

A quarter century of ‘The Proper Scope of Government’: Theory and Applications

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Abstract. A quarter century ago in a seminal paper, Hart, Shleifer and Vishny (NBER1996, QJE1997) developed a theory of the 'Proper Scope of Government.' Oliver Hart, 2016 Nobel Laureate, reflects on that framework and its place in economics, as well as the inspiration for his more recent work on norms, guiding principles, and contracts as reference points. In discussion with Karen Eggleston, Hart answers questions posed by economists who have built upon Hart, Shleifer and Vishny (1997) and offers insights on how the theory applies to understanding public and private roles in healthcare, education, and other publicly-financed services.

Webinar: https://www.youtube.com/watch?v=sDp7ytudbsE&feature=emb_logo

[Oliver Hart](#) is currently the Lewis P. and Linda L. Geysler University Professor at Harvard University, where he has taught since 1993. He is the 2016 co-recipient of the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel, a Fellow of the Econometric Society, the American Academy of Arts and Sciences, the British Academy, and the American Finance Association, a member of the National Academy of Sciences, a Distinguished Fellow of the American Economic Association, and has several honorary degrees. Hart works mainly on contract theory, the theory of the firm, corporate finance, and law and economics. His research centers on the roles that ownership structure and contractual arrangements play in the governance and boundaries of corporations. He has published a book (*Firms, Contracts, and Financial Structure*, Oxford University Press, 1995) and numerous journal articles. He has used his theoretical work on firms and contracts in several legal cases. He has been president of the American Law and Economics Association and a vice president of the American Economic Association.

*This keynote is part of the Stanford Asia Health Policy Program colloquium series entitled: **Health, medicine, and longevity: [Exploring public and private roles](#)***

Oliver Hart, Andrei Shleifer, Robert W. Vishny, The Proper Scope of Government: Theory and an Application to Prisons, *The Quarterly Journal of Economics*, Volume 112, Issue 4, November 1997, Pages 1127–1161, <https://doi.org/10.1162/003355300555448>.

Preface

Karen Eggleston, Director of the Stanford Asia Health Policy Program

Thank you for your interest in Oliver Hart's 2021 keynote address for the Stanford Asia Health Policy Program's [colloquium series on public and private roles](#). As an economist and former student of Oliver Hart, I am excited to preface his keynote remarks with this explanation of our webinar "**A quarter century of 'The Proper Scope of Government': Theory and Applications.**"

For many services, from health and education to collecting garbage or running prisons, whether the government should contract out to a private organization is controversial. With continuing debate about public and private roles in everything from pandemic response, to innovation to address other global challenges like sustainability, this is an opportune time to discuss how conceptually rigorous thinking can inform a sometimes divisive and ideological question.

Oliver Hart, Andrei Shleifer, and Robert Vishny developed a theory of 'the proper scope of government' in a seminal paper 25 years ago – dating from the [1996 NBER working paper](#) published in the *Quarterly Journal of Economics (QJE)* the following year.¹ To reflect on the legacy of that framework, I invited keynote remarks and reflections from [Oliver Hart](#), the Lewis and Linda Geysler University Professor at Harvard University and the 2016 co-recipient of the Nobel Prize in economics. During the webinar, Oliver Hart responded to questions, including several pre-recorded from scholars who graciously shared reflections for a video I designed to celebrate a quarter century of Hart, Shleifer and Vishny. That documentary is available on the Stanford Asia Health Policy Program website and on our center's YouTube channel at <https://www.youtube.com/watch?v=g9JRhGpXC2Y&feature=youtu.be>. Please see the end of this keynote transcript for the Table of Contents of the HSV25th tribute documentary.

Oliver Hart:

A huge thank you for putting this all together and for producing that [video](#). Some may have seen it, some haven't yet. I have certainly. It's amazing. Karen assembled a wonderful group of people who reflected on the work. I found the whole thing overwhelming, actually, because I hadn't realized how many people have been influenced by this paper and how they've been using it in different contexts. I knew some of the applications, but there were others I didn't know, and so that was all amazing. I actually felt a little bit like I was going to my own funeral, in the sense that when you go to a funeral everyone says wonderful things about the person, and you sometimes think "well, there were a few negatives as well," but nobody mentions those. I felt a bit that way. People were so nice about the work and there were very few criticisms, even though I'm sure they had some. In fact, I have my own, a few of which I'll be mentioning today.

What I thought I would do is start by reflecting a little bit on how I would write the paper differently now.

Why the Application to Prisons?

One thing that I would *not* do differently is choosing to focus on prisons. Some of the people in the pre-recorded questions and video, including David Martimort, expressed surprise that we had chosen prisons, or asked why we had done so. Actually, I think there was a very

¹ Oliver Hart, Andrei Shleifer, Robert W. Vishny, The Proper Scope of Government: Theory and an Application to Prisons, *The Quarterly Journal of Economics*, Volume 112, Issue 4, November 1997, Pages 1127–1161, <https://doi.org/10.1162/003355300555448>.

good reason for that. In a lot of the examples where there's a choice between the government doing the activity directly or contracting with a private provider, some people might well ask why you really need the government involved at all. For example, schools: of course, governments are heavily involved in schools, but some conservatives might feel that there should only be private schools or we could perhaps use vouchers, or something like that. The same argument can be made with medical care, maybe even garbage collection. You could imagine each household deals with their own garbage or deals directly with a private contractor, and we don't have a town-run system. What I think was nice about the prisons example is that it is a clear case where nobody would say, "We can leave that to the market." It's obvious that the prison has to be paid for by government. Then, the question that the three of us considered comes to the fore. The government can do it two ways: it can have its own workers run the prison, or contract with a private company. I think that is why it offers a good example, and I would stick to it. But there are other things that I wouldn't stick to.

