

# PUBLIC PROGRAMS, PRIVATE FINANCING

MARGARET H. LEMOS\* & GUY-URIEL CHARLES\*\*

## I

### INTRODUCTION

What sorts of organizations should we rely on to deliver goods and services to the public? Economic theory typically divides the universe of options into three sectors: the private market, the public sector, and the nonprofit or philanthropic sector.<sup>1</sup> Each sector has unique strengths and weaknesses, and none is capable of dealing effectively with the full range of social problems. The interesting question has always been how to allocate resources and responsibilities among the different sectors so as to harness the strengths and compensate for the weaknesses of each type. One might approach that question by thinking about how organizations from different sectors can complement each other: government, for example, might play a valuable role in correcting private market failures.<sup>2</sup> But it also is possible to imagine hybrid arrangements in which different types of organizations work together, creating a sum that is greater than the whole of its parts. For example, many advocates of privatization argue that the government can deliver public goods more efficiently if it relies on private firms to do some or all of the work.<sup>3</sup> On that view, combining the government's political decision-making processes and power of compulsory taxation with market competition and profit motive produces results that surpass what either the public or private sector could accomplish in isolation.

This article examines a different approach to hybridization—one in which for-profit investment and/or philanthropic donations are used to fund government. The first combination, commonly known as a “public-private partnership,” has been prevalent in other parts of the world at least since the 1990s, and is on the rise in the United States.<sup>4</sup> The second, dubbed “patriotic philanthropy” by one of

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\* Robert G. Seaks LL.B. '34 Professor of Law, Duke University.

\*\* Edward and Ellen Marie Schwarzman Professor of Law, Duke University.

1. *See generally, e.g.*, BURTON A. WEISBROD, *THE NONPROFIT ECONOMY* (1988) (situating nonprofits alongside government and the private market in a three-sector economy).

2. *See infra* Part I.

3. *See, e.g.*, Jon D. Michaels, *Privatization's Progeny*, 101 *GEO. L.J.* 1023, 1030–34 (2013) (describing efficiency rationales for privatization of government functions).

4. *See, e.g.*, MOODY'S INVESTORS SERV., *PUBLIC-PRIVATE PARTNERSHIPS: GLOBAL P3 LANDSCAPE* 9–10 (Sept. 8, 2014) (describing the expanding public-private partnership market in the U.S.).

its most prominent practitioners, likewise shows signs of growth.<sup>5</sup> Public-private partnerships have received substantial attention in the already-vast literature on the privatization of government functions.<sup>6</sup> Most treatments, however, focus on the promise and peril of relying on profit-motivated firms to produce or deliver public services and amenities; the implications of private financing are of secondary concern. Meanwhile, patriotic philanthropy has flown almost entirely below the academic radar, perhaps because it is difficult to find fault with gifts, or because the phenomenon is decentralized and difficult to track.<sup>7</sup>

The goal of this article is to begin to trace some of the consequences of public reliance on private funding. Commentators focused on campaign finance and lobbying have explored similar questions that arise when public officials are dependent on private money for political support.<sup>8</sup> Those explorations provide some insights into the incentives of government officials who face, for example, the prospect of large donations to support new public initiatives. But private financing for government programs also raises a distinct set of concerns about government capacity, and about the important differences between modes of funding that are collective and compulsory, on the one hand, and individualized and voluntary, on the other. We cannot hope to give those issues comprehensive treatment in this short essay. Our aim, rather, is to stimulate a conversation about the values at stake in decisions about how—and by whom—public services are funded.

The discussion that follows proceeds in three parts. Part I sketches the conventional divisions between for-profit, governmental, and nonprofit organizations, highlighting some of the most critical advantages and disadvantages of each type. Part II describes public-private partnerships and patriotic philanthropy in more detail. Both hybrid forms appear at first blush to be best-of-both-worlds combinations of public capacity and private initiative. Yet there are reasons for pessimism as well as optimism, and Part II outlines some of

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5. See Margaret H. Lemos & Guy-Uriel Charles, *Patriotic Philanthropy? Financing the State with Gifts to Government*, 106 CAL. L. REV. (forthcoming 2018).

6. See, e.g., Pamela Bloomfield, *The Challenging Business of Long-Term Public-Private Partnerships: Reflections on Local Experience*, 66 PUB. ADMIN. REV. 400 (2006); Dominique Custos & John Reitz, *Public-Private Partnerships*, 58 AM. J. COMP. L. 555 (2010); John Forrer et al., *Public-Private Partnerships and the Public Accountability Question*, 70 PUB. ADMIN. REV. 475 (2010); David W. Gaffey, *Outsourcing Infrastructure: Expanding the Use of Public-Private Partnerships in the United States*, 39 PUB. CONT. L.J. 351 (2010); Paul Landow & Carol Ebdon, *Public-Private Partnerships, Public Authorities, and Democratic Governance*, 35 PUB. PERFORMANCE & MGMT. REV. 727 (2012). On privatization more generally, see, for example, JOHN D. DONAHUE, *THE PRIVATIZATION DECISION: PUBLIC ENDS, PRIVATE MEANS* (1989); *GOVERNMENT BY CONTRACT: OUTSOURCING AND AMERICAN DEMOCRACY* (Judy Freeman & Martha Minow eds., 2009); Michaels, *supra* note 3.

7. See Lemos & Charles, *supra* note 5, at Part II.C (offering a descriptive account of patriotic philanthropy and noting that, although private financing for public education has provoked significant debate, most of it has been focused on the substance of philanthropic interventions rather than the fact of private financing for government programs).

8. See, e.g., LAWRENCE LESSIG, *REPUBLIC LOST: HOW MONEY CORRUPTS CONGRESS—AND A PLAN TO STOP IT* (2012).

the relevant considerations. Part III considers the relationship between private funding and the public treasury. It is tempting to view private financing for government as a supplement to public revenues. That perspective suggests that the effects of private financing should be, at worst, neutral; the public sector should be left no worse off by an infusion of additional funds. We think that view is mistaken. For a variety of reasons, private and public funds may operate as substitutes, not supplements. Part III fleshes out that argument, explaining why private funding may lead to redistributions or contractions of the public fisc.

## II

### SUCSESSES AND FAILURES IN A THREE-SECTOR ECONOMY

Economic theory distinguishes among three types of organizations that provide goods and services to the public: for-profit enterprises, government, and nonprofit or philanthropic organizations. The three types of organizations differ in various ways, including how they derive revenue and what they can do with it. Those differences, in turn, translate into distinctive strengths and weaknesses for each type.

#### A. The Private Sector

Economists long have emphasized the capacity of the private market to devise efficient means of satisfying individuals' wants and needs. As Adam Smith wrote in *The Wealth of Nations*, "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their self-interest."<sup>9</sup> The lure of profit encourages managers to meet consumer demands while minimizing cost. And competition among firms prevents managers from maximizing profit by sacrificing quality or charging excessive prices.

Despite their promise, markets can fail to allocate resources effectively, resulting in a smaller pie than would exist under ideal conditions.<sup>10</sup> There are various types of market failure, most stemming from informational challenges; two are particularly relevant to the discussion here.<sup>11</sup> The first arises when there is an information asymmetry between producers and consumers—when

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9. ADAM SMITH, *THE WEALTH OF NATIONS* 14 (Random House 1937) (quoted in WEISBROD, *supra* note 1, at 45).

10. Julian Le Grand, *The Theory of Government Failure*, 21 *BRITISH J. POL. SCI.* 423, 425 (1991) ("[F]ormally, an allocation of resources is defined as allocatively efficient if it is impossible to re-allocate resources in such a way more persons better off without making someone else worse off: a definition that is also known (after its originator) as Pareto-efficiency.").

