Chapter 10

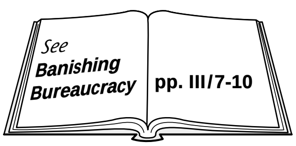
Managed Competition

Using Competitive Contracts and Benchmarks to Create Consequences

> *It is better for the public to procure at the market whatever the market can supply; because there it is by competition kept up in its quality, and reduced to its minimum price.*
>
> THOMAS JEFFERSON

***Managed Competition* makes potential providers of government services—whether private firms or public agencies—compete against one another to win government work. The contests create economic or psychological incentives that stimulate performance.**

When the subject of cutting government costs comes up, as it persistently does, many a public manager's fancy turns to contracting out services. More than likely, they know a story or two about the millions saved when a lean business, driven by the fabled *bottom line,* took over a public bureaucracy's work.



Ted Staton, the city manager of East Lansing, Michigan, had heard a good one: how Indianapolis mayor Steve Goldsmith had saved $65 million over five years by contracting out management of the city's wastewater treatment facility. "I'd had lunch with Goldsmith," says Staton. "I'd read the Indianapolis story and heard about the gains in efficiency at the plant."

Staton was relatively new in his position. A self-styled reinventor, he'd been hired in 1995 to shake up a traditional bureaucracy. From the beginning, he'd also been hunting for savings. The city budget had been bleeding slightly red year after year, because growth in property taxes, the city's main revenue source, consistently ran lower than growth in costs. So in 1996 Staton drew a

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bead on the city's wastewater treatment operation. With 26 employees, it cost about $3 million a year to run. "I had a gut sense that perhaps our wastewater operation wasn't as efficient as it might be," he recalls.

Staton's judgment was not shared by the unit's managers and employees. "They were pretty defensive," he says. "You know: they couldn't get more efficient; they were already the envy of all of Michigan." The facility was exceeding state standards for effluents, but Staton still thought contracting out the work might save money.

Staton saw an unexpected opportunity in a flier that came across his desk announcing a conference about contracting out wastewater operations. He ordered the director of public works, Pete Eberz, to attend.

The conference had an unexpected impact on Eberz, a veteran administrator. He came away impressed by a speaker who argued that government-operated wastewater facilities could run at the same or lower cost as privately managed plants—if they adopted the operational practices of private firms. Eberz told Staton not to contract out the work, but to give the workers a chance to show they could match the private sector.

The first step was to compare the city's performance with what businesses could do. "We needed a comparison to tell how far out of line we were," Eberz explains. "Maybe we were so bad that we ought to privatize, or maybe we were very competitive. We didn't know." If there was a cost gap with the private sector, the city could develop a plan for closing it.

In April 1997, the city hired EMA Services to conduct a comprehensive "optimization" study that compared East Lansing's performance with that of 120 other privately and publicly managed wastewater facilities. During the next five months, EMA reviewed the plant's technology, operations, maintenance, consumption of energy, chemicals, materials, staffing plans, barriers to efficient staffing, job descriptions and lines of responsibilities, and employee training and performance incentives.

Then EMA officials came to East Lansing to share their findings with the city manager and wastewater unit employees. "I knew it would be a tense meeting," says Staton.

"There was a lot of fear," recalls Antoinette Imhoff, a laboratory technician with more than 20 years on the job, "especially among those close to retirement."

Rumors swirled about possible layoffs. "I tried to stop all cooperation with the process," says Ed Mahaney, a lab technician who served as steward for the employees' union. The union refused to cooperate unless it was assured in writing that there would be no layoffs.

Other employees thought the study would be beneficial. Before he was hired into the maintenance unit, Dennis Smith had worked on the construction crew that built the plant, 20 years earlier. Now a shift supervisor, he had helped select EMA to conduct the study. "I was optimistic about the study," says Smith. "I'd always felt like we were overstaffed and underworked. Of course, to a lot of people I was a bad guy for even going to the meetings."

Staton recognized that employees were divided. "Some thought it was a reasonable approach and privatization might become a reality unless they did it. They felt pressured by the threat of the competition, and they understood the pressures facing government." Others, he says, "thought if employees stuck together, they could keep this from happening."

EMA officials delivered the good news first: the plant had an excellent track record, they said. Then they talked about improvements that could be made and new equipment the city should invest in. Finally came the news few employees wanted to hear: the plant could operate 20 percent more efficiently and save $614,000 a year. Much of the savings would come from eliminating eight of the 26 jobs.

