budget of the United States Government, Fiscal Year 1987 M-6-9 (Budget Message of the President).

A variety of privatization initiatives have been featured prominently in the Administration's last two budget proposals. The Administration's FY 1987 and FY 1988 privatization proposals included: (1) the sale of certain tangible federal assets, including Conrail, Amtrak, two Naval Petroleum Reserve oil fields, five Power Marketing Administrations, and "excess" real property, not yet identified, valued at \$800 million; and (2) the sale of a number of federal loan portfolios, including phase-out of the Rural Electrification Administrations. OMB, Budget of the United States Government, Fiscal Year 1988 2-45-51 [hereinafter OMB, 1988 Budget]; OMB, Budget of the United States Government, Fiscal Year 1987, *supra*. Thus far, the Administration has sold certain government loans, but its most publicized sale has been the sale of Conrail. See generally Selby, "Inside the Conrail Deal," Institutional Investor, Apr. 1987, at 95.

5. "Privatization is a natural counterpart to other administration initiatives—such as federalism, deregulation, and an improved tax system—that seek to return the Federal government to its proper role." OMB, 1988 Budget, *supra* note 4, at 2-44.

6. For an analysis of the different theoretical perspectives on privatization, see *supra* Starr, The Meaning of Privatization 6 Yale L. & Pol'y Rev. 6 (1988).

For arguments advocating privatization in the United States, see E. Savas, Privatizing the Public Sector: How to Shrink the Government (1982); S. Butler, *supra* note 2; Hanke, The Theory of Privatization, in The Privatization Option, A Strategy to Shrink the Size of Government 1 (S. Butler ed. 1985).

For a look at the meaning of privatization in an international context, see "Privatization, Everybody's Doing It, Differently," The Economist, Dec. 21, 1985, at 69.

7. OMB, 1988 Budget, *supra* note 4, at Supp. 2-38.

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goods and services produced currently by government, but to find private, more efficient ways to supply the same goods and services. Despite this benign definition, privatization in practice does not always replace Government provision with private provision. Some privatization measures do result in the withdrawal of the good or service from certain constituencies, and hence confront the same political resistance as expenditure reductions. Whether privatization measures simply replace one method of delivering goods and services with a more cost-effective alternative or lead to reallocation or withdrawal of those goods and services altogether depends on the type of inefficiency the particular proposal is designed to correct.

This Current Topic examines two of the Administration's privatization proposals, programs that were designed to correct different types of inefficiency. Increased contracting-out of commercial activities attempts to correct inefficiencies in production; the privatization of federal credit programs attempts to correct perceived inefficiencies in supply. The objective of this Current Topic is to examine these two proposals on their own terms, that is, to examine whether implementation of these programs can lead to more efficient production or more efficient supply, and to demonstrate the difficulties inherent in both strategies. Contracting-out, for example, may result in increased efficiency as the Administration claims; however, there are a number of institutional barriers that make these gains short-lived, if indeed they materialize at all. The Administration's proposals to privatize federal credit programs, however, are more problematic. They cannot be justified plausibly on grounds of increased efficiency; rather they can be justified only as an ideological choice as to who receives credit.

I. Two Types of Inefficiency

The Administration's privatization proposals target two types of inefficiency: inefficiency in production and inefficiency in supply. Inefficiency in production relates to the process of producing goods and services. The assertion is that a given supply of inputs, capital, and labor will produce more output when the inputs are privately owned than when government purchases the inputs, through ownership of capital assets or employment of workers. In other words, private, competitive production is more cost-efficient than government production. The Administration's proposal to increase con-

tracting-out of commercial activities emphasizes cost-efficient production.

The general phenomenon of contracting-out is a strategy of partial privatization.⁸ It accepts the premise that government is an appropriate purchaser of a particular good or service, and that government financing or provision is proper; contracting-out only addresses the issue of whether government is a proper *producer* of the good or service. Moving production from one government agency to another, or leaving production with the original agency, does nothing to change the character or scope of the federal sector. At most, it may reduce the cost of government production. Reducing the cost of government, even if not the scope of goods produced by the government, is one goal of privatization, of course; complete privatization, however, allows the private sector not only to produce certain goods and services, but also to decide whether to produce those goods and services at all.

The second type of inefficiency relates not to the process of production but to the process of deciding how much and what to produce. The assertion here is that governmental institutions will produce a sub-optimal amount of goods and services because these institutions have a bias toward oversupply. In other words, there is an inefficient bias toward too much government whether government plays the role of producer or simply finances the private production of goods and services. The Administration's proposals for privatizing federal credit programs seek to correct such perceived inefficiencies in supply by abdicating the decision to supply credit to the private sector. The following two sections examine how the contracting-out policies of this Administration and its federal credit reform policies attempt to correct these two types of inefficiency, and the shortcomings of these approaches.

II. *Contracting-Out*

A major thrust of the Administration's privatization strategy is the aggressive implementation of the Commercial Activities Program, a

8. *But cf.* Sundquist, *Privatization: No Panacea for What Ails Government*, in *Public-Private Partnership: New Opportunities for Meeting Social Needs* 303, 307 (H. Brooks, L. Liebman, & C. Schelling eds. 1984) (contracting-out is the truest form of privatization because "[t]he responsibility is not shifted, only the actual performance of the work"). *See also* Kolderie, *The Two Different Concepts of Privatization*, 46 *Pub. Admin. Rev.* 285 (1986) (government performs two distinct functions: (1) policy decisions to provide a service by purchasing it and (2) actual production of the good or service by government employees).

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program established by OMB Circular A-76 (A-76) for contracting-out commercial activities to the private sector. The A-76 program accounts for only a portion of all government contracts; it is emphasized here because the A-76 program, unlike other types of government contracting programs, has a built-in mechanism for measuring the relative productive efficiencies of the private sector vis-à-vis the public sector.

A-76 sets forth the government's policy of relying, where possible, on the private sector to produce those goods and services needed by the federal government. It states:

In the process of governing, the Government should not compete with its citizens. The competitive enterprise system, characterized by individual freedom and initiative, is the primary source of national economic strength. In recognition of this principle, it has been and continues to be the general policy of the Government to rely on commercial sources to supply the products and services the Government needs.⁹

The A-76 policy predates President Reagan's adoption of privatization by over 30 years.¹⁰ However, the Reagan Administration is the first to seek vigorous implementation of A-76, a policy previous administrations have virtually ignored.¹¹ Moreover, the policy expressed by Circular A-76 is identical to the principles underlying the Administration's privatization strategy. The Administration uses language almost identical to that quoted above in a recent Office of Management and Budget analysis to describe the principle underlying its privatization strategy:

[G]overnment should not compete with the private sector in supplying ordinary goods and services. . . . Candidates for privatization should include any Government operation that sells goods or services in com-

9. OMB Circular No. A-76 (rev.), 48 Fed.Reg. 37,110, 37,114 ¶ 4a (Aug. 16, 1983).

10. The policy of contracting-out commercial activities was announced in the Bureau of the Budget Bulletins in 1955, 1957, and 1960. The Office of Management and Budget (Bureau of the Budget's successor) reissued the policy as OMB Circular No. A-76 in 1966. It was revised in 1967, 1979, and 1983. *Id.* at ¶ 4b. In 1981, the program's name was changed from the Commercial/Industrial Type Activities Program ("CITA") to avoid confusion with the Comprehensive Employment Training Act ("CETA"). Dempsey, Contracting Out Under OMB Circular No. A-76 in the Department of Defense, 16 Nat'l Contract Mgmt. J. 41 (1982), *reprinted in* 19 Y.B. of Procurement Articles 1009, 1011 (1982).