11. See, e.g., Charles Wolf, Jr., *A Theory of Nonmarket Failure: Framework for Implementation Analysis*, 22 *J. L. & ECON.* 107 (1979) (identifying some reasons for market failure including externalities, public goods, information asymmetry, and distributional equity). For seminal discussions of market failure, see, for example, JESSE BURKHEAD & JERRY MINER, *PUBLIC EXPENDITURE* 97–144 (1971); Francis M. Bator, *The Anatomy of Market Failure*, 72 *Q. J. ECON.* 351 (1958); Paul A. Samuelson, *The Pure Theory of Public Expenditure*, 36 *REV. ECON. & STATS.* 387 (1954).

producers have more information than consumers about the nature, cost, and quality of goods. In order for competition to combat opportunistic behavior by producers, consumers must be able to distinguish better products from worse ones, and to reward honest sellers by giving those sellers their business. That is easy enough to do when the quality of products is easily observable; consumers can judge for themselves whether one baker's pies are tastier than another's, and spend their money accordingly. The challenge is that some indicia of quality cannot be observed by consumers, or can only be observed with great difficulty. Those sorts of informational challenges can crop up where it is difficult to gauge whether another provider would have performed a particular service better. Legal services offer a ready illustration: a client may find it hard to assess her attorney's performance—was a lawsuit won or lost because of or in spite of the attorney?—or to determine whether another attorney might have been more successful or more efficient with her hours.<sup>12</sup> In circumstances like this, the profit-drive associated with the private market is not a feature but a bug. If producers are pursuing their self-interest, the quest for profit gives them an incentive to cut corners, pad bills, and so on.

A second type of market failure arises from the well-known problem of free-riders. The private market is likely to undersupply so-called collective or public goods—products or services that can be enjoyed by many people regardless of whether they have paid for them. Conventional examples include national defense, environmental protection, and public sanitation measures. Individual consumers may want those things but not be willing to pay for them, or to pay the full cost. Instead, individuals may hope that others will pay and that they will be able to enjoy the benefits for free. Because demand will appear to be low, the private market will tend to produce less of collective goods and services than the public actually wants and needs.<sup>13</sup>

Both types of market failures stand as impediments to an efficient allocation of resources. But private markets have other limitations as well. Although efficiency is the north star in most economic theory, it is not the only relevant value; equity may matter, too. That is, one might care not only about the overall size of the pie, but also how it is sliced and distributed among individuals. There is little reason to believe that private markets are well-suited to serve values associated with distributional equity. On the contrary, “most economists have acknowledged that, even at a theoretic level, the income distribution generated by a private market would not necessarily, or even probably, be ethically desirable, even if all people began life with equal endowments of human and

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12. WEISBROD, *supra* note 1, at 46.

13. This can be understood as a different kind of informational asymmetry—one in which consumers possess more information than producers. *See id.* at 6 (“Consumers, in the aggregate, may highly value particular collective services . . . . But individual consumers may find that self-interest dictates acting as if they cared little, in the hope that others will pay for the services. Consumers do not have the incentive to reveal their true willingness to pay, by making voluntary payments, if they feel that they can benefit from others' contributions.”).

material capital, but especially if they did not.”<sup>14</sup>

## B. The Public Sector

Where private markets fall short—whether with regard to allocative efficiency or distributional equity or both—government can offer a needed curative. Indeed, economists often conceptualize government primarily, if not exclusively, as a means of addressing the shortcomings of the private market. In that framing, the private sector is the default; the role of government, and of private philanthropy, is to cure market failures. One need not adopt that framing, however—nor the implication that a free market is logically prior to the state—to recognize that one of the functions of government may be to supply the goods that private markets are unlikely to provide on their own.<sup>15</sup>

As compared to the private sector, the government offers a different set of strengths and weaknesses. Government officials are paid fixed salaries; they do not take home more money at the end of the year if they figure out a clever way to cut costs, build a better widget, or drum up consumer demand. The upside is that government may be able to avoid the first type of market failure described above: When it comes to goods and services with difficult-to-observe qualities, civil servants may be more trustworthy providers than the managers of for-profit enterprises.<sup>16</sup> And even if the government does not provide the good or service itself, it can regulate in ways that minimize the risk of opportunistic behavior by for-profit providers.<sup>17</sup>

In addition to the power to regulate, government possesses the power to tax, to extract revenues from individuals who may not be willing to pay voluntarily. That means that government can avoid free-rider problems—the second type of market failure described above—simply by compelling individuals to contribute to the financing of public goods. You do not want to chip in on the cost of national defense, public schools and highways, or environmental-protection efforts? Too bad. Taxes are compulsory, and they cannot be avoided on the ground that other people, who may or may not be taxpayers, will also benefit from the services your tax dollars support.<sup>18</sup>

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14. BURTON A. WEISBROD ET AL., *PUBLIC INTEREST LAW: AN ECONOMIC AND INSTITUTIONAL ANALYSIS* 9 (1978).

15. See Barry Bozeman, *Public-Value Failure: When Efficient Markets May Not Do*, 62 *PUB. ADMIN. REV.* 145 (2002) (challenging the market-failure framing).

16. See, e.g., WEISBROD, *supra* note 1, at 43–58

17. See generally, e.g., STEPHEN BREYER, *REGULATION AND ITS REFORM* (1982) (using concepts of market failure to explain and evaluate regulations).

18. See *Johanns v. Livestock Mktg. Ass’n*, 544 U.S. 550, 559 (2005) (“‘Compelled support of government’—even those programs of government one does not approve—is of course perfectly constitutional, as every taxpayer must attest.”); DAVID J. MCCARTHY, JR. & LAURIE REYNOLDS, *LOCAL GOVERNMENT LAW* 382 (2003) (“Taxes are imposed without consideration of whether the individual taxpayer will benefit from the services to be funded by the tax.”).

The government also assesses demand in a markedly different fashion than the private market—by votes, as opposed to willingness and ability to pay. A political decision process that relies on votes rather than payments “allows everyone who is affected by the consumption and production of a good or a service to have a say in its level of provision.”<sup>19</sup> This feature can help government overcome certain types of market failures, because if the consumption or production of a good or service generates externalities—either positive or negative—the political process can take those into account. Likewise, a “one person, one vote” system can promote values associated with equity by weighing everyone’s preferences equally, whereas the “one dollar, one vote” metric in the private sector gives greater weight to those with more dollars to spend.<sup>20</sup>

The fact that the government is capable of stepping in to address market failures does not mean that it will, of course. Moving from the private to the public sector does not mean abandoning concerns about failure so much as renaming them—and so the topic becomes government failure instead of market failure.<sup>21</sup> To begin with, the nature of the political process suggests that government will only provide collective goods that enjoy majority support.<sup>22</sup> But it might fail even to do that. The same collective-action problems that can impede effective private action also can get in the way of valuable government interventions—even those that a majority of citizens would favor. As one commentator observed, “[f]or government to act, substantial segments of the public must be aroused, public officials must be informed, laws must be written, majorities must be assembled, and programs must be put into action.”<sup>23</sup> Those challenges are particularly pronounced when the action in question will bestow

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19. Le Grand, *supra* note 10, at 436.

20. *Id.*; see also WEISBROD ET AL., *supra* note 14, at 34–35 (discussing differences between one-person-one-vote and one-dollar-one-vote demand mechanisms).

21. For extended discussions of government failure, see generally CHARLES WOLF, JR., *MARKETS OR GOVERNMENTS: CHOOSING BETWEEN IMPERFECT ALTERNATIVES* 34–102 (2d ed. 1993); Le Grand, *supra* note 10; cf. Bozeman, *supra* note 15 (discussing a form of government failure that the author calls “public value failures”). The vast literature on public-choice theory is also, of course, relevant to the question of government failure. Seminal works include KENNETH JOSEPH ARROW, *SOCIAL CHOICE AND INDIVIDUAL VALUES* (2d ed. 1963); JAMES BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT* (1962); WILLIAM A. NISKANEN, *BUREAUCRACY AND REPRESENTATIVE GOVERNMENT* (1971); MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* (1965); GEORGE JOSEPH STIGLER, *THE CITIZEN AND THE STATE: ESSAYS ON REGULATION* (1975).

22. Rob Reich, *What are Foundations For?*, BOSTON REV. (Mar. 1, 2013), <http://bostonreview.net/forum/foundations-philanthropy-democracy> [<https://perma.cc/JY9V-AQ35>] (“If a majority of citizens prefer police protection and a minority prefers arts funding, then politicians will vote to fund the police and not the arts. Further, standard models of political behavior in a democracy predict that politicians will fund the public goods preferred by majorities at a level that satisfies the “median voter,” who sits in the middle of the political spectrum. . . . So public funding of the arts may generate plenty of Norman Rockwell, but probably not avant-garde or radical art.”).