Some employees reacted bitterly. "There was denial," says Eberz. "People said, 'We don't believe you.' And there was fear—'you're taking my job away.' "

Even Smith, an enthusiast for improvements, was startled. "I never dreamt we could cut as far as they proposed. I stood up and said, 'Cut it less.' "

The consultants said that outsourcing would not be necessary—the city's staff could achieve the savings. The next step, they suggested, was for employees to join with management in developing and implementing a cost-saving improvement plan.

When Eberz tried to form a planning committee, it wasn't clear that employees would participate.

> *I said, "Look, we're either going to improve or privatize. Right or wrong, the cat's out of the bag; the numbers are out there. We can't just ignore it. With you or without you, we're going to follow the council's directive to be cost-competitive."*

Mahaney, the union steward, pressed Staton on the key issue: What about the jobs? "The only person there who could answer that question was me," Staton says. "I stood up and said, 'You have my word: we will do this through attrition.' "

"I think he actually said it three times," says Mahaney.

The employees' mood changed quickly. "From that point forward," says Staton, "the extremely reluctant employees started to become more cooperative. They actually built a plan that we presented to the city council." The six-year plan included the staff reductions and an additional incentive for employees: a "gainsharing" provision to give them 25 percent of the savings, minus the cost of new equipment. When the council approved the plan in October 1997, it pledged that staff reductions "will be obtained through attrition and retirement."

In the first two years, the wastewater treatment unit met its savings targets with little difficulty.

USING MANAGED COMPETITION

The threat of competition forced East Lansing's wastewater treatment workers to cut costs. Managers and employees had to agree to meet the competition's "price," a stunning 20 percent below their existing costs, or face the possible loss of their jobs through contracting out.

Competition is a powerful force for improving government's performance. It breaks down the traditional monopoly that government employees have over their work, forcing them to compete for work just like businesses in a marketplace. To illustrate the negative impact of public monopolies, former Indianapolis mayor Steve Goldsmith, a great champion of managed competition, describes what would happen if fast food businesses did not face serious competition. "They're always competing in terms of price, food quality, and service," he says.

> *No one says they're perfect. But imagine what they would be like if there were only one fast food chain. If people had no choice, if there were no competition, if fast food were a monopoly, two things would definitely happen. Prices would go up, and quality would go down.*
>
> *Most of government is run that way.*

"Competition is the driving force of excellence," adds Ron Jensen, the former public works director in Phoenix who invented public-private competition for municipal services. "Would Roger Bannister have broken the four minute mile barrier without the competition of other runners? Our national commitment to land on the moon was spurred on by the fact that the Russians had the first satellite in space."

We call this approach *managed* competition because it is not a cutthroat contest to drive down prices but a carefully directed use of market forces. It requires potential providers of government services, whether they are private firms or government agencies, to compete against one another for government work on the basis of their performance.

Reinventors use two tools to create managed competition. The strongest, competitive bidding, forces organizations to compete with one another to provide public goods and services. The second, competitive benchmarking, is what East Lansing used. Rather than contract out or create a formal public-private bid, Staton and Eberz created a competitive standard, based on a study of private sector performance, and asked their employees to meet that benchmark. If they had conducted a bid, they might have found a bidder who proposed to cut costs by more than 20 percent. Instead, competitive benchmarking allowed them to avoid the time and cost of a bidding process and, more important, avert a confrontation with the employees' union. Had the treatment unit's employees failed to close the cost gap the consultants identified, the city still could have contracted out the work.

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Competitions create winners and losers—and then the winners have to deliver. When government agencies award contracts to private bidders, they must carefully monitor the contractors' performance. But when a public sector provider wins, much more than contract management is necessary: government employees have to learn how to improve their organizations.

Indianapolis's garbage collection crews redesigned their work processes to win their bids. "My guys figured out how to go from 800 homes per day on each trash route to 1,200," explains Michael Stayton, then the city's public works director. The crews reconfigured the daily pickup routes and, Stayton says, created "a nifty shuttle system for the garbage trucks. When a truck gets full, instead of taking it back, emptying it, and going back out, now an empty truck comes out, the crew gets on it, and the full truck is taken back to the station." As a result, the city team's bid was about 25 percent less than those of private competitors, without reducing workers' wages and benefits.