11. For a discussion of the history of Circular A-76, see Implementation of Circular A-76: Hearings Before the Subcomm. on Human Resources of the House Comm. on Post Office and Civil Service, 98th Cong., 2nd Sess. 2-11 (1984) (testimony of William Russell, Chairman, Business Alliance on Government Competition). Between 1983-85, the number of contracts awarded under the A-76 program increased by 10%. CBO, Contracting Out: Potential for Reducing Federal Costs vii (June 1987) [hereinafter CBO, Contracting Out].

petition with the private sector or that provides goods or services that could be offered by the private sector.¹²

The A-76 program attempts to correct inefficiencies in production by introducing the competitive discipline of the private market into government bureaucracies. The process by which competition is introduced, however, encounters serious obstacles that are inherent in bureaucratic institutions. The Reagan Administration claims to have already realized substantial savings from its emphasis on the A-76 program. To evaluate whether the Reagan Administration's use of the A-76 procedure has yielded and can yield the savings claimed for it, it is necessary briefly to consider how the A-76 program actually works.

*A. The A-76 Procedure*¹³

The A-76 process begins with a review of all operations within each federal agency to determine which activities are commercial in nature and which are inherently governmental.¹⁴ Under A-76, only activities classified as commercial in nature may be contracted-out. A-76 defines a commercial good or service by two standards: (1) there must be a commercial source capable of providing a good or service comparable to the good or service produced by the government; (2) no activity, regardless of the availability of commercial alternatives, can be contracted-out if it is an inherently governmental function.¹⁵ A-76 goes on to define a governmental function as one that "require[s] either the exercise of discretion in applying

12. OMB, 1988 Budget, Special Analyses 2-38 (1987) (emphasis in original) [hereinafter OMB, Special Analyses].

13. For other summaries of the A-76 review procedure, see generally, CBO, Contracting Out, *supra* note 11, at 1-6; OMB Circular A-76: Hearings Before the Subcomm. on Human Resources of the House Comm. on Post Office and Civil Service, 99th Cong., 1st Sess. 4-12 (1985) (statement of Col. James M. Schroeder, Director, Department of the Army, Commercial Activities Division) [hereinafter Hearings Before Human Resources Subcomm.].

14. Certain federal activities are exempt from A-76 review by statute and/or by specific provisions in A-76 itself. See, e.g., 38 U.S.C.A. § 5010(c)(1)(A) (West Supp. 1987) (prohibiting Veteran's Administration health care facilities from contracting-out direct patient care or activities incident to direct patient care); Volunteers in the Parks Act of 1969, Amendment, Pub. L. No. 98-540, 1984 U.S. Code Cong. & Admin. News (98 Stat.) 2718 (defining "management and regulation of natural resources on Federal lands" as an inherently governmental function, thereby exempting them from A-76 review); 10 U.S.C. § 2304 (1987) (note exempting core logistic functions of Army, Air Force, Navy, Marines, Defense Logistic Agency, and Defense Mapping Agency from contracting-out); OMB Circular No. A-76 (rev.), *supra* note 9, at ¶¶ 8b, 8c (authorizing the Secretary of Defense to exempt commercial activities for national security reasons and authorizing retention of in-house performance of commercial activities in hospitals operated by the government if in the best interests of direct patient care).

15. OMB Circular No. A-76 (rev.), *supra* note 9, at ¶ 5c.

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Government authority or the use of value judgments in making decisions for the Government.”¹⁶ Of course, all A-76 contracts are limited to goods and services in support of governmental functions.¹⁷ The purpose of the second A-76 standard is to distinguish between goods and services that are inherently “governmental” and those that may properly be considered wholly “commercial” (private) even when used as an input of government or when financed by government.¹⁸

If a good or service is defined as inherently governmental, then it must be produced by the government. On the other hand, once an agency determines that a good or service is commercial, the agency cannot begin or continue production of the good or service unless it determines that a private firm cannot produce the same good or service at lower cost to the government. To determine whether a good or service can be supplied to the government more efficiently by the private sector, A-76 requires agencies to estimate the cost of producing the good or service in-house (i.e., using federal employees and government facilities) and compare the in-house estimate against bids submitted by private-sector contractors.

An in-house estimate is developed in several stages, two of which are particularly significant. In the first, the agency develops a complete description of the good or service under consideration, known as a Performance Work Statement (PWS), which a team comprised of government management analysts reviews to identify opportunities for increased efficiency in government production.¹⁹ The review team also describes the Most Efficient Organization (MEO) for providing or performing a certain service. The MEO describes a streamlined government operation, incorporating management im-

16. *Id.* at ¶ 6c.

17. Circular A-76 provides for procurement of commercial services that the government will use for itself, as opposed to services or goods that the government may purchase for someone else. OMB Circular A-76 (rev.), *supra* note 9, at ¶ 4a.

18. For example, the provision of Armed Services for the national defense is an inherently governmental function that may be supported by a myriad of commercial activities such as the laundering of uniforms. Under A-76, the government may not contract out the provision of service personnel, but it may contract for certain support services, such as laundry. *See id.* at ¶ 6e.

19. The Department of Defense initially used private sector consultants to evaluate activities under the A-76 review procedure. Now that the A-76 process is firmly underway in that department, in-house personnel conduct nearly all A-76 reviews. Civilian agencies, on the other hand, have only begun to implement the A-76 program, and thus they rely on private consulting contractors to conduct A-76 reviews. Civilian agencies may be expected to depend on in-house personnel as the A-76 program becomes more familiar and entrenched. Hearings Before Human Resources Subcomm., *supra* note 13, at 254-55 (statement of David L. Muzio, Deputy Associate Director, Office of Federal Procurement Policy).

provement techniques and possibly proposing reductions in the government work force. It is this MEO report, not the report describing actual agency production methods and costs, that is used to estimate the cost of government production.²⁰ In the second stage, the agency solicits bids from the private sector. If a private contractor can underbid the agency's MEO-based price estimate by 10%, the commercial activity must be contracted-out.²¹

B. The Potential for Expenditure Reductions

The Reagan Administration claims that substantial savings have been realized by the A-76 program to date, and predicts that even greater savings will result from increased implementation. According to a 1981 Administration estimate, the federal government performs commercial activities valued at approximately \$20 billion each year.²² Of that \$20 billion, the Administration estimated that approximately \$6 billion worth of activities could be performed by the private sector without interfering with government programs or implicating national security.²³ The Administration predicted that by subjecting eligible commercial activities to A-76 review, it could save \$1 billion by FY 1988.²⁴ This estimate includes savings that would inure as a result of the review process itself, even if some activities subjected to review are not, as a result, contracted-out. The mere promise of A-76 review is claimed to encourage greater efficiency in government. The threat that contracting-out poses to federal employees is considered an inducement for them to streamline their operations in preparing the MEO. If federal employees "win" the bid, and the activity is not converted to contract, "agencies are expected to make improvements identified in management

20. CBO, *Contracting Out*, *supra* note 11, at 4.

21. *Id.* The 10% margin is a "conversion differential" designed to take account of costs and disruptions that occur when a government function is contracted-out to the private sector. *Id.* The contractor's bid is also adjusted to reflect the costs of administering the contract. And the agency must adjust the contractor's bid to reflect the income tax advantage that accrues to the federal government when work is contracted out. *Id.* at 4-5.

22. OMB/OFPP, *Enhancing Governmental Productivity Through Competition: Targeting for Annual Savings of One Billion Dollars By 1988 I* (1984) [hereinafter *Enhancing Governmental Productivity*].

23. *Id.* The federal government enters into \$43 billion worth of contracts with the private sector each year. Contracts issued pursuant to A-76 comprise part of that figure; however, OMB does not know the exact value of A-76 contracts. Hearings Before Human Resources Subcomm., *supra* note 13, at 1 (statement of Rep. Gary L. Ackerman).

24. *Enhancing Governmental Productivity*, *supra* note 22, at 3. This estimate is based on calculations performed by the OMB and the OFPP between 1979 and early 1984. *Id.* at 2.

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reviews.”²⁵ The Administration estimates that programs reviewed under the A-76 procedure that remain in-house achieve savings on the average of 20% after adopting methods for improving efficiency identified in the MEO.²⁶

Not only has the Reagan Administration heralded A-76 as an effective tool for cutting government expenditures, the Congressional Budget Office (CBO) also has forecast substantial savings from the A-76 program over both the short-run²⁷ and the long-run. There are a number of reasons, however, to believe that the estimates of the Administration and the CBO are inflated. Specifically, the Administration has done a poor job of documenting actual savings or losses from the program, in part due to agency intransigence and in part because of the difficulties of calculating actual savings due to the structure of the A-76 program. Because CBO must rely on the Administration's savings estimates, its own calculations are likely to be inflated as well.

