LAW, ECONOMICS, AND THE REINVENTION OF PUBLIC ADMINISTRATION: USING RELATIONAL AGREEMENTS TO REDUCE THE COST OF PROCUREMENT REGULATION AND OTHER FORMS OF GOVERNMENT INTERVENTION IN THE ECONOMY

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TABLE OF CONTENTS

INTRODUCTION

The 1990s have provided a singular opportunity to reconsider basic beliefs about how government agencies should regulate economic activity. Spurred by a desire to reduce public expenditures and increase economic growth, Congress and the executive branch are experimenting with new techniques for improving the performance of regulatory authorities.[1] Ini-

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1. *See* Contract with America Act, Pub. L. No. 104-121, §§ 241-242, 110 Stat. 847, 865 (1996) (incorporating amendments to Regulatory Flexibility Act adopted as provisions of Small Business Regulatory Enforcement Fairness Act, allowing judicial review of agency failures to comply with Regulatory Flexibility Act); Exec. Order No. 12,931, 3 C.F.R. 925 (1994) (directing heads of executive agencies to replace existing procurement rules with "guiding principles that encourage and reward innovation"); Donald F. Kettl, *Building Lasting Reform: Enduring Questions, Missing Answers, in* INSIDE THE REINVENTION

tiatives such as the National Performance Review[2] (NPR) display a commitment to explore how public agencies can achieve important economic regulatory aims at a lower social cost.[3]

The modern interest in reinventing economic regulation has created exciting possibilities for redesigning the administrative process and altering the strategies that public authorities use to oversee private firms. No field of administrative law and policy reflects new views about the appropriate techniques for economic regulation more strongly than public procurement. The past five years featured significant reforms in the federal government's procurement statutes and regulations,[4] and many recent changes seek to align public purchasing policy with rules and practices that govern contracting in the commercial marketplace.[5]

Advocates of these adjustments and related measures have expressed great confidence in the capacity of new administrative techniques to transform the relationship between the government and its suppliers. Clinton administration officials responsible for procurement policy have embraced the view that recent reforms will enable government purchasing agencies to copy commercial practices by forming "partnerships" with their best suppliers.[6] Senator John Glenn, a major sponsor of various procurement reform measures, said "[t]here's no reason we can't have procurement processes that are every bit as efficient as our private corporations."[7]

MACHINE 9 (Donald F. Kettl & John J. Dilulio Jr., eds., 1995) (describing reform objectives of National Performance Review).

2. *See generally* NATIONAL PERFORMANCE REVIEW, FROM RED TAPE TO RESULTS: CREATING A GOVERNMENT THAT WORKS BETTER & COSTS LESS (1993) (discussing cutting red tape in government) [hereinafter NPR REPORT].

3. *See* NATIONAL PERFORMANCE REVIEW, IMPROVING REGULATORY SYSTEMS — ACCOMPANYING REPORT OF THE NATIONAL PERFORMANCE REVIEW 26 (Sept. 1993) ("The President should direct agency heads to use innovative regulatory approaches whenever they are appropriate....Wider use of such approaches to regulation can lower the costs of meeting regulatory goals by giving regulated entities more flexibility and increasing the economic efficiency of regulations.").

4. *See* William E. Kovacic, *Evaluating the Effects of Procurement Reform*, PROCUREMENT LAW. 1 (Winter 1998) (discussing recent reforms in government contracting).

5. *See* NPR REPORT, *supra* note 2, at 28 (stating that one aim of NPR is to rewrite Federal Acquisition Regulations to "foster competitiveness and commercial practices"); *see also* William E. Kovacic, *Procurement Reform and the Choice of Forum in Bid Protest Disputes*, 9 ADMIN. L.J. AM. UNIV. 461, 466 (1995) (suggesting that legal regime controlling private contracting provides appropriate baseline for evaluating rules for public contracting).

6. *See Agencies Asked to Test Evaluation Subfactor to Reward Contractors Who Suggest Ways to Improve RFPs*, 63 Fed. Cont. Rep. (BNA) 10 (Jan. 9, 1995) (describing efforts by Steven Kelman, Administrator of Office of Federal Procurement Policy, to enhance partnership relationship between government and its suppliers).

7. Eric Schmitt, *Hoping for Big Savings, Senate Votes to Streamline Purchasing by*

Modern public procurement reforms and other reinvention initiatives coincide with the development of a new, economically-oriented literature relevant to economic regulation and administrative law.[8] This literature has supplied new tools for understanding the existing institutions of administrative law and assessing the impact of specific mechanisms for governing the behavior of public agencies and for controlling firms subject to economic regulatory oversight. The most important of these tools consist of learning in the fields of cost-benefit analysis, game theory, industrial organization, information, principal-agent relationships, and public choice.

This Article uses the example of procurement regulation to suggest how insights of economics literature relevant to public administration can inform the design of legal rules and the institutions entrusted with applying them. The Article considers how reinvention reforms to date have failed to establish conditions necessary to achieve the goal of creating commercial-style partnerships between the government and its suppliers. In particular, the Article focuses on how the existing scheme of procurement regulation discourages the use of relational understandings between the government and its suppliers to reduce the adverse effects of imperfect statutory and regulatory commands.