In East Lansing, implementation of the cost-cutting plan was slow and difficult. Dick Hansen, a maintenance mechanic who chaired an implementation group of employees, says they came across many barriers. Sometimes, facility managers ignored their recommendations or made decisions that contradicted the plan. Sometimes employee anxiety got out of hand, because "[employees] just don't trust management." The city's personnel system also stood in the way, since it was not designed to support bonuses and gainsharing incentives. And some man-

TOOLS FOR MANAGED COMPETITION

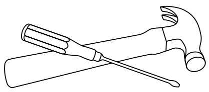
Competitive Bidding forces organizations to compete to provide goods and services paid for by the public sector. There are three basic variations: private-versus-private competition (known as *contracting out* or *outsourcing*); public-versus-private competition; and public-versus-public competition, in which only public organizations are allowed to bid. See p. III/70.

Competitive Benchmarking measures and compares the performance of public and private organizations. It publicizes the results in "report cards," "performance tables," and other types of scorecards. This creates psychological competition between organizations, appealing to their members' pride and desire to excel. It can also be used as the basis for financial rewards. See p. III/93.

agers signaled that the facility might not have to reach its $650,000 cost-cutting target. "They [would] say, 'All we have to do is come close,' " explains Hansen.

These difficulties are all part of trying a new way of doing business. "We're just starting down this path," says City Manager Staton, well aware that he and his top managers are on the hook for delivering the results they promised to the city council. The hook was created by managed competition.

COMPETITIVE BIDDING



Of the three ways to use competitive bidding, contracting out is the most familiar and widely used among government officials. Also known as outsourcing, it makes private organizations compete to provide goods and services to government. These services may be for government's own use, such as copying and printing, or for use by its customers, such as road repairs and school lunch service. Rather than hire workers to perform these activities, agencies invite private organizations to bid for contracts that specify the scope of work and other conditions. After contracts are signed, government employees monitor contract compliance and enforce contract provisions.

Public-versus-private competition uses the same bidding mechanisms as contracting out, but it changes the pool of bidders. It allows public providers—departmental units, teams of managers, teams of employees—to compete with private providers for the right to keep performing their work. In public-versus-public competition, bidding for work is restricted to public organizations.

The Basics of Contracting Out

Contracting out is a well-tested tool in both the public and private sectors, and in recent years governments have increased its use. In the process, they are expanding its application to public functions that were previously off limits, such as the management of public schools and prisons.

These trends began in the late 1970s and are strong at the local, state, and national levels. Between 1987 and 1995, more than half of the 82 American cities surveyed by the Mercer Group outsourced solid waste management services, janitorial services, construction projects, and food services at public facilities. Taylorsville, Utah, an edge city near Salt Lake City with a population of 60,000, has only 12 municipal employees, including the mayor; everything but planning and permitting is contracted out or shared with another government. Similar growth in outsourcing is occurring at the state and federal levels, as well as in Australia, New Zealand, and the U.K. By 1991, outsourcing accounted for nearly a third of Australia's federal outlays.

Contracting out has spread to many new arenas. Defense departments are contracting for services that have been handled in-house for decades. The Australian military, for example, hired a private contractor to completely manage one of its bases. In 1993, the Minneapolis board of education contracted with a consulting firm, the Public Strategies Group, to provide leadership services, including a superintendent. Other school districts have contracted out other management functions. And Wyoming, Arizona, Indiana, and Wisconsin have put major pieces of their welfare systems in contractors' hands.

The main reason for this trend is that contracting usually saves money. Private companies tend to have fewer layers of management, they adopt cost-saving technologies more rapidly, and they use their personnel more flexibly. This helps makes them more efficient than most public bureaucracies.

Labor unions often charge that private contractors cost less because they pay workers less. For low-skilled jobs such as custodial work, this is often true. But after a careful study, the Council of State Governments concluded that in many cases "private providers can provide services at low cost without lowering wages." It attributed the private sector's lower costs to a variety of management factors: "private firms give fewer days off with full pay, use more part-time workers, have greater managerial authority to hire and reward good workers, and, if necessary, to discipline or fire unsatisfactory ones [and] have clearer job definitions and greater accountability."

Saving money is not the only benefit of contracting out; it can also improve performance. State administrators told the council that they use the tool to meet demands for increased personnel, to reduce red tape, to increase flexibility in hiring personnel, and to achieve speedy implementation and high-quality services. In other words, public managers find that private businesses can be easier to deal with than their own bureaucracies.

The Limits to Contracting Out

There is no simple formula for drawing the line between private and public production of government services. It is theoretically possible to contract out any government service or compliance function that can be quantified and is available from private organizations. But decisions about which public services to deliver through contractors are subject to the traditions, histories, ideologies, and public values of a particular nation, state, or community.