CBO calculated its estimate of potential long-term savings from the A-76 program on an accrual basis, the accounting method used in generating cost comparison information under A-76.²⁸ It estimated that the A-76 program would result in \$325 million worth of cost reductions between 1988-92 if the current level of A-76 review remains constant over that period.²⁹ CBO estimates savings of \$650 million if A-76 reviews increase by 100% over the next five years.³⁰ CBO's savings estimates reflect cost reductions in two areas: reductions due to the relative efficiency of contractor performance versus government performance, and reductions due to management improvements in government activities that, although reviewed, were not contracted-out.³¹

25. CBO, *Contracting Out*, *supra* note 11, at viii.

26. *Id.*

27. CBO estimated that at the current level of implementation, the federal government could save \$70 million in a single year. This near-term cash savings potential represents only about half the estimated savings (\$130 million) when measured on an accrual basis. *Id.* at 19.

28. *Id.* at 17. The accrual method accounts for costs in the period in which they are incurred without regard for when payment on the contract is actually made. Thus, estimates of savings generated by A-76 using accrual accounting reflect, for example, savings in pension costs that result from federal employees who are laid off because their jobs have been contracted-out. *Id.*

29. *Id.* at 23, Table 5.

30. *Id.* at 22-24.

31. *Id.* at vii-ix. See also *Enhancing Governmental Productivity supra* note 22, at 5 (“Agencies must perform an internal management review of the in-house organization to determine the most efficient and effective operation. . . . The knowledge that the resulting plan will form the basis for cost comparison with commercial firms provides a

Unfortunately, CBO data and calculations may be overly optimistic. The savings data for activities converted to contract are themselves based on an estimate of past savings that have never been verified and may never have materialized.³² A-76 does not require agencies to provide post-contract audits to determine whether expected savings were actually realized after an activity was contracted-out. Furthermore, the savings estimate for activities remaining in-house is based on estimates contained in the MEO's—not the agency's actual performance after an A-76 review. This in-house data is as unreliable an indication of actual savings as are the estimated savings due to conversion to contract. The data that CBO used to estimate the cost-reduction potential of the A-76 program are themselves merely estimates of potential savings.³³ So long as post-audit information is sparse or unavailable, it is impossible to know whether government agencies or private contractors are the more efficient providers.

The baseline savings estimates yielded by the initial review cost comparisons probably overestimate agency costs and underestimate the cost of contracting-out for at least two reasons. First, the government may underestimate the amount of work federal employees perform in providing a good or service.³⁴ Consequently, the agency

powerful incentive to develop innovative and less costly ways of meeting performance standards").

32. CBO mainly relied on the Department of Defense's (DoD's) experience with the A-76 program because civilian agencies have had little experience with the program to date. CBO, *Contracting Out*, *supra* note 11, at 16. Based on DoD's experience, CBO assumed that 65% of activities reviewed will be converted to contract and that those remaining in-house could be expected to realize savings on the average of 20%. *Id.* at 28. Until 1986, however, DoD reported savings from contract conversions as the difference between the agency's MEO and the contractor's bid. Hearings Before Human Resources Subcomm., *supra* note 13, at 13 (testimony of Col. James Schroeder). According to a report issued by the Army Inspector General in 1985, this method of estimating savings from A-76 makes those estimates "highly suspect." *Id.* (colloquy between Rep. Gary L. Ackerman and Col. James Schroeder). The Inspector General's report, a copy of which is on file with the House Subcomm. on Human Resources, has not been released to the public.

33. CBO's data is based on DoD experience between 1984-86. CBO, *Contracting Out*, *supra* note 11, at 28. Yet DoD did not perform post-performance audits until 1986. Other agencies, including OMB, do not seem inclined to gather that information either. OMB recently computerized records of A-76 activities in all government agencies. Although MEO estimates and contractor bids are available in the database, actual post-performance costs are not. Hearings Before Human Resources Subcomm., *supra* note 13, at 232-34 (colloquy among Rep. Gary L. Ackerman, William E. Mathis, Acting Administrator, OFPP, and David Muzio, Deputy Associate Administrator, OFPP) (actual costs are expected to be monitored by agency managers, and budget allocations adjusted downward to reflect projected savings).

34. This tendency to underestimate is illustrated by the few available studies of post-performance contracting costs. For example, the General Accounting Office (GAO) reviewed a "judgmental sample" of 20 activities contracted-out under the A-76 program

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report setting forth the government's contract specifications leads contractors to offer bids that are lower than the actual cost of providing the good or service and thus apparently low enough to move production into the private sector. Second, the competition among private firms for government contracts often results in contractors' underbidding of the job.

The cost of contracting increases where contractors who underbid a job are able to renegotiate their contracts or obtain judicial relief, thereby adding unanticipated costs to the contract. If the government makes an error in its contract specifications, private contractors may seek contract reformation or contract rescission.³⁵ When a contract is actually rescinded, the agency, stripped of its own capacity to perform the work, must either reassemble its former capabilities or open up the contract again for bids. Relief is also available for contractors who underbid a job if the court finds that the government's acceptance of a contractor's bid was unconscionable.³⁶

by DoD between October 1, 1978, and February 28, 1981. See GAO, DoD Functions Contracted Out Under OMB Circular A-76: Contract Cost Increases and the Effects on Federal Employees (Apr. 15, 1985). Although GAO reported savings on 17 of these functions, all but one function experienced increases in contract cost. GAO attributed cost increases in 12 of the 20 functions to ambiguities or actual errors in describing the scope of work already being performed by government employees, which formed the basis of the contractor's bid. *Id.* at 3-4.

35. Where contract requirements are ambiguous, a court interprets the contract in favor of the contractor when each of four requirements are met: (1) the contract was ambiguous; (2) the contractor sought to clarify known or potential ambiguities; (3) the contractor's interpretation of the ambiguity was reasonable; and (4) the contractor reasonably relied on the interpretation. See *M.G.C. Company*, 86-1 B.C.A. (CCH) ¶ 18,571 (Nov. 25, 1985).

36. In cases where the contractor seeks rescission on the ground that his accepted bid contained an error, the legal standard is whether the government knew or should have known of the error. If the court finds that the contracting officer had actual or constructive knowledge of an error in a bid, the court will find the government's acceptance of the bid to have been "unconscionable" and will grant the contractor relief. See *Ruggiero v. United States*, 420 F.2d 709, 713 (Ct. Cl. 1970). The common indicia of constructive knowledge, especially in cases where a mistake is not apparent on the face of the bid, is whether a contractor's low bid is in line with the bids of other contractors, with the government's estimated in-house costs, and with the government's experience with previous contractors performing similar work. *Sol-Mart Janitorial Services*, 87-2 B.C.A. (CCH) ¶ 19,713 (1987) (variation of 13.4% between contractor's bid and government's estimate of cost of procuring service put government on notice of a mistake in bid); *Figgie International, Inc., Badger-Powhatan Division*, 83-1 B.C.A. (CCH) ¶ 16,421 (1983). *But cf. Wender Presses, Inc. v. United States*, 343 F. 2d 961 (Ct.Cl. 1965) (government did not have constructive knowledge despite 125% variance between bids). Where there is a reasonable explanation for disparity between bids, the inference of error is negated. *All American Poly Corporation*, 84-3 B.C.A. (CCH) ¶ 17,682 (1984).