The Article begins by identifying the sources of efficiency-reducing laws and regulations and by describing the approaches that government agencies can use to reduce the efficiency losses associated with specific legal commands. Part II explains the importance of relational agreements in permitting regulated firms and regulators to mitigate the adverse effects of efficiency-suppressing legal rules. Part III reviews features of modern procurement regulation that diminish reliance on relational adjustment by procurement regulators and government contractors. This section examines how the use of decentralized enforcement and the application of powerful sanctions to punish apparent deviations from statutes and administrative rules destroys the relational features of government contracts. Part IV analyzes how the loss of relational adjustment may affect the behavior of regulated firms.

Military, N.Y. TIMES, June 9, 1994, at B10.

8. For conceptual overviews of this literature see JEAN-JACQUES LAFFONT & JEAN TIROLE, A THEORY OF INCENTIVES IN PROCUREMENT AND REGULATION (1993); David P. Baron, *Design of Regulatory Mechanisms and Institutions*, *in* II HANDBOOK OF INDUSTRIAL ORGANIZATION 1347 (Richard Schmalensee & Robert D. Willig eds., 1989); Paul L. Joskow & Nancy L. Rose, *The Effects of Economic Regulation*, *in* II HANDBOOK OF INDUSTRIAL ORGANIZATION 1459 (Richard Schmalensee & Robert D. Willig eds., 1989); William P. Rogerson, *Economic Incentives and the Defense Procurement Process*, 8 J. ECON. PERSPECTIVES 65 (1994).

I. EFFICIENCY-REDUCING REGULATION: CAUSES AND RESPONSES

In public contracting and other regimes of economic regulation, legislatures and government agencies sometimes establish legal commands that reduce economic efficiency.[9] Inefficiencies associated with economic regulation arise from a variety of sources. The first is the impossibility of drafting statutes or regulations that precisely condemn only harmful conduct and leave affected parties free to engage in behavior that is benign or beneficial. Statutes and regulations almost invariably tend to prohibit some conduct that is socially desirable.[10] Some degree of overinclusiveness is the inevitable product of the drafter's inability to foresee (and devise administrable standards for addressing) all contingencies that might dictate departures from a given standard.

Second, inefficient regulations can arise from reliance on faulty analytical models, flawed information, or mistaken judgments about the effects of specific forms of intervention. In the late 1960s, the Department of Defense (DOD) adopted policies that mandated the negotiation of a firm fixed-price contract to cover the development and early production phases for several weapons systems.[11] From a theoretical perspective, these policies overlooked the extent to which such pricing formulas created incentives for perverse behavior by weapon system suppliers and government purchasing agencies alike. Moreover, the policies also made insupportably heroic assumptions about the extent to which design-related technical uncertainty — a principal cause of cost increases in weapons development and production — had been eliminated before the terms of the fixed-price contract were established.[12]

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9. *See* STEPHEN G. BREYER, REGULATION AND ITS REFORM 197-314 (1982) (discussing economic inefficiency associated with regulatory schemes designed to abate pollution and to control entry or rates in airline, natural gas, rental housing, and telecommunications sectors); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 523 (4th ed. 1992) (citing examples of statutes and administrative regulations that reduce economic efficiency); DANIEL F. SPULBER, REGULATION AND MARKETS 21-69 (1989) (describing inefficiencies associated with many forms of economic regulation); Thomas K. McCraw, *Regulation in America: A Review Article*, 49 BUS. HIST. REV. 159, 171-75 (1975) (discussing economists' critiques of effects of economic regulation).

10. *See* William M. Landes & Richard A. Posner, *The Private Enforcement of the Law*, 4 J. LEGAL STUD. 1 (1975) (discussing economics of private versus public enforcement of legal rules).

11. *See* William B. Burnett & William E. Kovacic, *Reform of United States Weapons Acquisition Policy: Competition, Teaming Agreements and Dual-Sourcing*, 6 YALE J. ON REG. 249, 261 (1989) (discussing weapons pricing).

12. *See* William E. Kovacic, *Commitment in Regulation: Defense Contracting and Extensions to Price Caps*, 3 J. REG. ECON. 219, 227-28 (1991) (discussing how flawed judgments about level of technical risk to be resolved have contributed to cost overruns on firm

Third, inefficiency can result from a conscious decision to subordinate efficiency to the attainment of non-efficiency objectives. Regulatory policies often seek to reallocate wealth through transfers among consumer and producer groups.[13] The establishment of regulatory commands also serves the credit-claiming desires of legislators and regulatory bureau directors by providing visible events in which proponents of new controls can depict themselves as champions of the public interest. A legislator might realize that a contemplated regulatory statute will raise overall industry costs without commensurate benefits in improved operation, but endorse the measure nonetheless because she can claim credit before voters for appearing to rein in a wayward regulated firm; because the restrictions benefit a politically important subset of all industry participants; or because her support for restrictions can induce affected parties to provide votes and campaign contributions that will facilitate her reelection.[14] In all of these instances, using regulatory commands to accomplish wealth transfers and facilitate credit-claiming aims can impose efficiency costs.