Sometimes, no one even realizes that a crucial government function is being performed by a private firm. For example, during the Persian Gulf War, a defense facility in Australia used satellites to track SCUD missiles launched by Iraq. "What is not well known," points out Gary Sturgess, an Australian state government reinventor, "is that the individuals who actually monitored the launches were employees of a private contractor, Serco Australia." Serco, he continues, is a wholly owned subsidiary of a British company that for 30 years has run the U.K.'s early warning system against air attacks.

Former Indianapolis mayor Steve Goldsmith declares that "with very few exceptions, virtually every aspect of government" can be competitively bid. But the devil is in the exceptions. Experiences around the world suggest several reasons to keep some government functions out of private vendors' hands:

• ***Don't contract out when doing so might jeopardize important public policy goals, such as safeguarding due process rights or providing security.*** Goldsmith, a former county prosecutor, exempted most police and other safety functions from competition. "The more you depend on due process, the less likely [you are] to compete it," he says. Law enforcement, criminal justice services, and other compliance functions must be conducted in ways that ensure fairness, privacy, and other legal rights. To some degree they are inherently inefficient. They are also extremely sensitive; leaders cannot risk their being abused for private gain. The closest most governments come to outsourcing these functions is contracting for the operation of low-security prisons.

Security is often a concern. When the U.S. Justice Department considered contracting out management of some federal prisons, its biggest concern was the potential for a strike by contractors' employees. In the end it decided it could not afford to take that risk.

• ***Don't contract out when doing so will create a private monopoly.*** In many rural or smaller suburban settings, there may not be enough private firms to generate competitive bidding. As the Council of State Governments cautions, "Without true competition, 'government monopoly' could be replaced by 'private monopoly.'" If this happens, the benefits of competition will not be realized. One way to avoid this problem is to use public-versus-private bidding, which allows public employees to compete as well.

• ***Don't contract out when critical public capabilities must be maintained.*** Few risks terrify local government officials more than the thought of a snowstorm that paralyzes their city. If the snow is not removed quickly, angry citizens may remove the mayor or city manager. Clearing the streets after a large snowfall requires a massive mobilization of people and equipment. In many cities, sanitation workers are called out to do this work. But if government contracts out trash collection to private firms, who will show up to work, around the clock and in miserable conditions, to remove mountains of snow? Not the private firms—unless it's in their contracts. And if it is, can a mayor be sure they will deliver?

"Once the city employees are gone, you have to pay top dollar for emergencies," says Steve Fantauzzo, a public employee union leader in Indianapolis. He uses the blizzard scenario to argue that governments should "maintain a flexible workforce to deal with emergencies: snowfall, water main breaks," and the like. (Of course, Indianapolis also pays top dollar for overtime for its own employees. Either way, emergencies are expensive.)

Other emergencies may arise when private contractors fail to perform essential services satisfactorily. When this happens—and it does—governments do not usually have workers of their own to throw into the breach. To avoid this scenario, some governments wisely limit how much of a crucial service may be contracted out. Indianapolis, for example, exposed only 10 of its 11 garbage collection districts to competition; the protected district remained in the hands of city employees. That way, says Mayor Goldsmith, "the city always has the capacity to collect trash in case problems arise with our private sector vendors."

Another way to prevent a calamity is to break up service contracts into smaller parcels so that a number of businesses get the work. Then if one provider fails, another can take over.

• ***Don't contract out when doing so would violate the public's strongly held values.*** Contracting out places a premium on the cost and quality of services. Sometimes, however, other community values should have priority. In Hampton, Virginia, for instance, a surprising number of community residents told the city council that they wanted their garbage picked up by city workers, even though a private firm had offered to do the work for less money. Citizens were willing to pay more to provide workers with better health insurance and retirement benefits than private businesses were offering, according to then–city manager Bob O'Neill. They said that "it's okay for the city to be a better employer," he recalls. The city council decided not to contract out the work.

A community's values usually clash with the prospect of having a private company make money by running the police department. Other functions, such as handling nuclear waste or guarding violent criminals, are sensitive enough that many citizens are anxious about having the profit motive involved (although for-profit firms manufacture nuclear weapons and operate nuclear plants).

Of course, public values are often hard to assess, and they are subject to change. They should be probed, and conclusions about them should be challenged. Public officials should be skeptical of claims that citizens won't tolerate contracting out a particular function. For instance, the former commissioner of the U.S. Internal Revenue Service, Margaret Milner, argued against using private tax collectors, as suggested by Republican congressmen. She said it raised concerns about privacy and would damage public perceptions of the agency's fairness. However, as the *New York Times* reported, the idea was first proposed by the Clinton administration, more than a dozen states made some use of outsiders to collect from delinquent taxpayers, and at least one state, Pennsylvania, already used private firms to collect current taxes.