23. Lester M. Salamon, *Of Market Failure, Voluntary Failure, and Third-Party Government: Toward a Theory of Government-Nonprofit Relations in the Modern Welfare State*, 16 *NONPROFIT & VOLUNTARY SECTOR* Q. 29, 39 (1987).

benefits on the public at large, or a large and diffuse segment of the public—as will be the case for many collective goods.<sup>24</sup> Just as individuals may prefer to free-ride off of others' willingness to pay for such goods, they may fail to contribute to the political efforts, like organization and lobbying, that are necessary to spur government to action.<sup>25</sup>

Finally, even when government acts, it may fail to act effectively, because the same feature that makes government less likely to exploit unsuspecting consumers—the absence of profit motive—also means that government agents have weak incentives to innovate or to minimize costs.<sup>26</sup>

### C. The Philanthropic Sector

The voluntary, or nonprofit, or philanthropic sector offers an alternative to the private and public sectors, and shares features in common with both. Like private-sector organizations, nonprofits have no power to compel action but must rely on voluntary transfers from individuals and firms. Like government, nonprofits, and the people who run them, are limited in their ability to take advantage of any surpluses they produce.<sup>27</sup>

These features help shape the role that the voluntary sector can play in relation to the private market and the state. On the one hand, the absence of a profit motive reduces the incentives that nonprofit managers and other philanthropists might have to use informational asymmetries to bilk unsuspecting members of the public. As a result, nonprofits—like government—may be better suited than private firms to provide goods and services that lack easily observable indicia of quality. On the other hand, and in contrast to government, nonprofits need not operate under majority rule, but can serve interests that are decidedly minoritarian in orientation.<sup>28</sup> Thus, private philanthropy can offer an important supplement to government, particularly when it comes to producing collective goods that lack majority support or powerful political backing.<sup>29</sup> Rob Reich explains:

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24. See generally OLSON, *supra* note 21.

25. WEISBROD, *supra* note 1, at 5 (“[G]overnment enterprises face political pressures that make them excessively responsive to well-organized demands from industry and other pressure groups but far less responsive to the interests of poorly organized groups such as consumers.”).

26. See, e.g., DONAHUE, *supra* note 6; Michaels, *supra* note 3. Cf. WOLF, *supra* note 21, at 65 (“Where the revenues that sustain an activity are unrelated to the costs of producing it, more resources may be used than necessary to produce a given output, or more of the nonmarket activity may be provided than is warranted by the original market-failure reason for undertaking it in the first place.”).

27. WEISBROD, *supra* note 1, at 41–42.

28. *Id.* at 6–7 (“In a democratic society in which governments tend to be responsive to majority wants, there is a need for institutions that can respond to the demands of persons who feel intensely about particular collective-type activities, such as the preservation of Carnegie Hall or other landmarks, research on muscular dystrophy, or helping native Americans.”).

29. For an empirical analysis see Yoshiho Matsunaga & Naoto Yamauchi, *Is the Government Failure Theory Still Relevant?: A Panel Analysis Using US State Level Data*, 75 ANN. PUB. COOP. ECON. 227 (2004).

In a democratic state, one simple way to predict what public goods will be produced is to look at which public goods are favored by a majority of citizens. . . . Foundations [and other philanthropic organizations] can yield more idiosyncratic results. . . . In a pluralistic democracy, people have diverse preferences about what kinds of goods to supply through the direct expenditure of tax dollars. Powered by donor preferences and free from the accountability logic of the market and democratic state, foundations can help to provide a welcome pluralism of public goods. The diversity of goods supplied by foundation grantees helps to create an ever evolving, contestatory, and diverse arena of civil society. Such decentralization tempers government orthodoxy.<sup>30</sup>

The same features that contribute to the strengths of the voluntary sector also feed into its weaknesses, however—producing what one might think of as voluntary failures.<sup>31</sup> Because nonprofits have to rely on voluntary payments, they run into a similar free-rider problem as the private market. Just like individuals might balk at paying for a good or service if they could reap the same benefits for free if others footed the bill, they might similarly hesitate before donating their money to worthy causes, hoping that other donors would make up the slack. If those potential other donors made the same calculation, the result would be rampant under-funding for nonprofits and their projects. Indeed, the strongest versions of free-rider theory would suggest that there should be very little private philanthropy at all.<sup>32</sup> That is plainly not the reality; the voluntary sector is alive and well in the U.S., flush from a record-breaking \$390 billion in donations in 2016.<sup>33</sup> Nevertheless, the potential for free riding and other obstacles to collective action stands as an impediment to funding collective goods with voluntary individual donations.

Granted, nonprofits need not rely on an aggregation of modest gifts; all it takes is one mega-rich philanthropist or foundation to cut through the Gordian knot of organizational challenges and other transaction costs to get results.<sup>34</sup> But that possibility also highlights another limitation of the voluntary sector: its reliance on wealthy individuals. As one commentator explains, private philanthropy “inevitably vests most of the influence over the definition of community needs in the hands of those in command of the greatest resources . . . . The nature of the sector thus comes to be shaped by the preferences not of the

30. Reich, *supra* note 22.

31. Salamon, *supra* note 23, at 39 (linking the concept of “voluntary failure” to “inherent limitations of the voluntary or nonprofit sector”).

32. TODD SANDLER, *COLLECTIVE ACTION: THEORY AND APPLICATIONS* 108 (1992) (“The large number of contributors associated with many charities raises a conundrum. If charities are providing a pure public good in their philanthropic activities, and if a large number of donors are relied upon for contributions, then the group should be latent and, hence, not form. . . . Yet fund-raising charities exist. Charities collect billions of dollars annually in the United States. . . . Clearly, the standard wisdom, drawn from conventional theories of pure public goods, does not apply to charities.”).

33. *Giving USA 2017 Infographic*, GIVING USA (June 12, 2017), <https://givingusa.org/see-the-numbers-giving-usa-2017-infographic/> [<https://perma.cc/7CE3-W5NB>].

34. *Cf.* Lemos & Charles, *supra* note 5, manuscript at 27 (noting that “philanthropy is becoming more top-heavy and donor-driven, with mega-rich ‘policy plutocrats’ ‘directing not only their money but also their time, ideas, and political leverage toward influencing public policy’” (quoting Kristin A. Goss, *Policy Plutocrats: How America’s Wealthy Seek to Influence Government*, 94 PS: POL. SCI. & POL’Y 442, 442 (July 2016))).



community as a whole, but of its wealthy members. As a consequence, some services favored by the wealthy, such as the arts, may be promoted, while others desired by the poor are held back.”<sup>35</sup>

This problem is compounded in the U.S., at least, by the favorable tax treatment of charitable donations, which amounts to a government subsidy for donors’ chosen projects: The government permits individuals to forego paying a certain amount in taxes by giving the money instead to the organizations of their choice.<sup>36</sup> As U.S. tax law is currently structured, the subsidy is only available to those in higher income brackets who itemize their deductions, and its magnitude increases as incomes and taxes climb higher.<sup>37</sup> Some critics argue that the consequence is a “plutocratic bias,” because “the favored beneficiaries of the wealthy receive the lion’s share of the subsidy.”<sup>38</sup> Others complain that “[m]oney that would otherwise be available for tax revenue that could be democratically directed is shielded from public control for private use.”<sup>39</sup>

A related set of critiques sounds in democracy. Philanthropy can have profound consequences for many people, and yet those people have no means of influencing, much less controlling, the behavior of the philanthropists. As one skeptic put it, “[o]ur functioning democracy, as imperfect as it is, holds to the ideal that all people should have an equal voice.”<sup>40</sup> Philanthropy operates outside of the democratic channels for public input, contestation, and deliberation; success is measured in terms of results, not process.<sup>41</sup>

#### D. Hybridization

The picture sketched here suggests that the private, public, and voluntary sectors sit alongside each other, operating as complements and sometimes as substitutes. Yet there has always been some blending of the categories—hybrid forms in which different types of organizations work together. The tax deduction for charitable donations, described above, can be understood as one form of hybridization, since it operates like a government subsidy for nonprofit organizations. The government also supports nonprofits even more directly by

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35. Salamon, *supra* note 23, at 41.

36. *See generally*, e.g., Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393 (1988).

37. *Id.*

38. Rob Reich, *Toward a Political Theory of Philanthropy*, in *GIVING WELL: THE ETHICS OF PHILANTHROPY* 177, 184 (Patricia Illingworth et al. eds., 2011).

39. Gara LaMarche, *Democracy and the Donor Class*, 34 DEMOCRACY J., Fall 2014, at 3–4; *see also* Salamon, *supra* note 23, at 41 (“Since . . . private contributions are tax-deductible, . . . they have the effect not only of allocating private expenditures, but also of allocating foregone public resources as well, though without the benefit of any public decision process. Not only is this situation undemocratic, but it can also create a self-defeating sense of dependency on the part of the poor since it gives them no say over the resources that are spent on their behalf.”).