Two Aspects I Would Model Differently Today

The model is in the tradition of some of my prior work – Grossman Hart Moore, often called the property rights theory of the firm – where you have contractual incompleteness, but you have symmetric information. There also are no wealth constraints, or at least they don't seem to be very important. So you would expect a la Coase or Nash that people would bargain to an efficient outcome ex post; in other words, contract renegotiation would always lead to an ex-post efficient allocation. That is a feature of the Hart, Shleifer and Vishny (1997) paper. All the action is on ex-ante non-contractible investments.

Let me say I didn't believe that at the time, empirically. It's just that the modeling kind of forced it on us. But more and more over time I've come to the view that the ex post potential inefficiency is first order important. It was of course stressed by earlier authors like Coase or Williamson, but it wasn't part of that initial modeling.

Modeling Ex Post Inefficiency

So just to take a concrete example: we focused on the problem of poorly-trained guards, i.e., prison guards who perhaps were not well qualified. A private provider might want to cut costs by hiring inappropriate guards and also under-train them. This might lead to difficulties, particularly when it comes to dealing with violent situations. I have to say that I think we were spot on there. If you think about all the stuff that's happened recently regarding the way the police respond to violent situations, it seems clear that these are very hard things to contract on. I actually think that was a very good thing for us to focus on.

It was a feature of the model that the choice of low-skilled guards was actually ex-post efficient. For those of you who remember the details of the model, we always assume that the cost cutting led to a quality reduction, but that the value of the reduction in cost exceeded the reduction in quality, so it was actually ex-post efficient to go along with this; the inefficiency came from the private provider allocating too many resources to discovering these cost cutting possibilities.

I don't really believe that is going to be the case; I think in practice, you're going to have an ex-post problem, so it is not going to be ex post efficient. Either you're going to be in a situation where you'd like to replace the guards with more expensive, better ones, or you'd like to change the training program. Then the problem may be that renegotiation is difficult: there might be a lot of argument; it takes time; and so on. Or maybe doesn't even happen. You may

just end up with the wrong guards and you would have to live with the ex-post inefficiency, i.e., resulting in more violence, which is ex post inefficient. I would definitely want to allow for that.

The trouble is, it's not easy to do in a model. If you try to model ex post inefficiency, how do you do it? One possibility is to introduce asymmetric information; that's something that Bajari and Tadelis (2001) did in a nice article in the RAND journal. A problem with that is there are always clever ways of getting around the asymmetric information with some sort of mechanism, from mechanism design theory. Another possibility is to use an approach that I've actually been working on for 10 years now, which is contracts as reference points. John Moore and I have a paper in 2008 where we talk about shading, i.e., that the problem that may arise ex post is that you will renegotiate efficiently, but it'll be a messy process and during that process at least one party may feel that the renegotiation didn't work the way they thought it should. So there will be some bad feeling in the relationship which will lead to a lack of cooperation going forward. That's another way to capture ex post inefficiency. But either way, I think that would be an important thing to have in the model.

Modeling with Separation of Incentives and Control

Another thing which I think is a feature of that model which I don't particularly like is that *incentives and control are bundled*. Andrei, Rob and I didn't allow for incentive schemes separately from the allocation of control. Just to give you an example of that: we always assume that if the government outsourced the prison to a private contractor, the private contractor would be bearing the costs and would therefore have an incentive to figure out ways to cut costs, sometimes excessively. We didn't consider the possibility that maybe you could mitigate the cost cutting incentives, by, for example, having some sort of cost-plus contract. The government could say "you're not bearing the cost; we agree to bear the costs." Of course, that would reduce the private contractor's incentive to reduce costs. I would now, if I was doing it again, probably allow for the possibility that you could design incentives and the allocation of control separately. These are two different dimensions. Under private provision, you could mitigate the incentive effects by having lower-powered incentives. Equally, under public provision, in principle, you could put the warden of the prison under very high-powered incentives. You could allocate some fraction of the cost to them as part of their incentive scheme. Those things would be possible, and I think it would be interesting to explore the implications of that.

This also relates to the possibility of *nonprofits (or not-for-profits)*. Several of the participants in the video – Joe Newhouse was one, but there were others as well – said, 'well, what about some sort of intermediate arrangement, where you have a private provider, but the private provider is a nonprofit.' It's another case where you sort of mitigate the incentive effects. With low-powered incentives, they don't really have a big incentive to cut costs anymore, or to shade on quality, so you can deal with that problem, even though you've handed over control to them.

I think that is only going to be a partial solution, for two reasons. First of all, even not for profits have ways to enrich themselves, even though they're not going to do it by distributing profit. Sometimes you read about not for profits in which the senior people in the organization, the top executives, are getting very high salaries. To the extent they cut costs and have more revenue, they're probably going to find some way to reward themselves.