Steps in Contracting: Avoiding the Pitfalls

Most government agencies do some contracting, but many do not do it well. Whether it is done with private firms, public organizations, or both, it involves a series of discrete steps. In what follows we provide a detailed description of each step, pointing out some serious pitfalls to avoid along the way.

1. *Decide the purpose of the contract.*

At the outset, a public agency must describe its objectives for the proposed contract. Unfortunately, agencies often do a poor job of figuring out exactly what their demands and expectations are—especially when they are purchasing services for someone else, such as food services for students. This can lead to costly amendments after a contract has been signed. The remedy is to start by asking the customers what they really want.

2. *Design the contract specifications.*

The organization must specify what the contractor will provide. This is spelled out in terms of:

- *Outcomes:* what results the contractor will produce.
- *Outputs:* what services customers will receive.
- *Processes:* which activities the contractor must undertake.
- *Inputs:* what resources the contractor must use.

Public agencies should emphasize the first two and avoid specifying processes and inputs as much as possible. But most are weak when it comes to detailing outcomes and outputs; instead, they write contracts that stipulate the use of the very inputs and processes they use to run their own organization. This causes several problems. It builds the inefficiencies of government work processes into the contract. It results in inflexible contracts, which are likely to require changes when inputs vary. And it increases the cost of contract administration, because monitoring input and process compliance is typically more labor-intensive than tracking outputs and outcomes. To overcome these difficulties, organizations must learn the art of performance measurement.

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3. *Design the contract conditions.*

Organizations must be clear about starting and end dates, payment conditions, dispute resolution procedures, and other arrangements with the contractor. Contracts must also be specific about what constitutes a performance failure by the contractors and what remedies are available to the government if one occurs.

One concern is poor service quality. Contracts can address this by using customer quality assurance tools, such as customer service standards and redress mechanisms. Contracts should also require providers to resolve customer complaints within a specific amount of time and to document any problems that arise. Contracts should always include rewards and penalties related to quality of service.

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Another major concern is service disruption. The agency should have contingency plans in place in case of failure—another provider or public employees who can fill the gap. The contract should provide a means for the agency to recover funds it spends dealing with service disruptions. To handle chronic problems, the contract should detail an escalating series of penalties, concluding in termination. Agencies can also insist on performance bonds or parent company guarantees to insure against failure, though this may prevent smaller contractors from bidding on work.

4. *Qualify potential bidders (optional).*

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Governments that have modernized their procurement systems often build in a step before requesting bids: they invite interest from potential bidders, then choose those who are qualified to bid. Particularly on complex projects or services, this gives them a chance to weed out bidders they don't feel have the expertise, track record, or capability to handle the job, before those bidders go to the trouble of assembling a bid. It also gives the contracting agency an opportunity to talk with potential bidders, to get feedback on its contract specifications and conditions before finalizing them. Entrepreneurial governments have learned that they can improve their bid processes enormously by soliciting potential bidders' ideas for improving work processes, contract specifications, and the like.

5. *Request bids.*

Organizations must invite bids, publicizing the specifications and conditions of the contract. Fairness is critical throughout the bidding process—all bidders must be treated equally. That means keeping politics out of the process. (It does not mean sticking with the traditional procurement processes, however; by all means, reinvent procurement.) Sometimes public agencies and elected officials try to steer contracts to favored businesses or away from firms that have angered them in some way. To prevent these behaviors, governments should give control over the bidding process to a neutral party—for example, a civil servant auditor or purchasing chief. They should also establish an oversight board or ombudsman to investigate complaints about the bid process.

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Governments must treat bidders well if they want to maximize competition. Agencies should provide potential bidders with clear information and stick to the timetables they announce for taking and evaluating bids and awarding contracts. In Phoenix, the city holds a prebidding conference at which vendors can critique draft specifications.

6. Evaluate competing bids.

The neutral body that evaluates the bids and chooses the winner must look at much more than the prices bid. Indeed, most experts warn against taking the lowest bid. Because you want to maximize value, not just minimize costs, you should look for the bid that will give you the best value for your money. This is often the lowest-priced *quality* bid.