Under the business judgment rule, however, reformation or rescission of a government contract is not allowed where a contractor deliberately underbids a job to beat out the competition, *SCM Corporation*, 85-1 B.C.A. (CCH) ¶ 17,783 (1984), or simply misestimates the cost of performance. *Superior Services*, 84-3 B.C.A. (CCH) ¶ 17,547 (1984); *Overhead Electric Company*, 85-2 B.C.A. (CCH) ¶ 18,026 (1985). *But cf. Don*

To the extent that a contractor obtains relief from the contract, an agency fails to realize some or all of the savings from privatization anticipated by the agency in its initial A-76 comparison between private costs and government costs. In some cases, the ultimate cost of private sector production may exceed the cost to the government had the activity remained in-house. The lack of adequate post-performance data also makes it difficult to evaluate how often contractors have succeeded in obtaining post-award reformation or rescission of a contract. The law of government contracting is *sui generis*; the basic rule appears to be that the government must often bear the risk of error.³⁷ There are numerous cases in which an overly zealous contracting officer accepted a low, apparently responsive bid that the courts subsequently decided was so disproportionate to other bids, or so out of line with the government's knowledge of costs, that acceptance of the bid was deemed "unconscionable."³⁸ It would appear that the incidence of post-award relief could increase as pressure increases on agencies to contract-out their commercial activities.

Despite these indications that the savings estimates proffered by the Administration and by the CBO fail to take full account of the costs of contracting-out, the estimates are often used to suggest that decreases in federal expenditures are attainable through contracting-out. A closer look at the estimates reveals that critical questions remain unanswered: Can the competitive discipline of the private market be superimposed on a government bureaucracy? And can bureaucratic incentives be restructured to encourage agencies to agree to more contracting-out?

C. *Preserving Competition in a Bureaucratic Setting:
A Prerequisite for Efficiency*

Savings from private sector production do not result from the mere fact that goods and services are being produced in the market, but from the presence of competition in the market. Price competition among government contractors ensures that contractors will produce goods and services in the most efficient manner possible,

Simpson, 86-2 B.C.A. (CCH) ¶ 18,768 (1986) (where government fails in its verification duties, rescission may be granted even if error due to mistake in business judgment). For an excellent treatment of the types and standards of relief available to government contractors, see generally Hagberg, *Mistake in Bid, Including New Procedures Under Contract Disputes Act of 1978*, 13 Pub. Contr. L.J. 257 (1983).

37. See *supra* note 35.

38. See *supra* note 36.

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and will sell them to the government at the lowest price possible.³⁹ Absent competition, contracting-out simply replaces one bureaucracy with another. Unfortunately, there are a number of forces at work that tend to move government contractors into a monopolistic position, thereby leading to increased costs over the long run.

One such anticompetitive tactic is a contractor "buy-in."⁴⁰ A buy-in occurs when a contractor deliberately underbids a job to get the government contract and then recoups its initial loss by expanding the work under the contract for a higher price.⁴¹ Another anticompetitive measure is the widespread use of the "umbrella" contract. An umbrella contract consolidates several agency functions into a single contract; the winning contractor typically performs only a portion of the contract itself and subcontracts out the other activities. This contracting technique introduces three problems. First, the introduction of a prime contractor as a "middleman" increases the cost of performing a specific function. Second, because only a limited number of large firms have the resources to compete for umbrella contracts, the government loses the benefit of active competition from smaller firms.⁴² Third, the introduction of a prime contractor complicates the agency's job of monitoring the subcontractors' performance.

There is an additional threat to free market competition in the government contracts market. Although the Federal Acquisition Regulations⁴³ require competitive bidding in most instances, many government contracts are awarded noncompetitively or with few contractors bidding. The competition is further impaired when contracting officers often develop close relationships with certain contractors and structure Requests for Proposals with those contractors in mind.⁴⁴

39. This premise forms the basis of the economic theory of privatization, which is basically a revival of the free market liberalism that defined the economic policies of the United States prior to the New Deal. See Moe, *Exploring the Limits of Privatization*, 47 *Pub. Admin. Rev.* 453, 459 n.1 (1987).

40. J. Hanrahan, *Government by Contract* 30-31 (1983).

41. A review of the few post-performance cost audits indicates that this practice is indeed prevalent. The GAO study attributed cost increases in five of twenty activities studied to work added to the contract subsequent to award. See GAO, *DoD Functions Contracted Out Under OMB Circular A-76*, *supra* note 34, at 3-4.

42. See *Hearings Before Human Resources Subcomm.*, *supra* note 13, at 269 (statement of the Graphics Industry Association).

43. See 48 CFR § 1.000-53.303-WH-347 (as revised 1987).

44. See Hanrahan, *supra* note 40, at 29-32. See also Brian-Bland & Rasor, *Lies, Half-Truths, and Misrepresentations: How the Military Gets its Money*, 5 *Yale L. & Pol. Rev.* 102, 104 (1986).

Competition between the agency and private contractors is also a key component in reducing government costs for activities that are not, ultimately, contracted-out. While it is possible to simulate market conditions at the time of A-76 review, the agency is not subjected to continuing price competition. Although the agency is expected to implement reforms set forth in the MEO, no mechanism presently exists for ensuring that those changes are made. A-76 requires review of the activity every five years; the agency continues to operate without the immediate threat of competition during the five-year period. When the activity is next subjected to A-76 review, the agency's past performance is not used in the comparison; rather, a new MEO is used. The Administration, however, has been impressed by what are likely inflated claims of increased efficiency in government activities that remain in-house after A-76 review, and thus has placed an increased emphasis on A-76 as a productivity improvement program.⁴⁵ A proposal to expand the A-76 competitive process to allow other federal agencies, in addition to private contractors and the soliciting agency, to bid on A-76 contracts is one OMB effort toward this end.⁴⁶ Of course, the problem with including other government agencies in the A-76 bidding process is that if a competing agency wins, the activity will be performed by an agency for which price competition is not a continuous incentive for efficiency.

Some theorists and policymakers associated with the privatization movement view such artificial attempts to graft market incentives onto a bureaucratic institution as fundamentally flawed.⁴⁷ Accord-

45. Hearings Before Human Resources Subcomm., *supra* note 13, at 254 (testimony of David L. Muzio, Deputy Associate Administrator, OFPP) ("Prior to 1979 [A-76] could be definitely classified as a contracting-out policy. Since 1979 and with the modifications in 1983 and 1984, that basic philosophy has changed to one of competition between the private sector, where capable of performing the service, with Government employees to determine who is the most capable"). Emphasis on management improvements for activities remaining in-house after A-76 review is just one OMB effort toward improving productivity.

46. OMB, Memorandum on Improving Productivity Through Use of Circular A-76, Sept. 27, 1984, *reprinted in* 42 Fed. Cont. Rep. (BNA) 479 (Oct. 1, 1984).

47. This position was succinctly expressed by Madsen Pirie:
When governments become aware of inferior performance of public sector supply, the attempt is sometimes made to graft onto the public program some of the efficiency-making expertise of the private sector. It is an attempt to use the methods which the private sector induces spontaneously because of its need to remain competitive and profitable. The effort is commendable but of temporary effect. When the novelty has died, the orthodox practices of the public sector reassert their effects. Streamlined business practices are an outgrowth of streamlined business. The one thing difficult to introduce is the incentive that will sustain these practices. In the private sector it is the pursuit of profit itself which ultimately serves that end. M. Pirie, *Dismantling the State: The Theory & Practice of Privatization* 18-19 (1985).

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ing to these theorists, the flaw is inherent in the structure of the bureaucracy itself. In government bureaucracies, market-determined costs for failure are not a daily reality. Instead, the democratic political process in which bureaucracies operate biases them toward inefficiency in several ways. First, politicians are principally concerned with "enhancing [their] power, protecting [their] perks and getting reelected."⁴⁸ Second, the class of beneficiaries and near beneficiaries of government programs is generally smaller and more organized than the taxpayers who pay for those benefits. Accordingly, assuming the overriding goal for politicians is reelection, there is an irresistible incentive to create or expand programs that mollify vocal interest groups, especially when costs can be dispersed or hidden through deficit financing.⁴⁹

The previous two factors speak to inefficiency in the decision to provide a good or service. The third factor, which is more pertinent to the A-76 context, is the inefficiency inherent in actual production by bureaucracies. Bureaucrats can enhance their pay, power, and prestige by increasing the size of their budgets instead of increasing efficiency and enhancing the value of public assets.⁵⁰ In addition, because the salaries of government employees are limited by statute, bureaucrats do not have the equivalent profit-related bonus as an incentive to maximize efficiency.⁵¹

Whether the A-76 program can generate the efficiencies claimed, but not adequately documented, by the Reagan Administration depends on the ability of the Administration to preserve and foster competition among contractors and its ability to replicate competitive conditions within government agencies if the activity remains in-house. Given the preexisting incentive structure of government

48. Banks, "A Talk with the Nobel Laureate," *Forbes*, Nov. 17, 1986, at 108 (quoting James Buchanan). Buchanan is cited not as a privatization advocate, but as an originator of the public choice theories that form the theoretical foundation of the privatization movement.