The second thing is that what you would ideally like to do is to align preferences between the government and whoever is running the public facility, let's say the prison. Ideally, you will want to transfer the social benefit of the prison to the provider, the Warden let's say, or the owner

of the prison if it's a private company. We have this $B(\cdot)$ in the model which reflects the benefits from having prisoners who are treated in the appropriate manner. It's obviously not going to be a luxury hotel, but you want them to be healthy and to be rehabilitated, to eat well, and be able to exercise, not escape, and not get into fights. These are all aspects of B . Then there are the costs of running the prison. In an ideal world, you would transfer the benefit to the owner, or to whoever is operating the prison, and then make them bear the cost as well. Then they'd be looking at B minus C . In fact, we can't do that. It's very hard to do that, because the $B(\cdot)$ is a rather nebulous thing. It's not a verifiable return that you can transfer contractually. That means that even though you can do many things that the model didn't allow – like, for example, create a nonprofit – you're never going to be able to fully align preferences. I think in a world where preferences aren't aligned, who has the residual control rights (i.e., who gets to decide on the things that were left out of the contract) is still going to matter. If you do it, you'll be maximizing your preferences; if I do it, I'll be maximizing mine, and it's not going to lead to the same outcome.

Addressing contractual incompleteness by incorporating guiding principles

I think there is a more general issue that I just want to flag. Even though these days I would want to try to include other things in the model to enrich it, it is not going to be easy. One of the reasons it is not easy is that we do not have a generally-accepted way of modeling incomplete contracts. The sad thing is that after all these years it has become clear that this is really a tough nut to crack. Whatever model you write down of contractual incompleteness, there's always the question of whether you couldn't do a little better: couldn't you try a little mechanism, or some bargaining protocol that you would agree to follow. Or when it comes to control – and this came up in some of the comments – maybe you don't have to allocate all the control to me or to you. We can actually divide up the control in certain ways. We can say the private operator gets to decide these things, while the government gets to decide those things. Some other set of things we have to negotiate over. It's very hard to know what the limit of all this is.

I just want to mention some recent work – not about that paper [Hart, Shleifer and Vishny 1997] or prisons or health care or anything like that, but about how two private companies can write better contracts with each other, given that any contract they write will be incomplete. With a couple of practitioners, David Frydlinger and Kate Vitasek, we've explored the idea of using *guiding principles* (Frydlinger, Hart, and Vitasek 2019). The parties agree in advance, recognizing that things are going to happen that they did not put into the contract. The pandemic is a great example I think. Mark Duggan actually mentioned the effects of the pandemic on prisons, but it obviously has affected everybody. Two parties can agree in advance that 'when something happens that we didn't allow for or contract on, we will use guiding principles to figure out the right thing to do.' There are six guiding principles: Loyalty, equity, honesty, integrity, autonomy, and reciprocity. The thing about these guiding principles is that these practitioners actually use them and advise their clients to use them. The reason I've collaborated with them is that they think that the reference points theory can help explain why the guiding principles work. We've written some papers together – they are on my website if you're interested.

Just as a final note, I would say you could use these guiding principles when the government contracts with a private provider, such as in a contract to provide prison services. I think that might be a way forward. Instead of actually retaining control, maybe the government

goes with the outsourcing solution but improves on the contractual incompleteness by adopting these guiding principles.

Karen Eggleston: Well, thank you so much. Everyone listening, feel free to put your questions in the Q and A. Many thanks to the people I already interviewed on the video. Some were able to join live today. I thought I'd start with some of those questions. You mentioned not only the original framework [property rights and Hart, Shleifer, and Vishny], but also your more recent work on guiding principles and contracts as reference points (e.g., Hart and Moore 2008). Having these two frameworks – focusing on *ex ante* and *ex post* frictions, respectively – raises the question: to what extent are these two frameworks substitutes or complements in the modeling of specific contexts, questions, or empirical applications?

Oliver Hart: In practice, both *ex ante* and *ex post* effects matter. The *ex post* problems are important, but I also think incentives are important. Innovation, for example. One of the things we pinpointed in that paper [HSV97] was that under private provision, you might have more innovation. I do think that is a very important effect. I think of that as an *ex-ante* effect, so I don't want to get rid of that at all.

The trouble is that with any models, by nature you want them to be simple. You don't want to over-clutter them. It's hard to have too many things going on. It's hard to capture all the *ex ante* effects and all the *ex post* effects in one model. Probably the right model depends on the context, so I think it's good to use a different model for prisons than for garbage collection, healthcare, or schools.

Karen Eggleston: Thank you. Elisabetta Iossa, whom you may have seen on the video, asked whether you can share your thoughts on a specific application. I know you're a theorist, so feel free to defer, but she asked: what are your thoughts on how ownership of hospitals may have affected the ability of governments to deal with COVID-19 in this country and elsewhere?

Oliver Hart: It's an excellent question. I bet she knows more about it than I do. My gut reaction is that at times of crisis, like the current pandemic – this is a situation where centralized authority can be pretty useful. I think I'm saying what many people have felt about the US. Having such a decentralized system, having all the states with their own policies – it hasn't been that great in this situation.

Some theories of the firm would say that the benefits of integration include not only solving *ex-post* renegotiation problems but also just getting better coordination. If you have a central authority, as you would in a single firm, the authority can basically say, “okay, this division will do this, and this division will do that.” That can work better than if you have separately-owned units who have to negotiate. I feel this is one of those situations.