40. Robin Rogers, *Why Philanthro-Policymaking Matters*, 48 SOCIETY 376, 377 (2011).

41. *Id.*

contributing to them itself.<sup>42</sup> As a result, private nonprofit organizations play a significant role in delivering the services that the government funds with tax revenues.<sup>43</sup>

Government also can and does use tax policy, favorable interest rates, and other feats of financial wizardry to subsidize private for-profit enterprises. Further, public services have increasingly been privatized, meaning that the government relies on private firms to perform functions that would otherwise be discharged by public-sector employees. In effect, the government takes on the role of consumer who buys a product rather than making it.<sup>44</sup>

We are interested in hybridization of a different type: scenarios in which government programs are funded by private actors, either via for-profit investments or philanthropic donations, or some combination of the two. Such arrangements often result in private actors taking over all or part of service-delivery as well as financing, and in the discussion that follows we address the consequences for both inputs and outputs. Our primary interest, however, is in the consequences of private financing for the public sector. Although there is no shortage of scholarly and popular commentary on the relationship among the three sectors described above—and between public and private more generally—the bulk of it focuses on questions of who or what is delivering goods and services to the public. Financing tends to fly under the radar, not because it is unimportant, but because commentators often assume that collecting and spending tax revenue is the irreducible minimum that government must do itself.<sup>45</sup> That assumption, it turns out, is false. The remainder of this article considers the implications.

### III

#### FOR-PROFIT AND PHILANTHROPIC INVESTMENT IN GOVERNMENT

What are the consequences of bringing for-profit investment and charitable donations into the public sphere? Does private financing for public programs offer best-of-both-worlds opportunities to exploit the advantages of public and private initiative and to avoid the pitfalls associated with each of the sectors? Or

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42. See, e.g., Salamon, *supra* note 23, at 30 (“[G]overnment has emerged as the single most important source of nonprofit income.”); Steven Rathgeb Smith, *Government and Nonprofits: Turning Points, Challenges, and Opportunities*, NONPROFIT Q. (Sept. 21, 2009), <https://nonprofitquarterly.org/author/steven-rathgeb-smith/> [<https://perma.cc/YV6F-YV5R>] (describing government support for nonprofits).

43. Salamon, *supra* note 23.

44. For a discussion of the “make or buy” decision more generally, see Paul L. Joskow, *Vertical Integration*, in HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 319 (Claude Menard & Mary M. Shirley eds., 2008).

45. See, e.g., GERALD E. FRUG ET AL., LOCAL GOVERNMENT LAW 738 (6th ed. 2015) (“Once you begin to take the idea of privatization seriously, you can quickly come to the view that government could be reduced to the performance of three tasks: the collection of revenue by taxation, the choice of services this revenue should buy, and the negotiation and drafting (and, perhaps, the monitoring) of contracts with private businesses for the delivery of the chosen services.”).

does the hybridization undermine what is special about government, or private markets, or philanthropy, without a corresponding bump in benefits? Although this article cannot answer those questions conclusively, this Part and the next outline some of the key considerations, suggesting reasons for both optimism and concern.

### A. Public-Private Partnerships

The first public-private combination we consider is of the for-profit variety: so-called public-private partnerships, also known as PPPs or P3s. Like more conventional modes of privatization, P3s typically feature the outsourcing of government functions: rather than developing and/or delivering a service to the public itself, government engages a private firm to do the work.<sup>46</sup> But P3s take the role of the private sector one step further, by combining private performance of government functions with private financing of the relevant projects.

Public-private partnerships tend to take one of two forms. In the first type, known as a demand-risk P3, a private developer fronts the money for a government project in exchange for the right to collect user fees that would otherwise have gone to the government.<sup>47</sup> The second type of partnership is known as an availability-payment P3. Under the availability model, the government commits to paying the private partner(s) a set amount contingent on the project's meeting certain quality benchmarks. Initial financing comes in whole or in part from the private entity, which then handles the work, while the government makes regular payments to cover operating and maintenance costs and to service any debt.<sup>48</sup>

Public-private partnerships first emerged in the 1990s in the United Kingdom and in Australia, where the availability-payment model is most common. In Latin America, by contrast, P3s typically have taken the form of demand-risk projects. The U.S. market was dominated by demand-risk projects in its early stages, but is now shifting toward availability-payment P3s.<sup>49</sup> P3s are currently used primarily for large infrastructural projects, including transportation initiatives such as roads, bridges, parking meters, and the like.<sup>50</sup> Private investment is less common,

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46. Gillian E. Metzger, *Privatization as Delegation*, 103 COLUM. L. REV. 1367, 1370 (2003) (describing the prevalent model of privatization in the United States as “government use of private entities to implement government programs or to provide services to others on the government’s behalf”).

47. MOODY’S, *supra* note 4.

48. *Id.* (describing availability-payment P3s).

49. *Id.*; see generally MOODY’S INVESTORS SERV., CERTAIN US P3 OBLIGATIONS WILL BE TREATED AS GOVERNMENT DEBT (Feb. 2, 2015) (describing trend toward availability-payment P3s).

50. Ryan Holeywell, *The Indiana Toll Road: A Model for Privatization?*, GOVERNING MAG. (Oct. 2011), <http://www.governing.com/topics/mgmt/indiana-toll-road-model-privatization.html> [<https://perma.cc/6SZM-W5MN>] (“[G]overnments’ desire for P3s is on the rise. With state and federal highway budgets stretched, lawmakers are reluctant to supplement them with higher gas taxes or general fund revenue. That makes P3s an attractive option, and in some circles they have been portrayed as a miracle cure for the country’s crumbling infrastructure.”).

but not unheard of, in the context of social infrastructure—examples include hospitals, schools, and prisons, among others.<sup>51</sup>

In the eyes of their supporters, P3s combine the efficiency of the private market with the government's ability to avoid certain types of market failures.<sup>52</sup> In short, private firms may be able to deliver services more cheaply than the government. Private contractors typically cost less than public employees, in part because they lack the civil-service protections and generous benefits that government workers often receive. And private firms have ample incentives to drive down costs as much as possible so as to maximize profits. Competition for lucrative government contracts sharpens those incentives.

In some areas, arguments like these might justify a complete shift from public to private provision of the relevant services. And, indeed, in some countries that is precisely what the term “privatization” refers to—rather than running, say, a water utility itself, the government sells it to private entities and gets out of the business altogether.<sup>53</sup> But in areas where it is difficult to establish competitive market prices—natural monopolies, for example, or services that generate significant externalities—concerns about potential market failures may justify a continued role for government.<sup>54</sup> Thus, the argument goes, public-private hybrids, or partnerships, can harness the relative strengths of both the public and private sectors to produce better results than could be expected from either sector working alone.<sup>55</sup>

There are several reasons to hesitate before accepting this sunny vision of P3s. The first will be familiar to readers who are steeped in the literature on privatization more generally. As the previous Part explained, one of the reasons for market failure—and, by extension, for reliance on government to supply particular kinds of products and services—is that it is difficult for consumers to monitor the quality of outputs. In scenarios that feature such informational asymmetries between producers and consumers, competition among profit-seeking firms will not reliably lead to better products and enhanced efficiency. On the contrary, the profit motive may lead firms to focus on easily measurable indicia of quality and to shirk on attributes that, although important, are harder to observe. One solution, then, is to rely on service-providers who lack the

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51. MOODY'S, *supra* note 4 (predicting that “social-infrastructure projects will continue to be in the justice and education sectors, with water and waste-water P3 projects to follow”).

52. INT'L MONETARY FUND, PUBLIC-PRIVATE PARTNERSHIPS 10 (Mar. 12, 2004) (approved by Teresa Ter-Minassian) (“[S]tandard arguments for and against government ownership . . . can be used to motivate PPPs as a means of combining the relative strengths of government and private provision in a way that responds to market failure but minimizes the risk of government failure.”); WORLD BANK REPORT, OVERCOMING CONSTRAINTS TO THE FINANCING OF INFRASTRUCTURE 3 (Jan. 2014) (“Conceptually, PPPs are an instrument to respond to market failures while minimizing public sector short-comings as a service provider.”).

53. *See, e.g.*, DONAHUE, *supra* note 6, at 222 (describing privatization abroad).