49. See S. Butler, *supra* note 2, at 14-15.

50. See generally W. Niskanen, *Bureaucracy and Representative Government* (1971). Moreover, bureaucrats can advance their own careers in the way they allocate staff and resources under their control, allocations that do not necessarily promote efficiency in production. Niskanen is cited not as a privatization advocate, but as an originator of the public choice theories that form the theoretical foundation of the privatization movement.

51. Bureaucrats tend to adopt policies that lighten their work load and make their jobs more pleasant and less stressful. For instance, they tend to seek easily administrable standards for dispensing outputs and respond to strong interest groups and politicians. Hanke, *supra* note 6, at 7. See also *The President's Private Sector Survey on Cost Control, War on Waste 151* (1984) (identifying three sources of inefficiency in government production). [hereinafter *Grace Commission Report*].

bureaucracies, replicating competitive conditions over the long-run is unlikely, especially if the Reagan Administration fails to institutionalize the program.

D. The Difficulties of Institutionalizing the A-76 Program

The most serious obstacle to the long-term success of the A-76 program is the complete discretion agencies have in deciding what activities potentially may be contracted-out.⁵² It is the agency that makes the initial determination that an activity is commercial or governmental in nature, and it is the agency that performs the cost comparison. And it is managers and workers within those agencies who are the most vocal opponents of the A-76 process.⁵³ Indeed, the Administration's current plans for A-76 jeopardize approximately 226,000 federal jobs.⁵⁴ Given the resistance of federal employees to the A-76 review process, the Administration must take steps to either restructure incentives toward review, or counteract that resistance with alternative procedures.

The Administration has proposed some measures to make the A-76 review process less threatening to federal employees. For example, it has proposed contracting-out certain activities to business ventures formed by federal employees displaced by A-76. These programs, however, are only in their formative stages, and their success remains to be seen. Federal employees may not be willing to surrender the security that government employment offers in exchange for the promise of a risky business venture.

While the Administration advocates expanding the number of A-76 reviews conducted, it steadfastly has refused to implement one proposal that could broaden the types of activities eligible for A-76 review by bypassing employee resistance. Representative Gary Ackerman, Chair of the House Civil Service Subcommittee on Human Resources, which is responsible for oversight of A-76, has argued that there is a need for government-wide guidelines for deciding which types of activities currently performed by the government should be considered commercial and which types should be consid-

52. Statutory exemptions and exemptions within A-76 place minimal limitations on agency discretion. *See supra* note 14.

53. *See, e.g.*, American Federation of State, County, & Municipal Employees, AFL-CIO, *When Public Services Go Private: Not Always Better, Not Always Honest, There May Be A Better Way* (1987); *Hearings Before Human Resources Subcomm.*, *supra* note 13, at 36-53, 56-59, 61-70, 71-81, 136-66, 275-79 (statements of various managers and employee organizations).

54. *Enhancing Governmental Productivity*, *supra* note 22, at 9.

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ered inherently governmental.⁵⁵ Since agencies have complete discretion in categorizing activities, a common result is that the same function is categorized as "governmental" in one agency and "commercial" in other agencies;⁵⁶ in fact, different geographic offices of the same agency have reached contradictory conclusions as to the nature of the activity under review.⁵⁷ Clearly, the distinction between commercial and governmental activities is highly manipulable and susceptible to agency tinkering.

Ackerman's proposal could lead to less contracting-out if the guidelines for defining commercial activities are narrowly drawn. It is more likely, however, that government-wide guidelines would result in more contracting-out, particularly if the Office of Federal Procurement Policy (OFPP) were charged with supervising, developing, and implementing the guidelines. Unlike OMB and GAO, for whom enforcement of A-76 is just one of a number of responsibilities, the principal responsibility of OFPP is to advance the goal of

55. Hearings Before Human Resources Subcomm., *supra* note 13, at 207 (statement of Rep. Gary L. Ackerman). See also House Panel Questions Amount of Savings from Contracting Out, 44 Fed. Cont. Rep. (BNA) 1085 (Dec. 23, 1985).

56. Also, an agency may designate a function as "commercial" in an initial review yet reclassify that function as "governmental" in a subsequent review, or vice versa. For example, an A-76 review of activities at the Directorate for Ammunition Operation at Letterkenny Army Depot in Chambersburg, Pennsylvania, which receives, stores, maintains, issues, and demilitarizes ammunition for the State Department, and for the DoD, concluded that the directorate was engaged in governmental activity. This initial A-76 determination, however, was reviewed in 1982 under the direction of a new commander to determine whether ammunition operations at Letterkenny were mislabeled in the initial review. That the same agency sought to reclassify the same activity differently in separate A-76 review can only be explained by the broad discretion conferred by A-76 at the activity level. Between the time of the two reviews, there had been no change in the scope of the directorate's mission; there had only been a change in commanders. Hearings Before Human Resources Subcomm., *supra* note 13, at 23, 35. See also *Arrowhead Metals Ltd. v. United States*, U.S. Cl. Ct. No. 291-85C (Sept. 19, 1985), reported in 44 Fed. Cont. Rep. (BNA) 729 (Oct. 14, 1985) (private contractor's challenge to Denver Mint's cancellation of an Invitation for Bids for production of blanks used in making coins denied; factors in agency's decision whether to contract-out function not limited to price; agency may also rely on reevaluation of whether coinage of money is within government function prohibition of A-76).

57. The Administration prefers leaving determination of the nature of the activity to agency discretion because, in a few agencies, activities commonly regarded as commercial in nature may implicate indisputable governmental functions, such as national security. For example, data processing performed at the Department of Health and Human Services may in fact be commercial in nature while data processing at the Central Intelligence Agency is not. The Administration contends that the agency is in the best position to know the implications of contracting-out a particular activity. Hearings Before Human Resources Subcomm., *supra* note 13, at 240 (statement of David L. Muzio, Deputy Director, OFPP). Nonetheless, broad guidelines might be attempted, with a provision for appeals to the OFPP if contract procurement of a particular activity impairs the agency mission or implicates national security. See also "NASA Not Conducting Cost Comparison Studies Required by A-76, GAO Reports," 44 Fed. Cont. Rep. (BNA) 1003 (Dec. 9, 1985).

private procurement. But at present OFPP has no power to enforce agency implementation of A-76.⁵⁸ By giving some enforcement oversight to an agency with a privatization mission, the Reagan Administration could establish, with some permanence, a countervailing political force to reckon with agencies and future administration officials whose own agendas would not include aggressive use of A-76. Additionally, the Administration could institutionalize its A-76 goals by pressing Congress to enact the A-76 policy into law.⁵⁹

Not only is it easy to manipulate the classification of a government function, but also it is easy to manipulate financial data in the review process. According to Bun Bray, former Executive Director of the Federal Managers Association, "the A-76 procedure is so flexible you can skew the data to fit your desired results."⁶⁰ The flexibility of the data thus allows future Administrations, and even officials in the current Administration who do not share the President's commitment to increased contracting-out of commercial activities, to thwart the use of the A-76 procedure.

The Reagan Administration certainly has advanced the use of Circular A-76 further than any previous administration. It has failed, however, to institutionalize the A-76 policy, leaving the determination of what should be contracted-out to forces generally opposed to the policy. So long as the Reagan Administration remains in office, these forces can be partially overcome; but the discretion that remains at the agency level, among other factors, calls into doubt whether the A-76 policy will be aggressively pursued by subsequent administrations.