For example, even though the UK seems to have dealt with COVID-19 quite badly in some respects (i.e., they've had a lot of deaths), when it comes to getting the vaccine out, because of the National Health Service – under which essentially everyone in the UK pretty much has a general practitioner – they've been able to get the vaccine out much faster than in the US. In the US it's a bit more chaotic. It's not a direct response in terms of ownership of hospitals, but more generally a response arguing that sometimes having a lot of authority at the top can really work well. It may not work well the rest of the time. There are tradeoffs. But in a crisis, it's clearer.

For example, if a country is at war, you can't have the separate states of the United States figuring out how to go to war.

Karen Eggleston: There's a question saying that this argument is related to the issue of federalism in general. Do you see it that way?

Oliver Hart: Yes. I'm not saying that centralized control is always better. I want to make it clear, that just because centralized control can work extremely well in a crisis, it does not follow that it is better on average. That's another story. If you compare the National Health Service to the American medical system, I think there are things to be said on each side.

Question from James Malcomson: Hart, Shleifer and Vishny (1997) "cover the polar cases in which the facility is owned either by the government or by a private firm, with the owner having full residual control rights. But with, for example, the privatized prisons in the UK, the government still owns the buildings, etc. My hunch is that this privatization passes some, but not all, of the residual control rights to the private operator, which gives something in between the polar extremes. To model this, I guess one would need to have two types of quality innovation, one to which the private model in HSV applies, the other to which the public model applies. That raises the question of when this intermediate case improves on both extremes."

Oliver Hart: I'm slightly going to dodge that one by saying that I did mention that splitting up control rights is possible. In reality, this is an example actually because you can say, "Okay, you own the prison, but I have the right to figure out what goes on in the prison for the next three years," or some similar sort of arrangement for a hospital. I think I don't have a crisp answer to what would be good or bad about that. It's certainly the case that it makes it easier for the government to replace the private provider at the end of the term of the contract, I would assume. If the government owns the prison, and this company isn't doing a very good job of running the prison, then the government can either bring it back in house or can go with a different contractor. Whereas, if the contractor owns the prison, you're going to have to buy it back from them, which is going to be costly and tricky. So that's bound to have an effect. It could, on the one hand, encourage better behavior, because you have to persuade the government to renew. They can easily get rid of you, so that keeps you on your toes. On the other hand, it could discourage long-run investments, which might be productive, because you don't have a simple way of taking advantage of them, since you can always be fired. It can definitely have an effect, but whether it's positive or negative is less clear; overall, one would need to look at the circumstances. Jim Malcomson also asked a second question; I don't know whether you want to discuss that one.

Karen Eggleston: Yes, he also just asked that second question in the Q&A... ["In HSV, the parties renegotiate to share the gains after the manager has taken actions. Ownership is important because it affects the default payoffs in that renegotiation. But, at least for public services in the UK, I am not aware of much actual renegotiation with existing managers/providers before the end of the contract – the renegotiation I am aware of is typically over terms for renewal of a contract at the end of its initial term. I would be interested in knowing whether Oliver sees some way in which the outcome in HSV can occur without explicit

renegotiation. Or does he envision the HSV model as a single period representation of what is actually a dynamic process?"]

Oliver Hart: Hello Jim, if you're there. He had said that there isn't a lot of renegotiation, in his experience. Given his knowledge of these things, during the term of the contract there isn't that much renegotiation. I'm less bothered about that than I once would have been. Once you start bringing in these ex-post problems, in the extreme case, the frictions are so great that renegotiation may not happen at all. To give you an example, if you do something in the contract that I feel was inappropriate (that is, it's not really within the spirit of the contract), I may not be that inclined to pay you to do the right thing. Here I'm talking about myself, so I don't know whether governments operate this way. We have to look at the particular cases. But giving into blackmail – where I'm paying you not to be bad – doesn't seem quite right. I might just refuse to do that and live with the consequences. But on the other hand, there are cases where renegotiation does take place. The pandemic would seem to be a good example. Mark Duggan mentioned the case of what happens to prisons during the pandemic.² Suddenly, you have to change the way you are treating the prisoners. All sorts of safety measures have to be introduced and they're going to be quite costly. There's going to be a question as to who bears the cost. Surely there was not a pandemic clause in the contract. Maybe there's no clause that really covers these kinds of situations. Some sort of renegotiation seems inevitable. In some cases, it has to happen.

Karen Eggleston: Thank you. Building upon that: as you saw, many of the interviewees in the video, and listeners today, are interested in health policy. There can be many different objectives. One listener asked whether you have any comments on this question of the multiple objectives such as: delivering healthcare, covering the maximum number of people, decreasing costs, promoting innovation (which you've mentioned), improving responsiveness, and so on. How would you think of that in terms of your framework?

Oliver Hart: At some level that benefit function $B(\cdot)$ we talked about, which in the paper was the benefits of having prisoners looked after in the appropriate fashion, can actually cover many things. I already mentioned some of them – we could be talking about physical health, mental health, rehabilitation, not escaping, etc. Economists can lump those altogether, because they think of things in monetary terms. Each one of those can be measured as some sort of monetary benefit, and you just add them together. The issue may be when it comes to alignment or incentive schemes. If you have one thing that you can measure, let's say prisoner escapes or lack of them, you could put that in an incentive scheme. But drawing on the work of Holmstrom and Milgrom (1991), we know that that isn't always such a great idea. Because if you care about some of the other things, then you don't want to overweight the one thing you can measure. It might be better to have more balanced incentives, i.e., not to focus so much on the one thing you can measure. I think it also makes control important. One of the things I can do, if I can't incentivize you, is at least have the ability to stop you from doing inappropriate things, which would come with control. It's possible to include those things, conceptually at least. In practice it's going to be a challenge.