54. INT'L MONETARY FUND, *supra* note 52, at 10.

55. *Id.*

incentive to maximize profit—namely, government and/or nonprofits.<sup>56</sup>

The difficulty here should be obvious. If a major justification for government action is that the combination of informational asymmetries and profit motive produces undesirable outcomes, then outsourcing service-provision to private firms creates more problems than it solves. Whether this problem is likely to arise in the context of a given P3 depends in large part on whether it is possible for the government to specify in advance the hallmarks of a job well done. As others have recognized, “private provision may be workable if the government can write a fully specified, enforceable contract with the private sector.”<sup>57</sup> But where “service quality is noncontractible”<sup>58</sup>—perhaps because means matter along with ends,<sup>59</sup> or where success entails hard-to-pin-down values like “tender loving care”<sup>60</sup>—relying on private firms to deliver governmental services risks importing private market failure into the public sphere. This importation risk is significant where the government is not any better positioned than consumers to address the issues that lead to market failure, such as information asymmetry.

A second objection to P3s is that the best-of-both-worlds argument supplies little reason to favor private financing; it focuses, instead, on the capacity of the private market to generate efficiencies in the production and delivery of goods and services. Recall that one of the reasons why government is able to avoid the sorts of failures that bedevil the private market is that it has the power to tax—to compel payment from consumers who might otherwise be unwilling to contribute to the cost of collective goods.<sup>61</sup> The advantage evaporates, however, if government must rely on voluntary investments from private firms. At the very least, it is far from clear that such investments will flow to the sorts of collective-goods projects that would otherwise be undersupplied by the private sector.<sup>62</sup>

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56. See WEISBROD, *supra* note 1, at 45–46.

57. INT’L MONETARY FUND, *supra* note 52, at 11.

58. *Id.* (“In general, services for which overall quality is inherently noncontractible . . . are not candidates for PPPs . . .”).

59. DONAHUE, *supra* note 6, at 79 (explaining that outsourcing is most attractive in circumstances where ends matter more than means, because “[t]he more precisely a task can be specified in advance and its performance evaluated after the fact, the more certainly contractors can be made to compete”).

60. WEISBROD, *supra* note 1, at 50.

61. *Cf. id.* at 20 (“[T]he advantage that government has in its ability to tax, which bypasses private firms’ dependence on prices or user fees, is an advantage in fund raising, not in production.”).

62. The problem flagged here may be ameliorated by an investment tool that is related to P3s but still in its infancy in the U.S.: the social impact bond (SIB), also known as “pay for success” or “social innovation bonds.” SIBs ameliorate some of the concerns about subject-matter skew associated with P3s, because they tend to focus on public policies that lack any clear profit component. They work as follows: “Money from private donors and philanthropic dollars are invested upfront to help get the program off the ground. If the program meets the predetermined requirements over a specified time, the money is returned [by the government, with interest].” Bill Bradley, *Social Impact Bonds: Beneficial or Bureaucracy-Bloating?*, NEXT CITY (May 8, 2014), <https://nextcity.org/daily/entry/senate-hearing-social-impact-bonds-helpful-harmful> [<https://perma.cc/UZ2S-QWB2>]; see also Matthew Bishop & Michael Green, *Philanthrocapitalism Rising*, 52 SOCIETY 541, 542 (2015) (“This is a way to transfer the risk of innovative public policy initiatives to the private sector, tapping non-profit operational expertise and for profit risk appetite.”); SOCIAL FINANCE, HOW PAY FOR SUCCESS WORKS,

This problem is most pressing in the context of demand-risk P3s, where the private investment is recouped primarily through user fees—payments by consumers who drive on toll roads, for example, or who use municipal parking spaces. From the perspective of would-be investors, that kind of deal makes no sense in areas that lend themselves to free riding, where private market failures would be most likely. It works only where consumers are, in fact, willing to pay for the service in question or where they can be compelled by the government to pay. To the extent that the service would not have been supplied on the open market, then, the reason is not market failure but government monopoly—a monopoly that the P3 effectively transfers to a private firm.<sup>63</sup>

Availability-payment P3s may hold more promise in combining the government's ability to avoid market failures with private-market efficiency. Like privatization more generally, the availability-payment model puts government itself in the role of consumer. Payment will come—ultimately—from the public coffers; the up-front private investment simply operates as a way of putting off the payday.

Yet to the extent that P3s simply delay, as opposed to obviate, the need for public financing, they trigger a third reason for hesitation. The ready money provided by private investors allows today's public officials to take credit for projects that tomorrow's officials, and citizens, will have to pay for. Concerns about similar temporal dynamics have prompted many state governments to adopt limitations on allowable public debt.<sup>64</sup> P3s tend not to trigger those limitations, however, because the obligation in question is contingent on certain performance benchmarks; in the argot of public finance, a contingent obligation does not count as debt.<sup>65</sup> Thus, P3s may offer a means by which government can evade democratically enacted limitations on public revenue raising. The upshot, as we describe in more detail in the following Part, is that governments can give

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pay-for-success-works/ [<https://perma.cc/X6BG-HRBB>] (last visited Feb. 17, 2018) (describing how SIBs are funded). SIBs have been used in the United States to develop programs designed at reducing recidivism, improving early-childhood education, and facilitating reentry by formerly incarcerated citizens. Bradley, *supra*.

63. Monopoly conditions are, of course, another likely source of private market failure. See, e.g., Bozeman, *supra* note 15, at 146. See also Le Grande, *supra* note 10, at 439–40 (noting that “replacing a government monopoly provider with a private monopoly might have an inegalitarian impact on that distribution, because (a) the latter would have more incentive its position to exploit its position to maximize profits and (b) any profits would accrue to its shareholders instead of to all taxpayers”).

64. As with restrictions on taxes, debt limitations may be substantive or procedural. Substantive limitations impose caps on debt; procedural rules require government to clear special democratic hurdles—such as voter approval, approval by a legislative supermajority, or both—before taking on new debt. RICHARD BRIFFAULT & LAURIE REYNOLDS, STATE AND LOCAL GOVERNMENT LAW 790 (7th ed. 2009). See also *id.* at 818 (explaining that limitations on debt “may be justified as a means of reconciling the conflict between short-term and long-term interest that debt creates . . . [T]he ability to shift the costs of debt into the future may . . . induce elected officials to incur debt too easily [and] to approve projects that are not fully cost-justified. . . . After all, they can get the credit for the new project, but the blame for the additional taxes needed to finance these projects or for the diversion of tax dollars away from other future needs will be borne by their successors.”).

65. *Id.* at 836.

lip service to fiscal austerity while offering consumers amenities that they cannot actually afford at current tax rates.

## B. Patriotic Philanthropy

Private investment in government need not be motivated by a quest for profits. Individuals, groups, and firms also may donate money to government, much as they might donate to a nonprofit, or give money and other resources directly to those in need.<sup>66</sup> Such “patriotic philanthropy”<sup>67</sup> comes in various shapes and sizes. Some gifts are solicited by government actors.<sup>68</sup> Others are made at the initiative of the donor. Some are open-ended, to be used by the recipient however it sees fit.<sup>69</sup> Others are earmarked for specific purposes.

It is difficult to develop a comprehensive sense of the substance of patriotic philanthropy, but gifts appear to cluster around certain types of initiatives.<sup>70</sup> Public facilities, for example, are recurring subjects of gifts. Relatedly, private gifts frequently support public exhibitions, both inside museums and outside in the form of monuments. Public schools also are longstanding—and controversial—targets of philanthropic giving. Public education was one of the earliest social services offered widely by government,<sup>71</sup> and it is one of the few public services that state governments are constitutionally obligated to provide.<sup>72</sup> Yet private dollars have been part of the public-education equation from the outset, particularly in the South, where Reconstruction governments struggled to

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66. See Lemos & Charles, *supra* note 5, manuscript at 27–28; see also Beth Gazley, *How Philanthropy Props Up Public Services and Why We Should Care*, NONPROFIT Q. (Mar. 27, 2015) (giving to government is not new. As we have argued elsewhere, however, there is reason to think that the phenomenon is on the rise in the U.S.: “We know that philanthropic support for public services is growing rapidly, outpacing the growth of the charitable sector overall.”).

67. E.g., Sophie Gilbert, *David Rubenstein’s Patriotic Philanthropy*, THE ATLANTIC (Oct. 29, 2014), <https://www.theatlantic.com/national/archive/2014/10/david-rubensteins-patriotic-philanthropy/382082/> [<https://perma.cc/BYH9-B5VZ>].