58. Presently, oversight of Circular A-76 is divided between GAO and OMB. The OFPP has little authority of its own to enforce A-76. OFPP's statutory authority is set forth at 41 U.S.C. § 401-15 (1987 as amended). OFPP has no authority to "impair or interfere with the determination by executive agencies of their need for, or their use of, specific property, services, or construction. . . ." *Id.* at § 405(c)(1). The Grace Commission proposed establishment of an Office of Federal Management to promote contracting-out of commercial activities. Grace Commission Report, *supra* note 51, at 151.

59. Senator Gordon Humphrey has introduced a bill requiring executive agencies to contract-out commercial activities. S. 265., 100th Cong., 1st Sess., 133 Cong. Rec. S525 (1987). Rep. Robert Smith introduced similar legislation requiring the federal government to contract-out commercial activities whenever a cost comparison demonstrates that the activity can be performed at a lower cost by the private sector. H.R. 1606., 100th Cong., 1st Sess., 133 Cong. Rec. H1290 (1987).

60. Hearings Before Human Resources Subcomm., *supra* note 13, at 69 (statement of Bun Bray, former Executive Director of the Federal Managers Association, citing comment of a DoD official).

III. Federal Credit Programs

Unless one is willing to assume that the private sector, acting within the same institutional framework as the government, is an inherently more efficient producer than the government, the A-76 program is difficult to endorse as an efficiency measure. Even harder to justify on grounds of increased efficiency, however, is the Administration's privatization policy in the area of federal credit programs, where the goal of increased efficiency is a guise for ideological preference.

President Reagan's FY 1988 budget includes three privatization measures directed at federal credit programs: (1) sale of loan assets from a variety of portfolios accompanied by a gradual reduction in monies available for new federal direct and guaranteed loans; (2) fundamental reform of budgetary treatment of federal credit programs; and (3) gradual increases in interest rates and fees attached to government loan programs.⁶¹ These proposals attempt to correct inefficiencies in the supply of credit, a different problem than that targeted by the A-76 program. The Administration hopes to move the decision of how much credit to supply, and to whom to supply the credit, to the private market. Moving the allocative decision to the private sector presents more difficult political problems than moving the production function to the private sector. To appreciate the implications of these proposals, a brief description of the government's involvement in credit markets is useful.

A. Forms and Extent of Government Involvement in Credit Markets

The federal government intervenes in credit markets through two principal mechanisms: (1) loan subsidy programs and (2) asset exchange programs designed to develop and facilitate secondary loan markets. There are two different types of programs that, in effect, subsidize the cost of borrowing: programs providing direct loans from the federal government and programs under which the federal government guarantees privately secured loans. In direct loan programs, the government originates and services the loan. Normally it does not charge the borrower an interest rate high enough to cover servicing costs and the cost incurred by the Treasury in financing the loan. Thus, direct loans result in a subsidy benefit to the borrower and a subsidy cost to the government.⁶² When the federal

61. OMB, 1988 Budget, *supra* note 4, at Supp. 2-36-38.

62. The government subsidizes direct loans through a variety of favorable terms: (1) below-market interest rates; (2) longer maturity periods; (3) interest deferral;

government guarantees privately originated loans or holds private loans against default, the government assumes either partial or total liability for the principal and interest if the borrower defaults. As a result, the privately set interest rate charged the borrower is reduced substantially. Like direct loans, loan guarantees usually involve a significant subsidy benefit to the borrower and a significant cost to the government, paid out when an insured borrower defaults.

The federal government also participates in the secondary credit market through five private financial institutions, termed "government-sponsored enterprises" (GSEs).⁶³ Although most GSEs were chartered and established by the federal government, all have been privately owned since 1969.⁶⁴

GSEs channel credit to segments of the economy designated by the government, such as housing, agriculture, and education. This is done by government creation of a subsidized secondary credit market for loans extended to these favored segments. By selling an equivalent amount of public securities, GSEs finance the purchase of, for example, existing housing, educational, and agricultural loans from direct lenders.⁶⁵ In purchasing the loan assets of private institutions on favorable terms, GSEs enable private institutions to

(4) waiver or reduction of loan fees; (5) insufficient collateral; and (6) grace periods for repayment. OMB, Special Analyses, *supra* note 12, at F-32.

63. The five GSEs are: the Farm Credit System (FCS), the Federal Home Loan Bank System (FHLB), the Federal National Mortgage Association (FNMA or "Fannie Mae"), the Federal Home Loan Mortgage Corporation (FHLMC or "Freddie Mac"), and the Student Loan Marketing Association (SLMA or "Sallie Mae"). *Id.* at F-22. *See also infra* note 65.

64. OMB, Special Analyses, *supra* note 12, at F-22.

65. For example, Freddie Mac, which is owned by savings and loans institutions, was established by Congress in 1970 to increase the liquidity and availability of mortgage credit in the residential mortgage market. Freddie Mac buys non-federally insured mortgages from the mortgage bankers, savings institutions, and commercial banks that originated the loans by issuing debt or by issuing pass-through certificates backed by mortgage pools. Fannie Mae was created in 1938 to provide a secondary credit market for residential mortgages underwritten by the federal government, such as loans insured by the Federal Housing Administration and loans guaranteed by the Veteran's Administration; it operates in much the same way as Freddie Mac. Debt issued by Fannie Mae is traded on the New York Stock Exchange. Sallie Mae was created by Congress in 1972 to increase the liquidity of government-insured student loans, thereby expanding funds available to lenders for additional loans. Sallie Mae uses two methods for increasing liquidity. One method is the direct purchase of insured student loans; Sallie Mae assumes title to the loan, and borrowers repay Sallie Mae. Alternatively, lenders can borrow from Sallie Mae. These latter loans, known as "warehouse advances," are secured by student loan portfolios. Lenders retain title to the loans and repay the principal plus interest to Sallie Mae. *See generally* Moran, *The Federally Sponsored Credit Agencies: An Overview*, 71 Fed. Reserve Bull. 373 (1985); OMB, Special Analyses, *supra* note 12, at F-22-29.

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increase the liquidity of their assets, thereby allowing them to make additional loans to the favored segments.

Since GSEs are privately owned, they are not included in the unified budget or the credit budget.⁶⁶ But because they receive favorable tax, regulatory, and financial treatment from the federal government, GSEs enjoy a significant advantage over other private participants in secondary credit markets.⁶⁷ As a result, securities issued by GSEs typically yield anywhere from 1/2%-3% below medium-rated corporate debt.⁶⁸ Although the government does not actually secure debt issued by GSEs, the many regulatory advantages accorded GSEs contribute to the perception that GSE debt is extremely secure.

The federal government's involvement in credit markets, through both direct and guaranteed loan programs and through the secondary credit market, is extensive. The actual volume of outstanding government direct loans totaled \$252 billion in FY 1986.⁶⁹ The same year, the volume of the government's contingent liability under guaranteed loan programs totaled \$450 billion.⁷⁰ And, in FY 1985, the volume of loan assets held by government-sponsored enterprises totaled \$418 billion.⁷¹ Between the years 1980-85, the fed-

66. OMB, Special Analyses, *supra* note 12, at F-22.

67. *Id.* at F-24, Table F-9 lists just some of the benefits GSE status confers:

	FHLB	FHLMC	FNMA	FCS	SLMA
Line of credit at Treasury	Yes	Yes	Yes	Yes	Yes
Exemption of corporate earnings	Yes	No	No	Yes	No
Exemption of interest income of investors from State and local taxes	Yes	No	No	Yes	Yes
Eligibility for Federal Reserve open market purchases	Yes	Yes	Yes	Yes	Yes
Equal Standing with Treasury debt as investments for most banks	Yes	Yes	Yes	Yes	Yes
Exemption from SEC registration and various State banking laws	Yes	Yes	Yes	Yes	Yes
Eligibility as collateral for public deposits	Yes	Yes	Yes	Yes	Yes

68. *Id.* at F-23.

69. *Id.* at F-32.