² See the section on “COVID-19 pandemic and policy response” in “The Legacy of ‘The Proper Scope of Government’ ” [documentary](#) starting at 1:07:41 (see appendix below).

Karen Eggleston: Thank you. Related to that, Anita Mukherjee – whom you may have seen in the video – and others like Mark Duggan mentioned that these days, there are a lot of new technologies, big data, and novel measurements; so there's improved contractibility in many ways. Does that help to solve the problem, or might it actually exacerbate multitasking problems? Perhaps it depends on the setting. Any thoughts about that?

Oliver Hart: Yes, Anita Mukherjee had many interesting things to say on the video,³ and I hope I get to meet her at some point in the future.

First of all, this question is in the category of “can we do a bit better?” Yes, contracts are incomplete, but can we think of yet another thing that we might be able to measure and put in the contract? What she's saying is, more things are becoming available, yet there is also this multitasking point that suggests it can be disadvantageous to put some things in the contract.

I think there's also the point that we all feel might be important but isn't easy to model: if you put more stuff into the contract and then something happens that was *not* in the contract, the fact that you put so much more in may make it more difficult to negotiate about the thing that you didn't put in. There are all sorts of stories about this. If you had put a lot of things in the contract but then something happens that wasn't included, I might say, “Well, Karen, I'm not going to be nice to you about that, because you didn't think of it. You seemed to think about everything else, but you didn't put this in. That's your problem.” Whereas if the contract was looser, I might take the view, “Well, we knew there was a lot of stuff left out. Now we need to use decency. We need to be fair about filling in the gaps.” I think there is a cost of putting too much in.

What might be better is to have some guiding principles, i.e., something more general to deal with stuff, rather than just trying to think of as many things as possible. That doesn't mean that there's no role for additional measures as they become available. However, I think it's also important to realize that the world seems to be becoming more uncertain and volatile. At the same time as we have more things to measure, somehow there's more uncertainty. Many people talk about that, and it may make it more difficult. I'm not sure which side is winning that race.

Karen Eggleston: Thank you. That also relates to Mark Duggan's point, and question: he suggests that one might have hoped, with all this technology and new ways to monitor quality – for example, monitoring bus stops and waiting times that Elisabetta Iossa mentioned⁴ – that improved technology might have affected the ability to contract out. But we haven't seen as much of a trend towards contracting out for prisons or for K-12 schooling as that might have implied. Do you think that helps to explain the patterns of contracting in or contracting out?

Oliver Hart: Well, I don't know. I think a lot of the people who appeared on the video or who are asking the questions actually know more about it than I do, especially about the government cases. As I say, I do know a bit about the ones that I've written about with practitioners. Those are private cases. They involve companies who have already decided to outsource. The question is, how to do it better. Actually, there was an example in our paper in the *Harvard Business*

³ See the sections on “Empirical evidence on prisons” and “Long-term care” in the tribute video https://www.youtube.com/watch?v=g9JRhGpXC2Y&feature=emb_title.

⁴ See the section on “Local government services and central government procurement” in the tribute video https://www.youtube.com/watch?v=g9JRhGpXC2Y&feature=emb_title about minute 27.

Review from 2019 when Dell outsourced its repair operations to Fedex. They started off with a 100-page-long contract with tons of statements about what Fedex had to do. It just didn't work very well, and neither party was happy. They eventually turned to a different kind of contract where they use guiding principles. It seems to work much better. I'm not on top of all the different outsourcing things that governments are trying, and which ones have succeeded and which ones have failed, so I don't know. Sometimes, you might have a very good measure, such as "If the bus is late, that causes this much (\$X) damage, and so you pay this (\$X) fine." I'm not saying that never works; we know that for simple transactions, a standard contract works great. But not for others. For example, consider the case of monitoring workers. As a worker, do you want to have all these performance measures, all the time? In principle we may move to a system where I'm being monitored all day, with everything I do being monitored. Am I taking too much time for a break? This is something that a lot of people hate. It can kill initiative or any sort of good work. Imagine as an academic, if that was the work environment: it would be a disaster. I think there are lots of situations where more monitoring actually may be bad.

Karen Eggleston: This also relates to the question that came up with Mark Duggan, Anup Malani and others about the Hart, Shleifer and Vishny framework being normative – as the title says, the *proper* scope of government. But also, the framework may apply in a positive sense, i.e., in explaining trends in contracting out observed in practice. Do you have thoughts about how it's used normatively or positively in the literature or in practice?

Oliver Hart: Hello to Anup Malani if he's there; I learned a lot of things about what he's doing which I didn't know about and they sounded fascinating. I think the people on your video, or at least some of them, are actually using this framework – and others too, undoubtedly – on the front line in advising governments. I'm sure they know more about it than I do.