The Government's Guide to Market Testing, produced by the U.K.'s Efficiency Unit, recommends that agencies make four assessments in addition to considering cost:

- ***A capability assessment.*** Does the bidder have the capacity—the experience, qualifications, and ability—to deliver the service? How has the company performed for other clients? Does it have solid personnel practices and policies?
- ***A technical assessment.*** Does the bid "meet the detailed requirements set out in the specification"?
- ***A quality assessment.*** Can the bidder deliver the service to the specified quality standards? Does it have relevant quality certifications?
- ***A financial assessment.*** Are all relevant costs included in the bid? Is it realistic, or is it unrealistically low? Does it include anything that might spark significant cost overruns during the contract?

Losing bidders should be briefed so that they can learn why they lost and how to compete more effectively next time. As the *Government's Guide to Market Testing* puts it, "Unless suppliers are convinced that the evaluation has been fair potential tenderers [contractors] will be less willing to bid for future contracts and services."

7. Negotiate and award the contract.

Once you have selected the best bids, you can often ask the bidders to sweeten their offers. Even after you have selected a winner, you can still negotiate many points.

8. Monitor the contract.

There are many ways to monitor performance: for example, customer satisfaction surveys, on-site inspections, complaint logs, and examination of contractors' documentation. Usually government units want to keep their monitoring costs down, however.

Some governments achieve economies of scale by centralizing contract monitoring in a single agency. Others use random inspections to cut costs but keep contractors on their toes. For example, the Oxfordshire County Council has computerized the inspection of 500 sites in which contractors clean buildings or provide food services. The computer generates a random sample of inspection visits, but it steers away from sites with continuously high performance and targets those known to have problems. The British Audit Commission reported that this method has helped keep the county's costs of inspection relatively low in comparison to those of other counties.

It is essential that agencies follow up vigorously on complaints about service. They should also report on contractor performance to elected officials, senior managers, and customers. Ideally, these reports should educate customers and elected officials about how performance can improve, how they can raise complaints, and how they can act as intelligent customers and overseers.

9. Administer the contract.

The hiring agency must pay its contractors, make decisions about any contract variations that providers request or that the agency thinks are needed, communicate effectively with the contractor, and design future contract bids. Effective contract administration depends largely on the relationship that the agency builds with the contractor. If it is based on trust and open, honest communication, problems that arise can usually be settled to both parties' satisfaction. The British government recommends that agencies appoint one person to handle relations with each contractor.

No matter how good the relationship, government organizations should have a strong bias against simply renewing contracts with providers. They should rebid contracts as much as possible, because competition helps to drive down costs and boost quality.

Choosing Public Services for Competition

Whether they include public competitors, private competitors, or both, public leaders have to decide what services will face competition. We have seen six different processes for doing this—only three of them effective. Some organizations use a combination of these methods:

• ***Asking public organizations to identify targets.*** This only works when government has unusually entrepreneurial managers. Few government employees will make recommendations that might put themselves—or their employees—out of work. In 1986 Brian Mulroney's Progressive Conservative Government in Canada announced a voluntary "make-or-buy" policy, under which federal departments were invited to identify bureaucratic functions that could be bid out. Not surprisingly, the initiative yielded little, and in 1990 the government quietly dropped it. In 1987, Texas adopted a law requiring some state agencies to contract with private vendors to provide goods or services if costs were at least 10 percent less than those of the government. Six years later, the state comptroller found that *not one service* had been outsourced as a result.

• ***Asking private providers to identify targets.*** Intuitively, most people would expect this to work. But when Texas's Council on Competitive Government, a body of elected officials, asked businesses to identify services they could do a better job of providing, potential vendors were reluctant to come forward. They were wary of disclosing in public their costs and other proprietary information, says Andrea Cowan, then a council staff member. And they were afraid that if they appeared to be raiding the state's services, they would be blackballed by vengeful state agencies. Such concern about revenge is a powerful deterrent. As former Indianapolis deputy mayor Skip Stitt put it, private vendors realize that "the people they're putting out of business are going to be their contract managers." (This is less of a problem with big national firms, which often lobby for outsourcing if the potential contract looks big enough. They have less at risk and more to gain than smaller local firms.)

• ***Letting a group of elected officials identify targets.*** This politicizes the selection process. It heightens the anxiety of public employees and union leaders, who often believe that politicians only want to outsource and downsize, not to give them a chance to compete. And it creates concerns among private vendors and citizens about whether the bidding process will be tainted by political favoritism.

This structure also has practical problems, which became apparent in the Texas Council's first years. Most elected officials don't sustain the attention and energy required to guide a large-scale competitive process. They just don't have the time, and in many cases, they don't stay interested for very long. Turnover is also fairly frequent and, therefore, disruptive. When Governor George W. Bush was first elected in 1994, for instance, he had no commitment to the council's work and only gradually warmed to the effort.