68. Jim Edwards, *Why BP is Getting Fed Up with Florida Milking it for Advertising Money*, MONEYWATCH (July 15, 2010), <https://www.cbsnews.com/news/why-bp-is-getting-fed-up-with-florida-milking-it-for-advertising-money/> [<https://perma.cc/RB7F-Q6RU>] (describing requests from Florida’s Governor Charlie Crist to BP for \$75 million to support cleanup and tourism advertising in the wake of the BP oil spill).

69. See David Margolick, *Justice Holmes’ 1935 Bequest Remains Unfulfilled*, N.Y. TIMES (May 3, 1983), <http://www.nytimes.com/1983/05/03/us/justice-holmes-s-1935-bequest-remains-unfulfilled.html?pagewanted=all> [<https://perma.cc/HR8E-SEY8>] (an example is the Holmes Devise: “When Oliver Wendell Holmes died in 1935, he left the bulk of his estate, more than \$260,000, to the United States Government. It was the largest unrestricted gift ever made to the American people . . .”).

70. See generally Lemos & Charles, *supra* note 5, Part II.C (offering examples).

71. David Strong et al., *Leveraging the State: Private Money and the Development of Public Education for Blacks*, 65 AM. SOC. REV. 658, 659 (2000) (“Publicly funded and controlled systems of education were one of the earliest social benefits extended to the masses . . .”).

72. Michelle Wilde Anderson, *The New Minimal Cities*, 123 YALE L.J. 1118, 1122 (2014) (“While laws provide an entitlement to a public education, and we have long struggled to interpret what constitutes a legally adequate education, there is little to nothing to indicate what other services the local public sector must provide.”).

fund their newly created state-supported school systems.<sup>73</sup>

Generalizations become more difficult when we move beyond these recurring categories. Some gifts offer financial support for law enforcement.<sup>74</sup> Others promote improvements at the other end of the criminal-justice spectrum—for example, seeking to reduce alcohol abuse among offenders, or to improve the health and mental-health services offered by juvenile justice systems.<sup>75</sup> Community and economic development projects also tend to attract philanthropic gifts.<sup>76</sup> The City of Detroit is perhaps the most striking example in this regard. Philanthropic organizations have played a leading role in the city's revitalization, spearheading a variety of significant initiatives including the M-1 rail—the country's first public transit system planned by private and philanthropic actors, and funded largely by a combination of private investments and gifts.<sup>77</sup>

Gifts are less common at the federal level than in states and municipalities, in large part because the default rule under federal law is that donors may not earmark gifts for particular purposes; instead, all donations must go to the general treasury.<sup>78</sup> That rule can be—and often is—superseded by more targeted statutes allowing particular agencies or actors to receive private gifts. For example, the Department of Justice has statutory authority to receive gifts,<sup>79</sup> as does the Federal Communications Commission,<sup>80</sup> and the Library of Congress.<sup>81</sup> And some federal agencies have their own foundations devoted to raising private donations; examples include the Centers for Disease Control & Prevention, the Food and Drug Administration, the National Air and Space Administration,<sup>82</sup>

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73. See Strong et al., *supra* note 71, at 662–63 (describing the need for private donations to support public schools for both White and Black children in the South during Reconstruction, and how private financing continued to fill the void for many southern African-Americans after states started channeling public money exclusively into White schools).

74. See David Amsden, *Who Runs the Streets of New Orleans?*, N.Y. TIMES (July 30, 2015), <https://www.nytimes.com/2015/08/02/magazine/who-runs-the-streets-of-new-orleans.html> [<https://perma.cc/5ZSC-ZXXH>] (describing gifts to law enforcement in Seattle and New Orleans).

75. See Lemos & Charles, *supra* note 5, manuscript at 32 (describing such gifts in California and Michigan).

76. *Id.* manuscript at 32–33.

77. *Id.* manuscript at 33.

78. The Miscellaneous Receipts Act requires federal agencies to turn over any funds to the general treasury, 31 U.S.C. § 3302(b) (2016), and the Anti-Deficiency Act prohibits agencies from expending funds in excess of their legislative appropriations, 31 U.S.C. § 1341(a)(1)(A) (2016). Close cousins to gifts to the general treasury, the Bureau of Fiscal Service may accept gifts to reduce the national debt. Over the last decade, totals have ranged from \$2 to \$7 million. See *Gift Contributions to Reduce Debt Held by the Public*, TREASURY DIRECT, <https://www.treasurydirect.gov/govt/reports/pd/gift/gift.htm> [<https://perma.cc/D6XR-BT8U>] (last visited Apr. 15, 2018).

79. 28 U.S.C. § 524(d) (2016).

80. 47 U.S.C. § 154(g)(3) (2016).

81. 2 U.S.C. § 156 (2016).

82. Rick Cohen, *Philanthropy Funding Government Work? There's a Foundation for That—Several, Actually*, NONPROFIT Q. (Apr. 13, 2012), <https://nonprofitquarterly.org/2012/04/13/philanthropy-funding-government-work-theres-a-foundation-for-thatseveral-actually/> [<https://perma.cc/XZ3N->



and the National Park Service.<sup>83</sup>

Even if the federal environment were more conducive to targeted gift giving, we suspect that the majority of gifts would still be aimed at state and local governments. Not only do state and local governments have greater needs for funds, but the smaller scale of local government creates more opportunities for gifts with meaningful impact. Perhaps not coincidentally, state and local law on gifts ranges from broadly permissive to silent, with only scattered restrictions.<sup>84</sup>

As with P3s, there is an optimistic best-of-both-worlds story to be told about patriotic philanthropy. For those who harbor anxieties about private philanthropy because of concerns about accountability, transparency, and abdication of the government's obligations, gifts to government may well look like a cure-all. The government is under no obligation to accept donations, nor to undertake the specific initiatives that private donors wish to fund. Unlike conventional philanthropy, then, patriotic philanthropy means that initiatives backed by private actors with big ideas and deep pockets must pass through a democratic check before being translated into projects with broad-based effects.

There is also reason to believe that patriotic philanthropy might generate more private support for public projects than taxation alone. Research on taxation and charitable giving suggests that people are more willing to turn over their money to Uncle Sam when they can earmark the funds. One study concluded, for example, that "the antipathy often expressed toward taxation is due more to coercion or lack of control over the use of resources, rather than to government per se, and that taxpayers embrace the voluntary, earmarked feature of a gift to a specific government agency."<sup>85</sup>

Despite the manifest benefits of patriotic philanthropy, there are reasons for concern here as well. The previous section suggested that bringing for-profit investment into government could exacerbate rather than minimize concerns about government failure without doing much to reduce the potential for market failure. The argument here is similar: Notwithstanding the optimistic vision sketched above, there is a risk that running private gifts through government will deepen rather than resolve democratic objections.

Patriotic philanthropy avoids the process-based objections to purely private philanthropy if, and only if, proposed gifts pass through a meaningful democratic process on their way to implementation. In at least some cases, however, gifts may *change* the democratic process, by skewing government priorities in the

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8KG5]. The CIA also has a foundation, In-Q-Tel, but it is more of an investment arm than a source of philanthropic donations. See IN-Q-TEL, <https://www.iqt.org/about-iqt/> [<https://perma.cc/C3CF-BBK9>] (last visited Feb. 17, 2018) ("IQT is the non-profit strategic investor that accelerates the development and delivery of cutting-edge technologies to U.S. government agencies that keep our nation safe.").

83. See *About the Foundation*, NAT'L PARK FOUND., <https://www.nationalparks.org/about-foundation> [<https://perma.cc/57ED-EJ2E>] (last visited Mar. 23, 2018).

84. See Lemos & Charles, *supra* note 5, manuscript at 34 & n.202.

85. Sherry Xin Li et al., *Giving to Government: Voluntary Taxation in the Lab*, 95 J. PUB. ECON. 1190, 1191 (2011).

direction of initiatives backed by private dollars. The key point here is that government officials may find it hard to turn down donations, especially big ones, and especially those that are offered by donors with whom the officials have—or might develop—ongoing relationships.<sup>86</sup> First, officials may worry about the public-relations consequences of declining what appears to be free money. Particularly at a time when many government units are struggling to make ends meet, news that officials have foregone an opportunity to pad the public coffers may not sit well with voters. Second, and perhaps more significantly, officials may be concerned about the likely reactions of donors and would-be donors. In many cases, the proffer of a gift is not an isolated event but one moment in an ongoing and potentially beneficial relationship. Today's gift, if handled well, may produce additional gifts down the road.<sup>87</sup> The people who are capable of making large donations to government programs also are people who are likely to provide other kinds of political support, including campaign contributions and independent expenditures.<sup>88</sup> Saying “thanks but no thanks” to such donors may seem imprudent at best, “political malpractice” at worst.<sup>89</sup> Instead, as one critic put it, “[w]hen a multibillionaire gets an idea . . . [about] matters of important public policy and the billionaire is willing to back it up with hard cash, public officials tend to reach for the money with one hand and their marching orders with the other.”<sup>90</sup>

Even if public officials are capable of declining proffered gifts, policy proposals that come with their own readymade funding sources—requiring reduced or delayed public outlays—will likely have an edge over initiatives that must be fully funded from the public fisc. That gravitational pull, moreover, is not limited to the initial bargain but extends through the life of the project. Losing private funding may seem even worse than refusing a gift at the outset. Thus, the same incentives that push government officials to reach for the money may also encourage them to hold tightly to funding already secured—even if doing so means contributing public money to the project or compromising other objectives.<sup>91</sup> Similarly, when and if the worst happens and the private money runs

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86. See Lemos & Charles, *supra* note 5, manuscript at 35–41.