In terms of if it is positive or normative, I don't see a big distinction between the two. I think of these models as providing a framework for deciding what we should do. Should prisons be run by private companies? Or should the government run them? This is, of course, a political issue. I think Obama just at the end of his Presidency announced that federal prisons would all be under public ownership. Then, we had Trump, who presumably did nothing about that. Now I think Biden has said the same thing as Obama. He presumably can only control federal prisons; there are also state prisons. It would be nice if this decision was made after thinking about it, maybe using the Hart, Shleifer and Vishny framework. I rather doubt it. But I think the point of that framework is not to give you the answer. Look at the model in the paper: There are benefits and costs. Therefore, it all depends on the particular situation. We did suggest that when it came to high security prisons, the trade-off went in the direction of government control, i.e., government ownership. But the best we can do as economists, or at least that I can do, is to provide a way of thinking about it. It's for the people who actually know more about the context at hand to decide. In that sense, I think it is both normative – this is the way you should think about it – and then it may also affect what decision they end up with, in which case it's positive as well.

Karen Eggleston: At the time when the paper was developed and published, some of your colleagues in the department – indeed co-authors – had done work on privatization. I'm wondering whether the framework, and your focus on it at the time, was at all related to the fall

of the Berlin Wall, the transition of centrally-planned economies to market-based economies, and privatization during that process?

Oliver Hart: It's a good question. I think the answer is that it didn't affect me, but in fact I do recall the origin of this paper being Andrei [Shleifer] coming to my office and saying that he thought government ownership versus private ownership would be an interesting application of my work on the theory of the firm. It was his idea. Rob Vishny was at Chicago – maybe they talked – but in any case, I wasn't the initiator of this particular application. Of course, Andrei was very involved in Russian privatization and things like that, so that may well have been the origin of his interest, but it wasn't the origin of mine. I was just interested because as a theorist, it seemed like a good application.

Karen Eggleston: You mentioned in several of your publications that you've worked on a couple of legal cases that draw from your broader work – maybe not specifically this paper. I wonder if you could mention some of your experiences from that?

Oliver Hart: Sure. I've worked on some cases which were very close to my theoretical work on the boundaries of the firm – not this paper, but the earlier ones (although it's really the same thing). I worked on two cases: one was Black and Decker vs USA and the other one was Wells Fargo US vs USA. They were cases where a company had taken some operations that it was carrying out in house and had spun them out to create a new entity. For example, Black and Decker had a unit that was dealing with health benefits for its workers and retirees inside Black and Decker. Then they decided to create a separate organization that would do it. They spun those operations out.

Wells Fargo did the same thing with respect to real estate. We think of Wells Fargo as being a bank. But in fact, Wells Fargo owns a lot of real estate, and the reason it does is that it has merged with other banks and then it doesn't need all the properties. It then leases them out. It has actually a big leasing operation which was in house, and then they put it into a separate entity, that is, they created a new entity.

It turns out that in both cases, there was a big tax benefit from doing this. We don't have to go into the tax details (they were rather complicated); I think it was a loophole that has subsequently been closed. There was a period during the late 1990s when there was a huge tax benefit from doing this. However, in order to enjoy the tax benefit, they had to show that there was a business purpose of the transaction. Other than for taxes, there had to be some sort of economic efficiency gain. Basically, Black and Decker and Wells Fargo both argued that creating a new entity would unleash incentives: Things will be operated much more efficiently when the people working on these things were their own bosses, basically.

The funny thing about both transactions was that the parent company retained complete control over the operation. Even though Black and Decker created a new entity, and Wells Fargo created a new entity, they both actually had 100% control over it. I argued that if we think of the boundaries of firms being about the allocation of residual control rights, there's been no actual change here. This arrangement is, in terms of actual control rights, just the same as a unit inside Black and Decker or Wells Fargo. To the extent there have been incentive improvements, it is because they've put people on higher-powered incentive schemes, which they could have done inside the firm just as well. The thing is, if they had done it that way, they wouldn't have got the tax benefits. That was my argument.

I was acting on behalf of the US Government in both cases saying this was a sham and they shouldn't be entitled, therefore, to the tax benefits. The first one was settled. The second one we won. I actually appeared in Federal Court in Minneapolis and explained the theory of the firm to the judge. I couldn't tell how interested he was, but he did cite my testimony approvingly in the judgment, so I guess at the end of the day it all worked out.

Then there was a third case. Here I may be going too far, but I was also involved in another case, which is still being decided. Actually, it was the other way around: it was a situation where there was an entity which was effectively 100% controlled by one party, Party A, but for tax reasons Party A wanted to claim that it was a partnership with Party B. But Party B actually had no effective control. It turned out to be like the other side of the coin. If you and I have a partnership, but you're running the show, is that really a partnership? I argued it wasn't. It's similar to an organization in which I might have a small equity stake like an incentive scheme, but I have no decision-making authority. These are the kind of cases I've been involved in. They've been quite fun, actually.

Karen Eggleston: Great, thank you for sharing. I believe in your guiding principles work there was also a case related to health policy involving hospitalists and a change in the contracting. Perhaps you could speak just a few minutes about that case?