Finally, the operation of a regulatory program requires the regulator and affected firms to expend resources to implement the regulatory requirements.[15] The cost of obtaining perfect compliance increases as the complexity of the regulatory regime increases. In some cases, complexity takes the form of an internally inconsistent structure of rules that impose contradictory requirements.[16] Public procurement regulations exhibit many such

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fixed-price contracts for weapon system development projects).

13. *See* MICHAEL A. CREW & PAUL R. KLEINDORFER, THE ECONOMICS OF PUBLIC UTILITY REGULATION 99-100 (1986) (discussing how public service commissions sometimes impose rate structures that sacrifice efficiency in order to achieve equity objectives for different groups of users); Joskow & Rose, *supra* note 8, at 1494 (describing how economic regulation seeks to redistribute income among classes of consumers); ROGER SHERMAN, THE REGULATION OF MONOPOLY 178 (1989) ("There can be no doubt that in their years under regulation the U.S. franchised monopolies [such as telephone companies] and other regulated industries where entry was controlled [such as airlines] have had prices that favored some consumers relative to others.").

14. *See* Fred S. McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. LEGAL STUD. 101 (1987) (describing how incumbent legislators indicate support for specific regulatory measures as way to induce potential subjects of regulation to contribute campaign contributions to incumbents).

15. *See* Patrick J. DeSouza, Note, *Regulating Fraud in Military Procurement: A Legal Process Model*, 95 YALE L.J. 390, 403-05 (1985) (discussing hidden costs and perverse incentives associated with implementing Department of Defense regulation of acquisitions).

16. *See, e.g.*, NPR REPORT, *supra* note 2, at 26 (stating "our [procurement] system relies on rigid rules and procedures, extensive paperwork, detailed design specifications, and multiple inspections and audits. It is an extraordinary example of bureaucratic red tape"); COMMISSION ON GOVERNMENT PROCUREMENT, I REPORT OF THE COMMISSION ON GOVERNMENT PROCUREMENT 31 (1992) (discussing public procurement regulation, noting existence of "a burdensome mass and maze of procurement and procurement-related regula-

inefficiencies.[17] In the 1980s, Congress and the DOD established numerous requirements that raised the cost of executing contracts with government agencies while offering few offsetting benefits.[18]

At some point in the relationship between the firm and its regulators, the costs of adhering to inefficient rules become apparent. Where the choice of an inefficient strategy is inadvertent, the fact and magnitude of the costs emerge in the course of day-to-day operation under the existing regulatory regime.[19] If such costs are substantial, regulators may seek to reduce them. Where the sacrifice of efficiency is deliberate, the full cost attributable to lost efficiencies likewise becomes evident over time. Here the firm's public overseers may try to have things both ways: to continue the nominal pursuit of non-efficiency goals while finding ways to diminish efficiency losses, thereby avoiding either raising rates to account for higher costs or minimizing injury to a firm that is being denied reimbursement for legitimate costs of doing business.

Parties to the "administered contracts" that characterize many forms of regulation can take several approaches in minimizing efficiency losses re-

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tions"); JAMES F. NAGLE, FEDERAL PROCUREMENT REGULATIONS: POLICY, PRACTICE AND PROCEDURES 532 (1987) (stating federal procurement regulations "are a mine-studded labyrinth bewildering and dangerous to government and contractors alike").

17. *See* JACQUES S. GANSLER, DEFENSE CONVERSION 137-50 (1995) (discussing inefficiencies of existing procurement regulatory controls).

18. *See* JACQUES S. GANSLER, AFFORDING DEFENSE 108-109 (1989); FRED THOMPSON & L.R. JONES, REINVENTING THE PENTAGON 179-92 (1994) (discussing policy behind defense cuts); THOMAS L. MCNAUGHER, NEW WEAPONS, OLD POLITICS: AMERICA'S MILITARY PROCUREMENT MUDDLE 127-128 (1989); WILLIAM E. KOVACIC, *The Sorcerer's Apprentice: Public Regulation of the Weapons Acquisition Process, in* ARMS, POLITICS, AND THE ECONOMY: HISTORICAL AND CONTEMPORARY PERSPECTIVES 104, 120 (Robert Higgs ed., 1990) (discussing economic ramifications of defense spending); William E. Kovacic, *Regulatory Controls as Barriers to Entry in Government Procurement*, 25 POL'Y SCI. 29, 30 (1992) [hereinafter Kovacic, *Regulatory Controls*]; Fred Thompson, *Deregulating Defense Acquisition*, 107 POL. SCI. Q. 727, 730 (1992-93) (explaining regulation of military purchases).