87. Cf. Cohen, *supra* note 82 (describing research suggesting that “nonprofits have traditionally been averse to challenging their foundation funders . . . for fear of losing not only current funders but scaring off other foundations”).

88. Goss, *supra* note 34, at 443 (“Donors also carry the promise of campaign cash, necessary to compete in the campaign finance arms race.”).

89. David Morton, *Miss Manor*, WASH. CITY PAPER (Feb. 13, 2004), <https://www.washingtoncitypaper.com/news/article/13028437/miss-manor> [<https://perma.cc/33B3-AJ8N>] (quoting the D.C. Mayor regarding a proffered gift).

90. Bob Herbert, *The Plot Against Public Education: How Millionaires and Billionaires are Ruining Our Schools*, POLITICO (Oct. 6, 2014), <https://www.politico.com/magazine/story/2014/10/the-plot-against-public-education-111630> [<https://perma.cc/LFR2-ZX6U>].

91. See, e.g., Landow & Ebdon, *supra* note 6, at 737–46 (describing how city leaders in Omaha, Nebraska, acceded to the demands of private donors who had funded a new convention center and arena and then used the threat of withdrawing private funding to gain continuing leverage in negotiations over related projects).

out, sunk costs and reliance interests are likely to bias public decision making in favor of maintaining programs already in effect. Importantly, those ongoing effects often will spill over into other policy spheres, as gifts draw money and other resources toward donor-supported initiatives and away from alternative uses.

The upshot is that patriotic philanthropy has the potential to induce government to undertake initiatives that would not otherwise be pursued. That can, of course, be a good thing: If the reasons why government would not otherwise have pursued the projects reflect public-choice dysfunctions or other sorts of government failures, the lure of seemingly free money can pull government in beneficial directions. But patriotic philanthropy can also contribute to, and exacerbate, the risk of governmental failure by making government all the more dependent on and responsive to moneyed interests.

#### IV

#### A BIGGER PIE?

The discussion thus far has offered several reasons to hesitate before embracing private financing of government as a win-win scenario. An obvious response is that private money—whether of the for-profit or philanthropic variety—simply expands the public pie. Private financing, in other words, supplements the public treasury, leaving more money available to the state to focus on other priorities. For small-government conservatives, that response is hardly a cause for comfort. In this Part, we argue that the notion of an ever-expanding pie should ring false even to those who would favor a larger public sector. As the old adage suggests, there are reasons to be skeptical that free money is in fact free.

#### A. Reliance and Redistribution

An initial reason for skepticism about the expanding-pie perspective is suggested by the discussion in the previous Part: Private financing might disappear for various reasons, and the state may be compelled to pick up the slack in funding, diverting resources from other potential uses. Private financing is significantly less dependable than broad-based, compulsory taxation, because it is based on the voluntary actions of a relatively small set of individuals or firms rather than payments extracted from the taxpaying public as a whole.<sup>92</sup> Proponents of using private funds to support public programs must therefore contend with the possibility that the private money might run out.<sup>93</sup>

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92. *Cf.* Salamon, *supra* note 23, at 40 (noting that “the voluntary system . . . has serious drawbacks as a generator of a reliable stream of resources to respond adequately to community needs”).

93. Indeed, many P3s are designed with the intention that the private money will run out; the whole point is that the private “partners” provide an initial investment, which the government repays (with interest, of course) down the road. In these circumstances, any expansion of the public pie is temporary at best, and triggers the concerns about public officials’ incentives for temporal cost-shifting that we

One possibility, of course, is that privately funded programs simply exist as long as the private money is flowing into the public sphere. If the money goes away, so too do the programs—no harm, no foul. But it will not always be that easy. Once in place, public programs may be difficult to unwind. That is true not only of social infrastructure and programs (think public schools, for example) but also of the kind of transportation projects that tend to attract the most P3s. It is one thing to live without a new road. It is another to clear the countryside, construct a freeway, and then leave it to crumble into disuse when funding for upkeep evaporates. When reliance interests develop around particular initiatives, government may face intense pressure to keep them going—with public funds, if necessary.

To be clear, the point here is not that it is always, or necessarily, cause for concern when private financing must be replaced with public support. On the contrary, private financing may operate as a spur to development or innovation in the public sector, encouraging the government to experiment with new programs and policies. The private, or voluntary, sector bears the initial risk of failure; tax dollars are put at stake if and when the projects in question prove to be successful. We do not deny that beneficial public policies can emerge from such scenarios.<sup>94</sup> Yet recognizing the potential benefits need not mean ignoring the risks. If, as we have suggested, there is likely to be a political thumb on the scale in favor of programs that attract outside financing at the outset, we should be clear-eyed about the role that private money is playing in shaping the government's priorities. And we should recognize that the fact that private money is supporting a program today does not mean it always will. In some cases, at least, private financing is likely to result in a redistribution of public resources rather than an expansion of the overall pie.

## B. Free Riding and Reverse Crowding Out

Private financing for government might also affect the public fisc indirectly and over the long term, by shaping citizens' preferences regarding public funding and taxation. There is ample evidence that public and private financing for public goods are sometimes substitutes rather than complements. As the significant literature on “crowding out” shows, governmental support for public goods sometimes displaces, or crowds out, private donations.<sup>95</sup> A similar phenomenon

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flagged in the previous Part.

94. See, e.g., Strong et al., *supra* note 71, at 662, 672–75 (explaining how initial private financing ultimately led to public funding of schools for African-American children in the south, and describing the initial donation as “a Trojan horse [that] allow[ed] blacks to ‘sneak past’ the normal barriers erected to their political influence”).

95. See, e.g., James Andreoni & A. Abigail Payne, *Is Crowding Out Due Entirely to Fundraising? Evidence from a Panel of Charities*, 95 J. PUB. ECON. 334, 334 (2011) (“The classic theory of crowding out is that individual donors, who are also often tax payers, will treat their voluntary private contributions as a substitute for their involuntary contributions through taxation and, as a result, reduce giving to a charity by the full amount of the [government] grant [to a charity].”).

could arise in the context of private financing for government, just in the other direction: private money might crowd out public money. We refer to this phenomenon as reverse crowding out.<sup>96</sup>

Consider the crowding-out question from the perspective of a citizen who lives in a world in which public goods can be funded either with public dollars or via private donations or investments. For present purposes, this hypothetical assumes a fully informed citizen: She knows that financing can in principle be either public or private, and she knows how programs are funded in fact. The citizen must ask herself why she should pay for public goods when someone else could pay for them. All else equal, the rational, self-interested taxpayer would prefer a world in which she has access to public goods but does not have to shell out for them. The more private money that is available to finance public goods, the more the fully informed taxpayer ought to favor a reduction in her tax liability in favor of private support.

To the extent that this reverse crowding out story is correct, it reveals a deeper and more perverse problem: It transfers the free-rider problem from the private market to government. As explained in Part I, the government's role in the provision of public goods is justified, in part, by its ability to address the shortcomings of the private market. One such shortcoming is the free-rider problem, in which an individual has an incentive to consume a public good but no incentive to pay for it. Government can solve this version of market failure because it can compel its citizens to pay taxes to support the state's priorities. It can force everyone to pay for public goods, whether they consume them or not, and whether they would prefer to pay for them or not.

As many states and local governments have learned, however, the government's compulsory power is not without a significant limitation. Citizens must be willing to authorize the government to levy taxes. Once authorized, the levy is compulsory, but voters can impose substantial constraints on the government's taxing power. Many states have adopted rules, either statutory or constitutional, that require proposed tax increases to run through legislative supermajorities or voter referenda, and/or that cap the permissible level of taxation.<sup>97</sup> And even where taxes are set via normal legislative procedures, citizen opposition can make even modest tax increases extraordinarily difficult to enact as a political matter.