Oliver Hart: Sure, well that's a case I'm currently very interested in. I mentioned this *Harvard Business Review* paper with David Frydlinger and Kate Vitasek who are practitioners, who actually put this guiding principle stuff into practice. Then we teamed up: I argued that we can understand this theoretically, and they argued that it seems to work in practice. At the same time, David Frydlinger and I have another companion piece which we're trying to get economists interested in, because most economists don't read the *Harvard Business Review*. Our paper has a model in it, but it also has several cases, and one of them is the one we're talking about. The reason it's on my mind is because we've been spectacularly unsuccessful in getting this paper published in a good journal and we're trying to find a way to sell it. I think in our revision we're going to focus almost entirely on the hospitalist case that you're referring to. I'm thinking about it, so let me just describe it, very briefly.

It involves the Vancouver Island Health Authority, obviously in British Columbia, which contracted with a group of doctors known as hospitalists. As I'm sure you know, hospitalists are doctors who work in hospitals seeing hospitalized patients and often dealing with quite complicated cases. This was an outsourcing arrangement between this government entity, the Vancouver Island Health Authority, and a group of hospitalists. After contracting for several years, there was a new law in Canada which said that family physicians would no longer follow their patients into a hospital, which apparently was quite common before, but it ceased. This change meant that the hospitalists had more work to do, because they didn't have anybody helping them. Their workloads went up and they became very stressed. Our reading of the situation was that the health authority wasn't seen as very accommodating to them; it did not let them hire more hospitalists to take up the work, so the stress levels and the work levels were going up. The hospitalists responded by refusing to admit patients from the emergency room into the main part of the hospital (the main channel for such admissions). Because they felt they had too many patients and didn't feel like they were doing a good job on the patients they already had, they perhaps felt ethically not so bad about refusing to admit new patients. There was a sort of bottleneck that developed and there was a lot of bad feeling on both sides. Basically, trust and

good feeling between the parties went down the drain. When the contract came up for renewal, they tried to renegotiate it but without success, because there was so much bad feeling about this incident. The point was that the hospitalists felt that Island Health Authority had just been very unconcerned with their situation.

Eventually after failing to renegotiate or renew the contract, they decided to try something different. They went for this guiding-principles approach or vested approach. Basically, they called in my co-authors. (I hadn't met them yet, but they were, as I say, on the ground doing these things.) They heard about this approach, got advice, and wrote what is called a vested contract or formal relational contract. It's a formal contract. Of course it has quite a few things in it of the standard kind – standard provisions – but then it adds these guiding principles (as mentioned earlier⁵). The principles are put into the formal contract, and they are explained, i.e., the parties say what they mean by equity or loyalty or autonomy.

Actually, the parties go through a whole process of arriving at the contract; it's described in the *Harvard Business Review* paper, for people interested in the details (Frydlinger, Hart, and Vitasek 2019). It is not just that we meet and we stick these words in the contract. We actually have to share and discuss our own visions and try to get to a point where we realize our visions are consistent. There's a lot of communication before we actually consummate the deal. There's also communication once the deal has been agreed on, during the relationship. We agree to communicate in various ways; we set up governance arrangements where we have teams talking to each other if problems arise, and so on. Communication channels and governance are all a crucial part of it.

They found that the kinds of things that had previously been extremely difficult to deal with were now possible to deal with. We give a couple of examples. One of them was related to advice about dying. It became established in Canada that people who were near death would be given some advice about what the possibilities were. It was a kind of new service – legalizing medical assistance in dying. This was an extra task that the hospitalists were expected to undertake. We interviewed some of the participants in this deal; they said that in the past with a conventional contract, there would have been a lot of argument about whether this was already within the scope of the contract. Did the initial contract already say that you, Karen, as a hospitalist, are obliged to provide this assistance given that there's a new Canadian law about it? The other view you might have is that this isn't part of the original scope of work; it's something new, and you need to be compensated for it in some way. There would have been a lot of argument. But now, what we were told, at least, was that with the guiding principles and all the rest of vested approach, they actually came to some reasonable solution for how to deal with this.

Something similar has gone on with the pandemic. The pandemic meant that there were many fewer patients in the hospital, but the patients there were sicker than before. The question arose of how to deal with the fact that actually there were too many hospitalists for the number of patients, yet on the other hand, they were doing more dangerous work. They've compromised: there's work sharing between the hospitalists; they are taking lower pay, but not as much lower as it would have been if both sides hadn't behaved reasonably; and they've agreed to “bank” some of the hours they are not working, i.e., they're willing to put in some extra hours later, when this is all over. Overall the parties have achieved a reasonable compromise – something that the participants say would have been harder in the old days.

⁵ Guiding principles of loyalty, equity, honesty, integrity, autonomy, and reciprocity; see discussion in Frydlinger, Hart, and Vitasek 2019.

Karen Eggleston: In settings where there might be issues with the efficiency or robustness or reliability of the legal system, do you think that guiding principles are even more important?

Oliver Hart: It's a good question. I suppose, possibly, in the sense that if you have a decent legal system, you can use the standard part of the contract to deal with a fair amount, and then the guiding principles are on top of that. If you don't have any sort of legal system, you're going to have to use norms to solve every problem, so I suppose it would be more important to have stronger norms. I think the point I would emphasize, though, is even in a good legal system, this can work as a very powerful addition to standard contracts.