19. In the field of public utility regulation, decades of experience with cost-based, rate-of-return regulation revealed that cost-based reimbursement schemes gave regulated firms weak incentives to reduce costs. Awareness of the size of efficiency losses resulting from weak cost-reduction incentives motivated public officials to experiment with price cap regulation for regulated utilities. On the efficiency properties of price caps, see Timothy J. Brennan, *Regulating by Capping Prices*, 1 J. REG. ECON. 133 (1989); Louis M. B. Cabral & Michael H. Riordan, *Incentives for Cost Reduction Under Price Cap Regulation*, 1 J. REG. ECON. 93 (1989). For a discussion of the influence of academic commentary concerning price caps and rate-of-return regulation on changes in government policy for telecommunications carriers, see Ronald A. Cass & Jack M. Beermann, *Throwing Stones at the Mudbank: The Impact of Scholarship on Administrative Law*, 45 ADMIN. L. REV. 1, 17-18 (1993).

sulting from efficiency-reducing regulations.[20] First, the regulatory authority may formally amend its rules or, in the case of a statute, recommend modification or repeal.[21] For a number of reasons, such an approach may be unattractive. Altering regulations or statutes ordinarily can consume substantial time and force the public authority to expend significant administrative resources and political capital. When it seeks to adjust its own regulations, the regulatory agency usually must announce its intentions, solicit views of affected parties, hold hearings, issue decisions, and withstand judicial review. Regulated firms that seek changes in statutes or regulations typically must devote extensive effort to persuading regulators or legislators to make the desired adjustment.[22] By alerting beneficiaries of the *status quo* to the possibility that a favored restriction might be relaxed, attempts at formal modification can catalyze powerful political resistance.[23]

A second approach, discussed more fully below, is for the public authority to exploit the relational features of the regulatory contract by signaling to the firm that it may depart from nominal regulatory requirements. This approach can implement changes more rapidly than attempts at formal modification and can accomplish the adjustments with substantially less transparency to external observers. Legislators also might find this method appealing since it allows them to take credit for sponsoring the nominal re-

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20. *See* Keith J. Crocker & Scott E. Masten, *Regulation and Administered Contracts Revisited: Lessons from Transaction-Cost Economics for Public Utility Regulation*, 9 J. REG. ECON. 5 (1996) (surveying modern economic literature that examines role of transaction costs in determining rules of relationship between regulated firms and their regulators); Victor P. Goldberg, *Regulation and Administered Contracts*, 7 BELL J. ECON. 426 (1976) (analyzing relationship between regulated firm and its regulator as administered contract).

21. The shift from imposing abatement requirements on all emissions sources to reliance on tradable emissions permits to control air pollution has resulted from a combination of administrative decisions by the Environmental Protection Agency (EPA), and amendments to the Clean Air Act by Congress. *See* Robert W. Hahn & Gordon L. Hester, *Where Did All the Markets Go? An Analysis of EPA's Emissions Trading Program*, 6 YALE J. REG. 109 (1989) (describing and evaluating EPA's use of tradeable emissions permits as technique for controlling air pollution); Robert H. Patrick, *Environmental Regulation Effects on Utility Profitability and Direction: Emission Allowance Endowments and Markets*, *in* ECONOMIC INNOVATIONS IN PUBLIC UTILITY REGULATION 81 (Michael A. Crew ed., 1992) (discussing impact of emissions trading provisions of 1990 amendments to Clean Air Act).

22. *See* Thomas M. Palay, *Avoiding Regulatory Constraints: Contracting Safeguards and the Role of Informal Agreements*, 1 J.L. ECON. & ORG. 155 (1985) (discussing use of informal, legally unenforceable contracts to avoid regulatory constraints).

23. The Federal Trade Commission (FTC) recently abandoned a measure to weaken standards that manufacturers must satisfy before labeling their goods as "Made in the USA." The FTC's proposal that goods containing as much as 25% foreign content could be called "Made in the USA" provoked overwhelming opposition in Congress. *See* Bruce Ingersoll, *FTC Reverses Its Plan to Relax Policy Governing Some 'Made in USA' Labels*, WASH. POST, Dec. 2, 1997, at A6.

quirements without forcing the firm to abide by restrictions that are known to be costly, because they either penalize operating efficiency or undermine the regulated firm's health. The efficiency-reducing impact of ill-conceived regulatory controls can be reduced by telling the firm that such requirements will not be rigorously enforced or will be ignored altogether.

II. THE ROLE OF RELATIONAL FEATURES IN RESPONDING TO EFFICIENCY-REDUCING REGULATORY COMMANDS

Virtually all contracts possess what researchers in business behavior and microeconomics refer to as "relational" features.[24] Considered from this perspective, the bare written terms of an agreement provide only a general structure for ordering the parties' affairs. Customs or understandings that permit the parties to respond to contingencies that the written document either treats ambiguously or fails to address at all govern day-to-day dealings. The costs of attempting to draft a "complete" agreement *ex ante* or redraft the contract *ex post* to account for new contingencies usually impel the parties to rely upon adjustment mechanisms that do not involve formal amendments to the original written agreement.[25]

The idea that regulators and regulated firms might use relational adjustment processes to order their affairs often has a sinister connotation.[26] Public regulators often are described as victims of capture by the regulated firm, so that government officials voluntarily bend the rules for companies they oversee and refrain from attacking deviations from established statu-

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24. *See* Stewart MacCauley, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963) (discussing use and non-use of contracts in creating exchange relationships and in settling disputes); Victor P. Goldberg, *Relational Exchange: Economics and Complex Contracts*, 23 AM. BEHAVIORAL SCI. 337, 338 (1980) (presenting essential elements of relational exchange framework); Keith J. Crocker & Kenneth J. Reynolds, *The Efficiency of Incomplete Contracts: An Empirical Analysis of Air Force Engine Procurement*, 24 RAND J. ECON. 126 (1993) (exploring contractual relationships from economic perspective).