70. *Id.*

71. B. Bosworth, A. Carron, & E. Rhyne, *The Economics of Federal Credit Programs* 4 (1986).

eral government held or influenced one-third to one-half of the funds in the credit market.⁷²

B. Traditional Justifications for Government Involvement

Two traditional arguments have been advanced in support of extensive government involvement in credit markets. The first argument directly addresses the Administration's contention that federal involvement in credit markets results in inefficient supply decisions. According to this argument, government involvement corrects market imperfections, thereby increasing the efficiency of credit markets.⁷³ For example, many borrowers would not have access to national credit markets were it not for the involvement of the federal government. Federal regulations restrict interstate banking, leaving borrowers to rely on local credit sources that may or may not be available when a need for credit arises. Thus, savings may be distributed to less-preferred activities in some markets, while other markets lack adequate resources to distribute funds to more preferred uses. Interest rates necessarily are higher in markets in which resources are scarce than in markets in which resources are plentiful. Government involvement knits together local credit markets to make more efficient use of savings. If credit markets are national in scope, interest rates will vary only with the risk of default for a certain category of borrowers and with the administrative costs of processing and servicing the loan. Government credit programs also can correct imperfections in credit insurance markets. Private firms are hesitant to insure loans where they cannot obtain enough information about the borrower to adequately evaluate the risk. This problem is particularly acute for small businesses and individuals. Private firms also are reluctant to insure loans where borrowers cannot offer collateral. This particular market imperfection is characteristic of the student loan market. Thus, these types of loans have no adequate resale market because of inadequate insurance and lack of standardization in contract terms. GSEs provide a resale market for these assets, and thereby enable private lenders to channel funds to government-funded activities.

Second, government involvement through loan subsidies is justified as a method for reallocating resources to social goals not profitable enough to attract private investment. The government has subsidized synthetic fuel production, low-cost rental housing, and

72. *Id.* at 5-6.

73. *Id.* at 7.

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education through subsidized loan guarantees and direct loans bearing an interest rate below the prevailing market rate.⁷⁴ These segments of the economy might not otherwise receive credit absent government intervention in the market.

C. *Reagan's Proposals for Privatizing Federal Credit Programs*

The Reagan Administration has sought to promote supply efficiency in federal credit programs through several different proposals. The proposals are directed at both primary and secondary credit markets.

1. *Privatization of Secondary Credit Markets* The Reagan Administration currently is studying ways to privatize two GSEs—popularly known as Fannie Mae and Freddie Mac.⁷⁵ The precise contours of this proposal are still being formulated by a subcommittee of the President's Commission on Privatization.⁷⁶ The only specific proposal advanced by the Administration thus far is a permanent limit on the volume of loan assets that all GSEs can purchase.⁷⁷

According to the Administration, GSEs lead to a misallocation of resources across all credit markets because sectors of the economy that do not have GSEs acting as intermediaries tend to have less financing available to them. This increases the cost of financing to those sectors.⁷⁸ Ironically, this argument for the privatization of GSEs suggests the need for more government involvement, not less. The argument that GSEs promote the misallocation of resources among credit markets must be based on the premise that credit markets are highly individuated, with the flow of capital across markets constrained. In a fragmented credit market, lenders prefer assets with which they are familiar. For instance, savings and loans institutions prefer mortgage assets because of these institutions' expertise

74. Bosworth, Carron, & Rhyne, *supra* note 71, at 9-10. The Rural Electrification Administration (REA) is another loan subsidy program designed to promote the purchase of a public good: specifically, the provision of electric and telephone services to rural and farm areas. REA loans, when first offered, bore interest rates comparable to those available in the private market. Over time, however, the extent of this subsidy was altered as REA interest rates failed to keep pace with prevailing private interest rates. OMB, Special Analyses, *supra* note 12, at F-33.

75. OMB, Special Analyses, *supra* note 12, at F-23. Since GSEs are already privately owned, "privatization" in this context is more akin to deregulation.

76. The report of the President's Commission on Privatization was given to the President on March 1, 1988. The parameters of the Commission's proposals with regard to federal credit programs do not differ significantly from those described in this Current Topic.

77. OMB, Special Analyses, *supra* note 12, at F-22-23.

78. *Id.*

in valuing the asset, their knowledge of local markets, and the economies of scale that have developed. If markets are fragmented, borrowers must compete for fewer capital resources than if markets are nationally integrated. This means that interest rates are higher in markets where resources are more scarce than in markets where resources are more plentiful. If the problem is higher interest rates in certain markets, as the Reagan Administration claims, the answer is greater integration of markets. GSEs promote just such national integration. Moreover, "[t]o the extent that [GSEs] reduce transaction costs, they do result in some reallocation of credit toward sectors such as housing, but a shift of credit flows that results from lower transaction costs improves the productivity of capital rather than misallocates it."⁷⁹ Thus, limits on the activities of GSEs do not lead to greater supply efficiency, as the Reagan Administration has argued; rather, limits inefficiently reallocate credit according to the caprice of the market.

2. *Portfolio Sales* President Reagan's FY 1988 budget proposes a second measure for privatizing federal credit programs—an expansion of the Administration's "pilot" program, begun in FY 1987, which authorizes the sale of existing government loan assets to the private sector.⁸⁰ President Reagan proposes selling loans with a face value of \$11.2 billion without recourse to private investors to produce offsetting receipts in the amount of \$5.3 billion. The Administration anticipates that the sale of these assets will reduce the deficit by \$4 billion.⁸¹

The pilot program appears to sacrifice good sense to the deficit god. By selling a productive asset in the competitive market for less than half its long-term face value, the Administration gains immediate, albeit costly, offsetting receipts in the year of the sale in order to duck under deficit ceilings established by Gramm-Rudman-Hollings II.⁸² Moreover, by insisting that the loan assets be sold without re-

79. Bosworth, Carron, & Rhyne, *supra* note 71, at 8.

80. The Administration proposes to sell loans from the portfolios of the following agencies: Farmers Home Administration, Rural Electrification Administration, Small Business Administration, Housing and Urban Development, Department of Education, the Export-Import Bank, Bureau of Reclamation, Health and Human Services, Department of Transportation, and the Tennessee Valley Authority. OMB, 1988 Budget, *supra* note 4, at 2-44.

81. Although proposed loan sales will reduce the deficit by \$4.2 billion in FY 1988, savings realized from these sales will decline to \$1.7 billion in 1989, to \$800 million in 1990, to \$300 million in 1991, and will be completely depleted by 1992. Committee on the Budget, U.S. House of Representatives, President Reagan's Fiscal Year 1988 Budget, Serial No. CP-2 111-15 (Feb. 1987).

82. Deficit ceilings were established by Congress in 1985. Balanced Budget and Emergency Deficit Control Act of 1985 (Gramm-Rudman-Hollings), 2 U.S.C.A. § 901-

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course, the President settles for a lower return on the sale than he might otherwise have realized.⁸³ The future savings that result from reduction in Treasury debt, however, are eventually offset by loss of future income from the assets sold.⁸⁴

Even if the loan assets are sold, it is still the government that has made the initial decision to allocate resources toward a particular use by financing or arranging for financing of the loan. Thus, in terms of the Administration's own views of efficient operation of the credit market, funds are still being channeled to uses the private sector might not consider optimal. Standing alone, the Administration's pilot program appears to be an ill-conceived, short-term deficit measure; but in conjunction with the President's proposals to reform budgetary treatment of credit programs, at most it forms the foundation for making expenditure reductions in federal credit programs more attractive to Congress.

3. *The Long-Term Logic of Portfolio Sales* The President's "Federal Credit Reform Act of 1987,"⁸⁵ introduced in Congress last year, suggests that the Administration may have in mind a larger, more sophisticated political strategy for completely privatizing federal loan programs than just a sudden transfer of loan assets to the private sector—a strategy to compel Congress to cut credit programs by restructuring Congress' incentives. The first step of the Administration's strategy is to measure the subsidy built into federal loans by comparing their face value to the price offered in the private mar-

22 (West Supp. 1987). In 1987, Congress raised the deficit ceilings set by Gramm-Rudman-Hollings and excluded revenues derived from the sale of loan assets from being counted towards deficit reduction in the year sold. Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987, Pub. L. No. 100-119, 1987 U.S. Code Cong. & Admin. News (101 Stat.) 754 [hereinafter Gramm-Rudman-Hollings II]. Nonetheless, to the extent the sale of loan assets actually lowers the deficit, fewer expenditure reductions and fewer revenue measures will be required to meet the deficit ceiling set in the following fiscal year. 133 Cong. Rec. H7707, H7710 (Sept. 21, 1987) (Joint Explanatory Statement of the Comm. of Conference).