• ***Setting up a nongovernmental commission to select targets.*** This worked well in Indianapolis, as we described in *Banishing Bureaucracy.* Local entrepreneurs and business leaders selected by the mayor formed the Service, Efficiency, and Lower Taxes for Indianapolis Commission (SELTIC) and scrutinized every city agency. They focused on taking action, not issuing reports, and they designed their activities to help educate the public about the managed competition approach.

"We told them at the beginning that we didn't want reports," says Mayor Goldsmith. "We wanted transactions that could be debated in the public domain." By handing the process over to the commission, Goldsmith also helped keep the taint of politicization out of the process.

SELTIC was linked to the city government by a full-time liaison, Skip Stitt, then an assistant to the mayor. And the commission had politically savvy leadership. Its chairman, Mitch Daniels, was a vice president of one of the city's biggest firms and a former political director in the Reagan White House. He developed the SELTIC tactic of building success by first going after relatively easy targets and then taking on bigger, more controversial activities.

• ***Requiring each organization to competitively bid a certain amount of services each year***. This is the method the British Conservative Government used to "market test" national services. It required every department and agency to seek bids—often from both public and private bidders—for services accounting for roughly 15 percent of its operating costs each year. It allowed the chief executive to select which services would be market tested and asked him or her to assign someone to be in charge of the process. Activities could be nominated by top managers, line managers, or Consultancy, Inspection and Review staff.

Once targets were selected, the organization usually appointed a project manager to conduct each market test and a separate leader to take charge of preparing the in-house bid. (He or she could hire external consultants when necessary.) Their respective teams were kept separate from one another. The project manager put together a team to evaluate bids, which reported to senior line management and got their approval before awarding the contract. When a private bidder won, the project manager typically became the "contact control officer" in charge of managing the contract.

This process led to a significant amount of market testing. It appears to have had one flaw, however: it allowed for considerable bias. Top management often leaned toward the ministers' preference for outsourcing; hence more services were outsourced without public competition than with it. But once the decision had been made to use public-versus-private bidding, some of the market-testing teams appeared to lean the other way. "I am suspicious as to the amount of in-house work that's been won," William Waldegrave, then the minister in charge of public sector reform, told us in 1994. "I think quite a lot of it is that we're specifying contracts in ways that are very hard for outsiders to win."

• ***Making competitive bidding compulsory.*** The British government's other method was to require local authorities to "competitively tender" a long list of services, with public providers bidding against private ones. Its Audit Commission required an annual audit of each local authority, and if the auditors found that an authority had not bid out a required service—or had not done so by the rules—it could levy financial penalties such as the loss of government funds. The government did so in some cases, although Audit Commission officials believed many local authorities found plenty of ways to rig the bidding in favor of their own units.

There are pros and cons to compulsory competitive bidding. On the positive side, in Britain it forced massive changes in local government. It acted like antitrust policy, forcing competition in areas that would otherwise have been locked up by monopolies. On the negative side, it stirred up enormous resentment at the local level. And because such a blatant use of central authority contradicted the Conservative Party's stated belief in decentralization, it sowed cynicism among local officials. When the Conservative Party lost power, it was the one major reform the Labor Government abandoned.

In the U.S., of course, it is hard to imagine one level of government ordering another to competitively bid a series of services. Hence this is simply not a practical alternative. On balance, we would not recommend such a heavy-handed approach, even in countries that are more like the U.K. than the U.S.

The most important lesson that emerges from this review is the value of using a neutral, independent body like SELTIC to decide which activities should be bid competitively. There are undoubtedly alternatives to a strictly private sector body, such as a public-private commission or a politically independent auditor's office. If you use an auditor's office, however, you will have to abandon any hope of using it to help agencies benchmark and improve their performance, because agencies will not willingly share information with it. Whoever is vested with the power to pick services for competitive bidding will inevitably be treated as a potential executioner by most agencies. The best solution might be to set up two different auditing bodies, one to be the bad cop, the other to be the good cop.

Competitive Bidding: Other Lessons Learned

In addition to all we have said so far about competitive bidding, government officials have learned much about how to strengthen the effects of this tool. Four lessons in particular stand out:

1. *Generate increased competition—and then generate even more.*

The more competition you create, the more value for the dollar providers will deliver. Research the potential providers, find out what will attract them to bid, and advertise aggressively. Then structure contract incentives in ways that appeal to many businesses.