25. Parties to long-term contracts sometimes commit themselves to engage in "cooperative readjustment" by which a contract's nominal terms are relaxed to account for changes in conditions over the life of the agreement. Robert E. Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 CAL. L. REV. 2005, 2024-25 (1987).

26. Many citizens appear to doubt the integrity of the defense acquisition system and the propriety of its participants. Market opinion research done in 1986 for the Packard Commission's study of defense acquisition found that "[o]n average, the public believes that *half* the defense budget is lost to waste and fraud." The survey indicated that "defense contractors are widely perceived to be *especially* culpable for fraud in defense spending." PRESIDENT'S BLUE RIBBON COMMISSION ON DEFENSE MANAGEMENT, A QUEST FOR EXCELLENCE: FINAL REPORT TO THE PRESIDENT BY THE PRESIDENT'S BLUE RIBBON COMMISSION ON DEFENSE MANAGEMENT 76 (June 1986).

tory or regulatory norms.[27] In public procurement regulation, hesitation and caution by law enforcement agencies to investigate or prosecute apparent supplier departures from nominal standards are taken as proof of the government's unwillingness to disturb cozy relationships with entrenched contractors.[28]

This perspective slights the possibility that regulators and regulated firms sometimes agree to ignore or bend formal commands because full compliance with such requirements would entail substantial efficiency losses. In public procurement regulation, it is possible that purchasing agencies sometimes operate by understandings that, in effect, contract around rules for which strict compliance would increase the price that government agencies pay for goods and services. The hesitation of government purchasing agencies and law enforcement officials to challenge certain departures from nominal standards may not reflect unseemly capture or capitulation to regulated firms. Rather, such hesitation may flow from awareness on the part of such officials that some departures from existing rules may reduce prices, improve quality, or speed delivery.

The realization that some deviations from nominal standards are desirable is reflected in many patterns of law enforcement. Law enforcement officials routinely exercise prosecutorial discretion and ignore some conduct that transgresses existing standards. Illustrations of what Richard Posner calls "discretionary nonenforcement" abound.[29] In countless situations, the exercise of prosecutorial discretion to tolerate departures from nominal standards lets the regulator reduce costs associated with statutes and regulations that adopt overinclusive prohibitions.

III. THE MODERN ENFORCEMENT ENVIRONMENT

During the 1980s, Congress responded to episodes of defense contractor misconduct or unsatisfactory performance by enacting a vast body of new

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27. *See* DeSouza, *supra* note 15, at 392 (observing that public regulators may overlook seemingly low price bids or minor fraud to maintain illusion of flourishing program and to maintain government funding).

28. *See* WALTER ADAMS & JAMES W. BROCK, THE BIGNESS COMPLEX 327-47 (1986) (discussing effect of "coalescing power" between armed services and suppliers of weapon systems).

29. POSNER, *supra* note 9, at 600:

> Discretionary nonenforcement is a technique by which the costs of overinclusion can be reduced without a corresponding increase in underinclusion....The police overlook minor infractions of the traffic code; building inspectors ignore violations of building code provisions that, if enforced, would prevent the construction of new buildings in urban areas; air traffic controllers permit the airlines to violate overly stringent safety regulations involving the spacing of aircraft landing at or taking off from airports.

Id.

regulatory controls. In 1988 alone, for example, Congress passed eight statutes embodying major substantive changes to the regulatory framework governing the conduct of the DOD and its suppliers.[30] As a group, the existing body of procurement statutes and regulations establish an extraordinary array of commands governing government contractors. Among other commands, suppliers are required to comply with hundreds of specific requirements that regulate behavior concerning cost and pricing choices, employment decisions, payments to foreign agents, the use of foreign-made inputs in manufacturing, the allocation of subcontracts to firms owned by specific social groups and programs to control drug abuse.[31] Despite streamlining reforms of the 1990s, both the basic statutory commands and their implementing regulations are exceedingly complex and entail substantial compliance costs.

As Congress increased the number of rules with which regulated firms must comply, Congress also strengthened the means by which compliance with such restrictions would be monitored.[32] A common regulatory technique is to require the contractor to sign a certificate warranting that he has complied with a specific regulatory requirement.[33] Signing a certificate is an important event because the government's discovery that the representations underlying the certificate are incorrect can (and often does) lead to a criminal inquiry.[34]

A second monitoring innovation has been to enlist private parties, such as the firm's employees and its suppliers, to identify and prosecute instances of misconduct. In 1986, Congress bolstered the *qui tam*[35] mechanism of the False Claims Act[36] to provide substantial bounties and other incentives to individuals (called relators) who provide evidence that contractors have presented the government with fraudulent claims for pay-

30. *See* Burnett & Kovacic, *supra* note 11, at 313 & n.223 (documenting procurement statutes adopted in 1988).

