

**Praxis Series**  
**Volume I, Issue IV**

# **Government Contracting and Competition – Another Principal-Agent Problem**

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## **Government Contracting and Competition – Another Principal-Agent Problem**

Most analyst and policy wonks do not consider the issues of government contracting as a form of Principal-Agent problem. A principal-agent problem is “a dilemma that arises whenever one party (the principal) employs another (the agent) to a job for him.” Contracting/acquisition/procurement whether for information technology, financial services, or any of a myriad of other support functions covered today under the broad lexicon of outsourcing would be subject to dilemmas of the principal-agent problem type. The problem: How to ensure that the agent acts in the best interests of the principal on whose behalf and with whose resources they (the agent) are employed. One of the most common means of attempting to align principal and agent interests is to design a contract with incentives that track to agent performance.

While incentive-based contracting has been in wide use throughout the government marketplace, either through the use of incentive fees or award fee contracts, the efficacy of its impact has been, heretofore, limited. Use of fee as a performance achievement tool (incentive) has often been limited in its impact, in part because it is seldom used and in part because even when used; contractors have found creative ways to circumvent the impact on profits.

There has, however, been recent innovation in the way in which government - particularly federal - procurements are conceived and structured thereby improving the alignment of principal-agent interests. This innovation has taken the name “performance-based contracting (PBC)”. Performance-based contracting actually attempts to align agency/department mission achievement with agent compensation, and in so doing reduces (though does not eliminate – more below) the agent propensity to act in and according to a plan that is counter to the government’s interests (the principal). PBC addresses, when properly conceived and implemented, the problem of agent interest more effectively than many prior approaches.

**What is Moral Hazard?** - The risk that a party to a transaction has not entered into a contract in good faith, has provided misleading information about its assets, liabilities, or credit capacity, or has an incentive to take unusual risks in a desperate attempt to earn a profit. In the federal space we are most concerned with the last of these types of moral hazard. A climate of moral hazard is one in which agents expect a third party to shoulder the risks associated with their higher risk behavior.

PBC does not replace the government’s requirement for continuous program performance monitoring. In fact, one consequence of the PBC approach can be to increase the requirements for post-award performance IV&V. Ideally the initial contract will specify the measures that will be used to gauge performance success, and require the agent (the contractor) to provide performance reports as contract deliverables upon which payment is contingent.

Yet, even with the PBC innovations – and innovations they are – their remain a number of principal-agent related problems – the most significant being the basic knowledge held by a number of key contractors that make them “effectively” indispensable in both the short- and the medium-term. The government contracting approach, in some instances, creates one of the more interesting market situations, a combination of two market types from an economist’s perspective – monopoly and monopsony concurrently.

Monopoly – the situation in which only one supplier exists in a market and therefore may exert substantial influence on the prices that may be charged. The federal government, PBC or no PBC, regularly executes single award contracts that translate into single supplier arrangements. Contract arrangements that amount to an effective monopoly for particular requirements - particularly in the short- to medium-term. This is particularly pronounced for the DOD and Intelligence community, although examples may be found throughout the federal space. Agents (a return to our lexicon) that find themselves in a monopoly supplier relationship, regardless of an existing and well-constructed PBC contract structure, may find themselves better served (interest) by using the associated monopoly power to alter the prevailing arrangements favorably.

Yet in the federal space the principal has more than simple contractual leverage over the agent in a number of instances. Competition plays a role in checking this behavior and its extremes to a degree. However, concurrently because upfront competition for “monopoly” contracts - that effectively “lock-in” the business for long periods of time are highly attractive – is fierce the competitors often take additional risk in their proposals (betting on the future is one common characteristic) to secure the contract. The threat of competition may linger and occasionally the losing bidder finds creative and innovative ways to place pressure on the winner or to threaten the winner’s long-term revenue stream with substitute or leap-ahead technology. Boeing loss of the JSF was followed a new or renewed emphasis on the unmanned combat aircraft as an example.

Contrast the monopoly supplier, with a federal government that is the only purchaser of certain types of technology and services – making it a de facto monopsony. This is particularly true for certain intelligence and DOD systems. The existence of a single buyer (a one principal market) creates counter leverage over the sellers, at least in the initial competitive sourcing period of the procurement process. The government buyer has market power (beyond that of simple consumer discretion) to shape the requirements, define many of the terms and conditions and in a PBC environment to influence the adherence of performance to customer objectives and the definition of measurement that will be used to assure program success. The fashion in acquisition has been for the principal (the department) to create a Statement of Objectives (SOO), defining what its objectives in any procurement are rather than attempting to tell the agent (the contractor) how to run its business or build the next breadbox. It remains to be seen how far the SOO model can be used to penetrate certain market segments such as military aerospace. Nonetheless, the monopsony and

monopoly market type characteristics co-exist, one more prominent than the other depending on the stage in the procurement process.

The backdrop to this discussion adds one more problem to the fabric of the principal-agent dilemma - the existence of moral hazard in some federal contracting environments. Moral hazard arises when an agent believes that it may behave in higher risk fashion because ultimately it will not be required to bear the full costs of this behavior. Particularly within the DOD and Intelligence Community (IC) environments there is an oligopoly of supply (generally) as opposed to the aforementioned contract-specific monopoly positions. The knowledge and capability to perform particular types of work is highly concentrated in a few companies. The government also practices something known as “sole source” contracting in which the vendor effectively does not have to compete for the work, these contracts tend to be awarded on a cost-plus basis with limits on the profit margins which the government is willing to pay. Sole source contracts are not the subject of this paper, although a degree of moral hazard can even be found in this environment to the extent the rate creep (over decades) amounts to a corporate premium (not profit) linked to the performance of esoteric work (some would call it the cost of unique knowledge) others would suggest conducting some form of reverse A-76.

Companies will take extra-ordinary business (financial) risk with the knowledge that the government customer is highly unlikely to allow them to collapse or fail. This knowledge, that for particular programs the customer cannot permit the company to cut its losses and move-on, creates conditions of moral hazard that underpin behavior in this market environment. Moreover, certain companies cannot be permitted to fail for perfectly legitimate national reasons; unfortunately this knowledge is built into their behavior. Competition curbs some behavior in the initial stages, as does the monopsony position of the government, but ultimately only the threat to future business in the form of reduced capture of “monopoly” type contracts restrains behavior (emphasis on restraint). The question becomes how to achieve the objectives of the principal in light of the dilemma of interest associated with the agent in the context of moral hazard. PBC, properly implemented and supported, provides an answer to this dilemma in many contexts but it cannot overcome completely the realities of the prevailing market environment. Nor is it clear that the marginal utility of attempting to solve the principal-agent problem completely is sufficient. One thing is clear; competitors (agents) and procurement officials (principals) need to understand this context and the implications that these market characteristics generate in behavior and outcomes.