In the absence of private funding of government-supplied public goods, citizens have a choice to make. They can either have the goods they want and pay for them in taxes, or they can stake out opposition to taxes and live with the

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96. *Cf.* WEISBROD, *supra* note 1, at 30 (recognizing the possibility of philanthropic contributions to government agencies, and observing that “voluntary contributions [may] not lead to increased governmental output, but to an offsetting decrease in tax-financed expenditures. . . . At issue is the magnitude of ‘crowding out’: increased private donations may decrease what government would otherwise have done.”).

97. *See supra* note 64 and accompanying text.

resulting reduction in public goods. But citizens cannot expect to benefit from government-supplied goods and services without chipping in toward the cost. The availability of private funding for the government's priorities introduces free riding into the calculus, because fully informed citizens now have the option of having the public good for free. One consequence of private financing, then, may be to reduce citizens' appetite for taxes.

The concern here is exacerbated by the fact that citizens may oppose particular government programs, either on grounds of principle or policy, or simply because they do not anticipate taking advantage of them. Tax payments cannot, of course, be earmarked, and taxes cannot be avoided on the ground that the would-be payer will not benefit from some or all of the services government provides.<sup>98</sup> But private donations and investments *can* be earmarked, and they are voluntary. In that sense, private financing represents a move from a compulsory and collective ethos of funding—in which all taxpayers contribute to the full range of government programs, including those that redound to the benefit of others—to a voluntary, a la carte approach in which individuals and firms choose which initiatives their money supports.<sup>99</sup> The more the latter approach appears to be an option—an alternative to conventional sources of public financing—the more difficulty government may face in drumming up political support for taxes.

### C. The Hollow State

Crowding out depends upon information symmetry: The citizen has the same information as the government as to how public priorities are funded. Where citizens suffer from an information deficit vis-à-vis the state, they may not realize that free riding is an option, or that public money may be replaced by private dollars. Such information asymmetry may give rise to a different (albeit related) problem, one we term “the hollow state.”

Information asymmetry with respect to the funding of public priorities precludes citizens from having an accurate gauge of the capacities and capabilities of the state. When the government's financing scheme is not transparent and citizens are unaware that public programs are being propped up by private dollars, citizens may have an inflated sense of what their taxes can buy.

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98. See *supra* note 18 and accompanying text.

99. As we have explained in other work,

[t]o the extent that individuals can control the amount or use of their tax payments, they do so not as consumers—making self-interested determinations about what services they want and how much they are willing to pay—but by voting as citizens. As such, broad-based taxes both reflect and reinforce a form of ‘fiscal citizenship,’ which one performs ‘by contributing one’s appropriate share—however modest—toward the financing of the political community of which one is a member,’ and then ‘by becoming informed about government taxing and spending policies, and by becoming involved (at least as a voter, and perhaps more deeply) in the determination of those policies.’

Lemos & Charles, *supra* note 5, manuscript at 7 (quoting LAWRENCE ZELENAK, *LEARNING TO LOVE FORM 1040: TWO CHEERS FOR THE RETURN-BASED MASS INCOME TAX* 17 (2013)).

That is, they may assume, reasonably, that government services are being funded by public money. As a result, citizens may believe that the public treasury is capable of producing more goods and services than it actually is. This enables the government either to claim that it is being financially austere, and/or to brag about its capacity, while in reality providing services that it cannot afford at existing tax levels.<sup>100</sup>

This kind of fiscal delusion might lower the public appetite for taxes, though for different reasons than the crowding-out concern described above. Even those who generally favor a robust state might oppose tax increases, based on the mistaken view that existing tax rates are sufficient to generate all of the public programs that they observe. Meanwhile, citizens who perceive that the government is doing too much might seek to limit or lower the government's taxing power, which might further debilitate an already hobbled state. The effects, moreover, would not be felt across the range of government projects, but only those that are unable to attract private financing. As suggested in the previous Part, that is unlikely to be a random sample. On the contrary, it is likely to consist primarily of the kinds of programs for which society needs government most—because private support, either of the for-profit or philanthropic variety, would not be forthcoming without compulsion.

Finally, the points we made at the outset of this Part bear repeating here: Constituencies and reliance interests can develop around existing programs, making those programs painful to dismantle if and when the private money runs out. We suggested above that one consequence is that public money may be pulled toward what were once private initiatives, diverting resources from other potential uses. But in some circumstances, there may not be any public money available to be repurposed. The state's coffers may simply be empty. Thus, private financing may induce citizens to rely on public programs that they—and their government—cannot really afford, and to incur heavy switching costs (in terms of disruption, waste, and the like) if those programs have to be abandoned down the line.

## V

### CONCLUSION

An increasingly common refrain in public discourse is that “[g]overnment can't do it alone,”<sup>101</sup> but needs help from the private and philanthropic sectors in

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100. See David Hall, *Why Public-Private Partnerships Don't Work: The Many Advantages of the Public Alternative*, PSIRU 13 (Mar. 2015), available at <http://www.psir.org/sites/default/files/2015-03-PPP-WhyPPPsdontworkEng.pdf> [<https://perma.cc/4QNL-T4NS>] (describing, and criticizing, the link between fiscal austerity policies and an embrace of P3s abroad).

101. Christopher Weber, *The Problem with Public-Private Partnerships*, NEXTCITY (May 7, 2012), <https://nextcity.org/daily/entry/the-problem-with-public-private-partnerships> [<https://perma.cc/99F6-KXM4>] (quoting Jacksonville mayor Alvin Brown); see also Carol Ebdon & Paul Landow, *The Balancing Act: Using Private Money for Public Projects*, 32 PUB. BUDGETING & FIN., Spring 2012, at 59 (noting that “[t]he estimated investment needs [for infrastructure] over the next five years are \$2.2 trillion, which is

order to satisfy its obligations to the public. Yet we lack a coherent account of the relationship between private financing and public legitimacy. Does it matter for the legitimacy of a representative democracy that citizens broadly finance their government?<sup>102</sup>

It might be that the best way to think about financing questions is from a utilitarian perspective: We ought to favor the mechanisms that deliver public goods to the public most efficiently. But that approach would ignore a fundamental argument from democratic theory. The lesson of modern democratic theory is that process matters—that a robust political process is the best way of ensuring that decisions about public policy are made in the interest of the public. American representative democracy envisions a government, elected by the people, that sets public priorities in the public interest. It assumes a certain set of values, like equal citizenship.

It further assumes, as formal matter, that each citizen has both rights and obligations, which include voting as well as taxation. Borrowing Hirschman's terms, everyone is presumed to have voice and to reciprocate with loyalty and not exit.<sup>103</sup> Public financing is consistent with that vision, as it collectivizes the costs of public goods and eliminates the opportunity to opt out. As we have emphasized, citizens cannot avoid paying general taxes on the ground that they find certain government policies unnecessary or even offensive. In contrast to private financing, which enables those with means to use their personal funds to support the public initiatives that they prefer, general taxes force everyone to have skin in the game.

If excessive private financing for government is inconsistent with key assumptions of democratic theory, what are its consequences for the public sector? If private financing does not simply supplement the existing work of government but *changes* it, should that be cause for celebration or regret? We do not purport to solve those fundamental questions in this brief essay. Our aim is significantly more modest and much less quixotic. Using public-private partnerships and patriotic philanthropy as points of ingress, we seek to highlight some of the benefits and risks of financing the public sector via organizations, and methods, typically associated with the private and philanthropic sectors. More broadly, we hope to stimulate a conversation about the consequences of relying on private funding for public priorities.

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beyond the collective ability of government to fund”); Stacia A. Wells & Robert M. Siegel, *Fixing US Infrastructure: New Model P3 Law A Good Start*, LAW 360 (Jan. 27, 2016), <https://www.law360.com/articles/751657/fixing-us-infrastructure-new-model-p3-law-a-good-start> [<https://perma.cc/UTY5-D7VZ>] (“[T]he United States is facing an infrastructure crisis and our needs are far greater than the government can provide on its own. Private capital and innovation are available to help.”).

102. Cf. ZELENAK, *supra* note 99, at 21 (“Taxpayer status is usually asserted as a reason why the speaker’s opinion on some question of government policy deserves to be taken seriously.”).

103. ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 77–78 (1970).