31. John W. Whelan, *Reflections on Government Contracts and Government Policy on the Occasion of the Twenty-Fifth Anniversary of the Public Contract Law Section*, 20 PUB. CONT. L.J. 1, 7-9 (1990).

32. *See* Steven D. Overly, *Government Contractors Beware: Civil and Criminal Penalties Abound for Defective Pricing*, 20 LOY. L.A. L. REV. 597 (1997) (discussing expansion of compliance oversight mechanisms and sanctions for misconduct).

33. *See id.* at 597 (detailing certification process).

34. *See* W. Bruce Shirk et al., *Truth or Consequences: Expanding Civil and Criminal Liability for Defective Pricing of Government Contracts*, 37 CATH. U. L. REV. 935, 951 (1988).

35. *Qui tam* is an abbreviation of the Latin phrase *qui tam pro domino rege quam pro si ipso in hac sequitur* meaning "who sues on behalf of the King as well as for himself." BLACK'S LAW DICTIONARY 1251 (6th ed. 1990).

36. False Claims Amendments Act of 1986, Pub. L. No. 99-562, 100 Stat. 3153 (codified at 31 U.S.C. §§ 3729-3731 (1994)).

ment.[37] Since 1986, the prospect of massive recoveries and the availability of attorneys' fees have combined to generate numerous *qui tam* lawsuits against suppliers of goods and services to federal agencies.[38]

The expansion of regulatory commands and the enhancement of tools for monitoring compliance have been accompanied by major increases in the sanctions for violations. Among the most important changes in economic regulation since 1980 has been a substantially greater emphasis on criminal prosecution to punish and deter departures from nominal standards. Criminal inquiries and prosecution are ever more common methods for addressing certain conduct (for example, alleged failures to comply with mandated cost accounting conventions, cost disclosure obligations, or pollution abatement requirements) that once were treated almost exclusively through civil dispute resolution procedures.[39]

Recourse to criminal prosecution assumes greater importance because penalties for criminal violations have become progressively more severe. For example, the procurement regulatory reforms of the 1980s established higher maximum sentences and fines for both individuals and corporations.[40] The implementation of the United States Sentencing Commission's Sentencing Guidelines[41] has raised the likelihood that individuals convicted of federal crimes (such as deliberately overcharging federal purchasers of goods or services) will serve time in prison and that guilty organizations will pay large fines.[42]

Congress also has significantly enhanced civil sanctions during the same period. The 1986 False Claims Act Amendments penalizes violations with a civil penalty of $5,000 to $10,000 per false claim (up from $2,000 before

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37. *See* William E. Kovacic, *Whistleblower Bounty Lawsuits as Monitoring Devices in Government Contracting*, 29 LOY. L.A. L. REV. 1799 (1996) [hereinafter Kovacic, *Whistleblower*]. The *qui tam* mechanism entitles the regulator to between 15-30% of all funds the government recovers. The False Claims Act also provides for the payment of attorneys fees to prevailing relators and creates safeguards against retaliation by the relator's employer.

38. From the end of World War II until 1986, *qui tam* filings averaged two or three cases per year. In the first decade of experience under the False Claims Act Amendments of 1986, over 1200 *qui tam* suits were filed. *See id.* at 1801 n.14 (noting that 1229 *qui tam* lawsuits had been filed through Mar. 15, 1996).

39. *See* KENNETH L. ADELMAN & NORMAN R. AUGUSTINE, THE DEFENSE REVOLUTION 149 (1990) (finding shift from reliance on "discussion and negotiation" to resolve "matters of interpretation, or even minor administrative errors" to greater recourse on criminal oversight).

40. *See* 18 U.S.C. §§ 3571-3574 (1994) (detailing amount of fines).

41. Sentencing Reform Act of 1984, Pub. L. No. 98-473, 98 Stat. 1837 (codified as amended at 18 U.S.C §§ 3551-3568 and §§ 991-998 (1994)) (stating general rules for sentencing, probation and appeals).

42. *Id.*

1986) and three times the amount of actual overcharges.[43] Specific episodes of misconduct routinely are the subject of both criminal proceedings and civil penalty actions.[44]

IV. CONSEQUENCES OF INCREASED ENFORCEMENT OF NOMINAL COMMANDS

The developments described above greatly increase the hazards for regulated firms that deviate from standards embodied in existing statutes and regulations. The expansion of monitoring mechanisms (particularly the decentralized *qui tam* procedures) increases the likelihood that departures from nominal regulatory requirements will be detected. At the same time, augmented criminal and civil sanctions raise the probability that deviations will be punished severely.

These changes reflect an assumption that deliberate departures from regulatory norms invariably or typically contradict the interests of taxpayers or consumers. Some episodes of challenged misconduct involve unambiguously harmful behavior,[45] yet the strengthening of monitoring devices and sanctions has ignored the possibility that some conduct identified as fraud may involve efficiency-enhancing efforts by the regulator and the regulated firm to contract around ill-conceived regulatory requirements. Expansive reliance upon decentralized enforcement schemes (such as *qui tam* actions under the False Claims Act) denies government purchasing agencies and the Department of Justice the discretion to decline to prosecute deviations from procurement regulations to avoid forcing regulated firms to comply with welfare-reducing requirements.[46]

By increasing the likelihood that departures from all procurement rules (wise or foolish) will be challenged, *qui tam* monitoring may increase the enforcement of standards whose application reduces the efficiency of sup-

43. 31 U.S.C. § 3729(a). *See* S. REP. NO. 99-345, at 39 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5266, 5267.