83. Review of OMB Guidelines for the Sale of Government Loan Assets, Hearing Before a Subcomm. of the House Comm. on Government Operations, 99th Cong., 2nd Sess. 5 (Sept. 26, 1986) (statement of Rep. Chester Atkins).

84. See *supra* note 81.

85. The President's Federal Credit Reform Act was introduced in both houses of Congress in 1987. H.R. 1754, 100th Cong., 1st Sess., 133 Cong. Rec. H1513 (1987); S. 745, 100th Cong., 1st Sess., 133 Cong. Rec. S3108 (1987). Congress concluded that more study was required and responded by adding provisions to Gramm-Rudman-Hollings II. Gramm-Rudman-Hollings II, *supra* note 82, at 787 § 212. The statute requires CBO and GAO to study the operation of loan programs for FY 1987 and 1988 and recommend more accurate methods of calculating costs to government of federal credit programs, methods of comparing costs of credit programs to other forms of assistance, and methods for improving the allocation of funds between credit programs and other programs.

ket by selling the portfolios on a nonrecourse basis. The Administration has taken this first step with its pilot program of portfolio sales. The second step, the Federal Credit Reform Act of 1987, if adopted by Congress, is to reform fundamentally the budgetary treatment of federal credit programs.

Current budgetary treatment of federal direct and guaranteed loan programs conceals the true costs of these programs to the federal government. The unified budget reports only the cash requirements of loan programs. Most loan programs are financed through revolving funds within the sponsoring agency; that is, loan repayments under a particular program are used to advance new loans. Only if repayments fall short of new loan requirements does Congress actually appropriate additional funds. More importantly, there currently is no way of measuring the actual cost to the government of a loan or a loan guarantee. The actual cost of a loan is the interest subsidy included in direct loan programs, or in the case of guaranteed loans, the costs associated with default. Interest subsidies are paid out over the life of the loan and are lumped together with other interest payments in the unified budget. Thus, it is impossible to identify the actual value of the interest subsidy through the unified budget. Loan guarantees, on the other hand, do not cost the government anything unless default actually occurs. Thus, the subsidy value of a loan guarantee does not appear in the unified budget until and unless a default occurs sometime in the future. The Credit Budget, adopted under the Carter Administration in 1980, is a mechanism supplementary to the unified budget that measures total credit commitments.⁸⁶ The Credit Budget records the volume of new loans issued, regardless of whether the sponsoring agency disperses new loans through its revolving fund. However, the emphasis on the volume of new loan activity obscures the true cost to the government of new loan activity—that is, the subsidy value of the loan. The potential for hiding the true costs of loan programs in the unified budget and the Credit Budget makes loan programs an attractive option for politicians seeking to reallocate resources toward social goals or to redistribute income.

President Reagan's credit reform proposal would make the subsidy value of federal loan programs explicit.⁸⁷ The proposal would require federal agencies to pay the subsidy value of direct loans and loan guarantees made each year directly into a central revolving

86. OMB, Special Analyses, *supra* note 12, at F-6.

87. The following description is based on Message from the President of the United States, Proposed Legislation—"Federal Credit Reform Act of 1987," House Doc. 100-50, 100th Cong., 1st Sess. (Mar. 16, 1987).

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fund to be established in the Treasury. The subsidy value of the programs would be determined by the price obtained by the central revolving fund's immediate sale of all direct loans in the private market and purchase of insurance from private sources for government guaranteed loans. The subsidy value of direct loans and loan guarantees would have to be appropriated each year by Congress.⁸⁸

By making the "value" of the subsidies explicit, the President gains some leverage in promoting reductions in direct loan and loan guarantee budget authority. Once the value of direct loans and loan guarantees can no longer be hidden in the Credit Budget, the conflict in Congress over the social value of government loan programs will necessarily increase and Congress will be forced to confront the allocative choices it makes between financing loan programs and financing other forms of governmental assistance. In a period of deficit-driven budget politics, it is unlikely that federal credit programs can be maintained at the same levels once the cost of government credit subsidies is made explicit.

Although the President's credit reform proposal fundamentally restructures the budgetary treatment of loan programs to induce expenditure reductions in these programs, the proposal suffers from the same problem that plagued the Administration's other attempts to reduce the size and scope of the federal government through expenditure reductions; it fails to create coalitions of lenders and borrowers who can exert pressure on Congress to abandon federal credit programs. Federal credit programs directly assist borrowers to whom private lenders are ordinarily averse to extending credit. The borrowers who currently benefit from federal credit programs are a more discrete group than those who might gain from the different type of allocative decision the private sector might make. Since the losers are easy to identify, and the winners are unknown and diverse, the borrowers who would benefit from the allocative decision of the private sector have less incentive to pressure Congress to abandon certain programs than those discrete groups such as students, farmers, and small businesses, that stand to lose considerable tangible benefits if the government abdicates to the private

88. Loan subsidies can be measured in one of two ways: (1) the subsidy cost to the government; or (2) the economic subsidy or value to the borrower, the method preferred by the Reagan Administration. See Review of OMB Guidelines for the Sale of Government Loan Assets, Hearing Before Subcomm. of the House Comm. on Government Operations 40 (Sept. 26, 1986) (statement of Charles Bowsher, Comptroller General). Sale of loan assets in the private market, however, do not accurately measure the subsidy value to the borrower. The amount private investors in the secondary market are willing to pay depends on their familiarity with the type of loan offered and the quality of documentation. Subsidy estimates based on the price received in the private market therefore are inflated. *Id.*

sector. In summary, portfolio sales and reform of the budgetary treatment of federal loan programs do not advance the goal of privatization any more than would a regular expenditure cut.

Conclusion

The Reagan Administration justifies its privatization measures purely on grounds of efficiency. The political repercussions and the allocative effects of privatization measures differ, however, with the type of inefficiency the specific initiative is designed to correct. In the case of contracting-out under the A-76 program, the Administration is principally concerned with productive efficiency; its initiatives in the arena of federal credit programs are concerned with allocative efficiency. None of these measures unequivocally can be said to correct the perceived inefficiencies at which they are targeted.

The Administration attempts to justify its aggressive use of the A-76 program as a way of procuring goods and services at lower cost. In other words, the emphasis of the A-76 program is on efficient production through private-sector procurement or increased efficiency in government production through imposition of competitive incentives on government bureaucracies. Although the Administration and CBO claim substantial savings from the program, both realized and potential, the savings estimates and projections are based on highly unreliable and incomplete data. Moreover, there is evidence to suggest that the benefits of competition among private-sector firms dissipate over time, with private firms moving into the same monopolistic position occupied by government bureaucracies before them. As a management improvement technique for activities remaining in-house, the A-76 program does an even poorer job of imitating competitive conditions.

The President's privatization initiatives in the areas of secondary credit markets and direct and guaranteed loan programs are promoted as a means of increasing supply efficiency. But supply efficiency, in this case, is a euphemism for ideological choice. Imposition of ceilings on the purchase of loan assets by GSEs undermines national integration of loan markets, thereby increasing allocative inefficiency instead of correcting it. Portfolio sales likewise do nothing to promote allocative efficiency, even assuming that the government is making poor allocative choices now. Currently, when a loan asset is sold, it is the federal government, and not private investors, that makes the initial decision as to which segment of the

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population is to receive credit. Even if the Administration is successful in reforming budgetary treatment of federal loan programs using portfolio sales as the mechanism for measuring subsidy values, it will have done nothing more than make expenditure reductions more likely.

In summary, contracting-out and the privatization of federal credit programs cannot conclusively be shown to promote productive efficiency or efficient supply decisions. Privatization raises an ideological issue about the proper role of the federal government. Efficiency arguments should not be allowed to obfuscate the true nature of the debate. Given the dubious claims of efficiency gains due to contracting-out and privatization of federal credit programs, these measures should not be pursued without serious consideration of the values that underlie them.