I also want to emphasize that, of course, some of what I'm saying is going to sound to a lot of people very similar to other things that you can find in the literature, such as ideas dating back to at least Macauley and Macneil about relational contracts.⁶ And then of course there's the whole game theory literature about repeated games. What I'm talking about is in a similar spirit. But I think it's distinct. Because if we think of the situation where the hospitalists had to work more and became very stressed, I don't think of that as something that a tit for tat strategy would really solve. I think a lot of the repeated game models are about, 'I'll be nice to you today, because if I'm not, you won't be nice to me tomorrow.' But there's some sort of notion that the problem today is of the same order as the problem next year or the year after. Whereas I think in a lot of situations, the problem that's hitting is actually a really big one. We're not going to see one like it again maybe for a long time. The pandemic is obviously an amazing example of that. It might be only every hundred years. When it comes to the older ideas of Macauley and Macneil, I think there is quite a big parallel, but I don't think they were ever suggesting that you actually put these guiding principles into the contract. My colleagues find that that it's not just that these norms are in the air. There are two things. First of all, the guiding principles are norms. These are things we're familiar with: equity, loyalty, reciprocity, honesty, and integrity. In a way, when you discuss them you're activating things that people are already familiar with. Nonetheless, just because they're familiar with them, it doesn't mean that they're going to use them automatically if they're not agreed on and discussed in advance. Putting them all into the formal contract is going to make them much more powerful.

Karen: For our final two questions for today: First, Jonathan Levin and Steve Tadelis had asked if you were starting out today in economics, what would you choose to focus on?

Oliver Hart: The honest answer is, I don't know. I think it would be more difficult for me now, if I were starting out. I am naturally a theorist. But I don't do what theorists do these days, and I don't think I would be very good at what they do. They're quite distant from the kind of stuff I work on. Even though I have worked on more technical things in my time, I don't think it was my comparative advantage to do that. I see what young theorists are doing, and it's not the stuff that I would be terribly good at. And it's not stuff that I'm terribly excited about, to be honest. Which probably, we should keep this to ourselves. But I could never be an empirical economist either... I might be a bit lost.

Karen Eggleston: Thank you for sharing your thoughts. I wanted to close with something quite related to that: I would like to quote from your conclusion in your published Nobel lecture, and invite your final thoughts on that:

⁶ See Macauley 1963, Macneil 1977, Macneil 1983.

“Economists are drawn to areas with simple, elegant, and uncontroversial models. The area of incomplete contracts is not like that; it is messy. But contracts are incomplete in reality, and contractual incompleteness underlies numerous significant phenomena, some of which have great policy relevance. I hope that economists, particularly young ones, will, in spite of the messiness, continue to work on this challenging topic.”

I assume that you consider *contractual incompleteness in publicly-financed services* as one of those ‘phenomena of great policy importance.’ Any parting thoughts?

Oliver Hart: Absolutely. Well, that was three years ago and nothing has changed. The point is that the way the economics profession works, in order to get papers published and to get jobs – certainly talking about the theory side – you have to do something clever. I see it again and again when we look at job market candidates. If you've done something complicated, clever, and non-obvious, people are impressed; and it doesn't make much difference whether it is miles away from an actually important question. People are still impressed. In contrast, if you work on an important question that is inherently messy, and you do a somewhat messy job, people are unimpressed. That is sad I think, but it's the way life is. I don't know how to solve that problem. I feel for them. I would like young people to work on this stuff, but if a student comes to me and says, “I want to work on incomplete contracts,” I feel I have to deliver a health warning like, “OK, but this may not be good for your future, because you probably aren't going to be able to write a clever paper which will impress people with its brilliance. It may be tough to get a job, even though the topic is important.” I would like them to work on it, but I'm not sure that they will do that well professionally by doing so. Things may change; let's hope they do, Karen.

Karen Eggleston: Thank you also for candidly talking about a journey of publication for your own work; that's a lesson for young people as well, that even Nobel Laureates can have a journey in publishing their latest research.

Anyway, I just want to thank you so much for your candidness, your brilliance, and your humility – it's a rare combination. We really appreciate your sharing with us today, thank you very much.

Oliver Hart: Thank you for doing it all. When you first approached me, I was of course flattered but I didn't know it would turn into something so interesting. Thank you for that.

Karen Eggleston: Thank you very much, and thanks everyone for [joining us](#).

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Appendix: Celebrating a Quarter Century of Hart, Shleifer, and Vishny’s *The Proper Scope of Government* (NBER 1996, QJE 1997)

A [tribute](#) documentary from Karen Eggleston & interviewees

[The Legacy of Hart, Shleifer, and Vishny’s *The Proper Scope of Government*](#)

8:40 **Use of HSV96/97 in Teaching:** What key points do you emphasize?
How do your students react?

20:50 **Applications of HSV96/97 in Research and Policy**

20:58 Empirical evidence on prisons
23:23 Local government services and central government procurement
30:20 Social safety nets in low- and middle-income countries
36:08 US health policy
58:38 Long-term care, residential services for older adults
1:01:20 Health policy in low- and middle-income countries
1:07:41 COVID-19 pandemic and policy response
1:16:43 Nonprofits, professional ethics, and intrinsic motivation

1:24:33 **The Significance of Oliver Hart’s Recent Research:
Contracts as Reference Points, and Beyond**

<https://www.youtube.com/watch?v=g9JRhGpXC2Y&feature=youtu.be>
<https://stanford.io/31LzGjR>

Separate videos: **Highlights** – see first 15 minutes of Jan 20th webinar
<https://www.youtube.com/watch?v=5XuIcelWo0g&feature=youtu.be>
Questions for Oliver Hart