44. WILLIAM P. RUDLAND, DEFECTIVE PRICING IX-50 (1st ed. 1990) (discussing how violations of federal cost disclosure requirements can result in civil and criminal liability for false claims); W. Bruce Shirk & Bennett D. Greenberg, *An Analysis of the Web of Civil and Criminal Liability for Defective Pricing of Contracts*, 33 CATH. U. L. REV. 319 (1984) (examining different ways contractors may be found guilty of criminal and civil liability by submitting inaccurate pricing data).

45. *See* ADELMAN & AUGUSTINE, *supra* note 39, at 151 (stating "[t]he sad truth is that there *have* been a number of cases in recent years of clear abuse by individuals and firms in the defense industry as well as by a very few individuals in government").

46. *See* Kovacic, *Whistleblower*, *supra* note 37, at 1834-38 (discussing circumstances in which purchasing agencies and Justice Department might decline to prosecute to avoid forcing firms to fulfill regulatory commands whose application would increase costs paid by government buyers).

pliers and purchasing agencies alike.[47] The combination of decentralized prosecution and substantial bounties will generate higher levels of enforcement of all legal commands, regardless of the actual harm of violations to society.[48] Bounty hunting can deny public enforcement officials discretion to reduce the adverse effects of ill-conceived measures through selective prosecution or *de facto* non-enforcement.[49] Because the drafter of statutes or regulations no longer can count on prosecutors to correct unduly expansive prohibitions by refusing to enforce the law, decentralized enforcement schemes place a premium upon ensuring that all nominal legal commands are narrowly circumscribed to address only genuinely harmful behavior.

The prospect of increased decentralized enforcement and recourse to powerful civil and criminal sanctions is likely to change regulated firm behavior in two principal ways. First, contractors are likely to expend additional sums to ensure that all features of their dealings with the regulators are conducted strictly by the book. Working to the rules can increase overall project costs, either in the form of increased expenditures to satisfy meaningless requirements or in the form of delays associated with implementing safeguards to ensure complete compliance. One also can expect the firm to expend more resources in interpreting regulatory requirements to ensure that a contemplated course of action is consistent with existing norms.

Second, regulated firms are likely to insist more frequently upon written waivers or formal modifications of existing standards before undertaking any conduct that might be characterized as a deviation from regulatory requirements. Measures that increase the probability of prosecution (for example, by decentralizing prosecutorial authority) and boost the severity of punishment can rob the regulatory agency/regulated firm relationship of its relational features because depending upon informal adjustment and accommodation processes can expose the firm to dangerous subsequent legal attacks. The costs of the regulator and the regulated firm increase as the parties resort more extensively to formal techniques for modifying regula-

47. *See* John R. Lott, Jr. & R. D. Roberts, *Why Comply: One-sided Enforcement of Price Controls and Victimless Crime Laws*, 18 J. LEGAL STUD. 403 (1989) (discussing impact of decentralized, private enforcement of price control laws).

48. *See* Kovacic, *Whistleblower*, *supra* note 37, at 1812-25 (discussing effect of decentralized monitoring and bounty hunting).

49. Discretionary nonenforcement can cure problems associated with overinclusive legal commands only where the government alone has power to enforce the law. By eliminating the government's enforcement monopoly, decentralizing the decision to prosecute to third parties precludes reliance on prosecutorial discretion as a tool for adjusting the boundaries of the law. *See* POSNER, *supra* note 9, at 600.

tory or statutory restrictions.[50]

Third, the existence of robust monitoring and enforcement tools is likely to frustrate efforts, adopted pursuant to the NPR, to reinvent government by encouraging government purchasing agencies to use practices that guide commercial contracting. As noted above,[51] one major NPR initiative is to transform government purchaser relationships with suppliers into "partnerships." A second goal is to "[s]implify the procurement process by rewriting federal regulations — shifting from rigid rules to guiding principles."[52] Both steps seek to encourage purchasers and sellers to rely more heavily on relational ties and understandings.

Robust decentralized enforcement and recourse to powerful civil and criminal sanctions will discourage the establishment of partnerships and strong relational ties. The possibility that conduct will be challenged as a deviation from an existing rule (including a "guiding principle"), subjected to ex-post inquiry and, in some instances, punished, will deter firms from building the types of relationships that characterize commercial practice. So long as one partner to the relationship has the ability to imprison employees of the other partner and insists on deputizing the employees of the other partner to monitor deviations from various rules, reliance on relational commitments is likely to be reduced.

Over the medium and long-terms, it is conceivable that expanded monitoring and enforcement could improve the quality of regulation. Encouraging scrupulous compliance with nominal standards could serve to make the full costs of such requirements more transparent. Let us assume that relational adjustment often serves to reduce the inefficient properties of procurement regulations without raising the cost or reducing the quality of goods and services obtained by the government. Without relational understandings to mitigate the costs of inefficient regulation, end users of the regulated good or service are likely to incur higher costs in the form of price increases (as firms comply with cost-increasing requirements and spend more resources to ensure complete compliance). Some deterioration in service quality may occur when, for example, programs encounter delays because firms insist upon formal contractual modifications before deviating from existing norms. By making the full costs of inefficient regulation more visible, expanded monitoring and sanctions may spur reconsideration of existing standards. Most graphically, if compliance costs deter success-

50. *See* Kovacic, *Whistleblower, supra* note 37, at 1840-41 (arguing that greater enforcement imposes costs on private parties and ultimately government).

51. *See supra* note 6 and accompanying text (describing efforts by Steven Kelman, Administrator of Office of Federal Procurement Policy, to enhance partnership relationship between government and its suppliers).

52. NPR REPORT, *supra* note 2, at 28.

ful commercial firms from doing business with government agencies, or induce skilled suppliers to exit government contracting, legislators and regulators may be forced to reassess the existing scheme of statutes and regulations.

The difficulty with realizing such a benefit from expanded detection and punishment is that it is impossible to predict with confidence the point at which the firm's overseers will conclude that the train indeed has left the tracks. Perceptions of a regulatory breakdown may occur only at extraordinary extremes of poor performance (i.e., high cost and low quality), and even then regulatory authorities and legislatures may refuse to acknowledge that the breakdown resulted from ill-conceived regulation, as opposed to intransigence or malfeasance on the part of the regulated firm. Meanwhile, as one awaits recognition that the underlying commands of the existing regulatory regime need repair, one suffers from higher costs and poorer service than would have been realized if relational adjustments to nominal commands had been allowed.

As a second beneficial long-term effect, insisting upon complete compliance might tend to inhibit the imposition of new ill-conceived requirements. Recourse to relational adjustment processes allows legislators to enact facially onerous restrictions in the knowledge that selective enforcement will reduce the actual costs associated with such controls. Relational adjustment permits the legislator to claim credit for championing new restrictions without adding significantly to the cost of the regulated firm's operations. Where relatively complete compliance is anticipated, the legislator, the regulatory agency and the regulated firm all realize that costs will increase. Thus, over the long-term, the supply of ill-conceived regulatory controls could decline.

It is impossible to predict when adverse feedback effects would induce legislators to indulge less frequently in the adoption of new, efficiency-suppressing regulatory requirements. Current experience with the federal government's modern campaign to punish the sale of illegal drugs may indicate how swiftly legislators recognize and respond to a breakdown in a regulatory system and may demonstrate whether past experience is taken into account in devising public policy in the future. The establishment of longer mandatory jail sentences for drug-related crimes has greatly increased the pool of individuals who must be incarcerated. The demand for new prison space appears to be racing well ahead of both current supply and scheduled additions to capacity. The need to appropriate additional funds for prison construction presumably will force Congress to reassess the wisdom of the existing campaign against the drug trade.

The issue for procurement regulation is whether there is a similarly clear feedback mechanism that would serve to identify the cost of sustaining ill-

conceived regulatory commands and elicit changes in existing policies. As suggested above, establishing a convincing causal connection between efficiency-suppressing requirements and a serious deterioration in performance might be extremely difficult and time-consuming. Moreover, given the short-term focus of much legislative decisionmaking, it is hardly evident that even widely recognized episodes of policy failure would discourage future recourse to similarly flawed strategies in the future. Thus, there are considerable risks to waiting for a regulatory system to collapse to motivate legislators to change existing restrictions for the better and fundamentally to alter future policymaking.

CONCLUSION

Since the early 1980s, suppliers of goods and services to government bodies frequently have found themselves the subjects of inquiries and prosecutions dealing with what are alleged to be fraudulent failures to abide by regulatory commands. The dramatic expansion of investigative tools and sanctions to combat fraud by government suppliers has focused increased scrutiny on relational departures from stated regulatory norms. In particular, the enhancement of whistleblower bounty mechanisms that deputize a firm's employees to monitor regulatory compliance, and expanded recourse to criminal enforcement of public regulatory commands, have greatly raised the likelihood that deviations from formal requirements will be detected and punished severely.[53]

Aggressive efforts to combat departures from nominal restrictions discourage reliance upon the relational features of regulatory contracts. In this environment, regulated firms increasingly will work to the rules by foregoing conduct that either clearly deviates from regulatory requirements or may be deemed, in an ex-post inquiry, to have transgressed existing commands. This will increase the cost of performance by regulated firms, as firms comply strictly with nominal regulations until formal modifications have been adopted. In the longer term, working to the rules may make the full costs of suboptimal regulations more visible. Such a development ultimately may increase pressure upon legislatures and public regulatory bodies to revise existing restrictions and to move more cautiously in deciding whether to impose new commands.

53. *See* Kovacic, *Regulatory Controls*, *supra* note 18, at 34-36 (discussing impact of *qui tam* monitoring and criminal enforcement).