The size of the contract you offer bidders will often determine who bids. If you cut it up too small, major national firms will not bid. If you make it too large, small, local firms may not be able to compete. Decide what type of firms you want, talk with them, and create contracts that will attract them. (If you want small businesses, minority-owned businesses, or businesses owned by women to have a better chance, cut your contract into smaller segments that they can more easily handle.)

Similarly, if your contracts are for too short a duration, some firms will not compete. In some service areas, governments set contracts to coincide with the life of the equipment to be used. For instance, Phoenix bids out its garbage districts for as many years as the garbage trucks are expected to last—usually five to seven—so the winner can buy new equipment and use it for the life of the contract.

If your contracts are long, on the other hand, contractors will not feel enough competitive pressure to continuously improve their operations. As the British Efficiency Unit points out, several things may happen during a long contract: "technology may improve," "new suppliers may enter the market," and prices may fall. When any of these happen, you may not want to be stuck with a long-term contract.

To enhance the attractiveness of the contract, minimize the documentation contractors have to produce and make sure the bidding process does not drag out too long. Lastly, when potential bidders drop out of the process, find out why and redesign future contracts to lure them back.

2. *Build the customers into the process.*

When defining a contract's purpose and specifications, be sure to consult with the intended customers to see what they value. To find out how well contracted work is being performed, once again, ask your customers. As the British Audit Commission advises: "Empowering consumers to act as monitors of service delivery by contractors will almost always be more effective and cheaper than employing an army of authority inspectors." Newspapers, for instance, track customer complaints about late deliveries to monitor performance by the agencies they contract with for delivery.

3. *To overcome managers' resistance to contracting out, tie their com-*

pensation to their organizations' performance, not to the size of their empires.

Contracting out threatens managers in bureaucratic systems, because their status and compensation depend on the size of their budgets and staff. They have a powerful reason to oppose handing resources to the private sector. The solution is to pay managers instead for how well they contribute to the organization's goals. That way, they will focus on effectively using resources, rather than on empire building.

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4. Minimize negative impacts on employees.

See *Banishing Bureaucracy* pp. III/18-20

In *Banishing Bureaucracy* we discussed what public organizations should do when the use of managed competition and other reinvention approaches means they will need fewer employees. Agencies should protect their workers from the threat of joblessness, unless they are in such a deep fiscal crisis that they can't afford to. We recommend that agencies adopt a no-layoff policy, as East Lansing's Ted Staton did, then use a menu of options for helping employees whose jobs disappear. This is not as difficult as it sounds. A U.S. Department of Labor study in 1989 examined dozens of examples of contracting out that each affected more than 2,000 employees. It found that, on average, only 7 percent of those employees were eventually laid off. Some 58 percent went to work for the contractor, 24 percent shifted to other government jobs, and 7 percent retired.

Your options to help dislocated workers include the following:

- Require firms that win contracts to hire them before anyone else.
- Keep those who are close to becoming vested with pensions on the public payroll, but make the private contractor pick up the cost.
- Retrain them and place them in other government jobs.
- Use a "job bank" to keep open some jobs that can be made available to them.
- Offer them severance packages or early retirement incentives.
- Provide them with outplacement services to find private sector jobs.
- Protect the benefit levels of those who go to work for contractors, by providing any benefits necessary to keep pace with those they would have received in public service, or by requiring the contractor to do so.

Public-Versus-Private Competitive Bidding

The lessons and pitfalls discussed so far apply as well to public-versus-private

bidding. Letting public employees into the bidding creates some new wrinkles in implementation, however.

pp. III/74-82

Why let government employees compete with private businesses to keep their own work? Why not just contract out the work? One reason is fairness. "Before we let entrepreneurs provide government services, let's allow government service providers to become entrepreneurs," says Mayor Goldsmith. After all, public employees did not create the inefficient systems in which they work.

Another reason is political pragmatism. By using this tool instead of simply contracting out, Goldsmith avoided increased strains with unions representing about 20 percent of his workforce. Too often political leaders underestimate the difficulty of contracting out if unions can rally elected officials and the public to their side. Massachusetts governor William Weld made this mistake, and the state legislature put the brakes on his effort to institute competition. Reflecting on his experience, Weld advised incoming governors to use the word *competition* instead of *privatization.*

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A third reason is to maintain some public capacity you can use in emergencies or to step in when private contractors fail, as we discussed earlier. In addition, some organizations decide that they need to preserve some in-house service delivery so they won't lose the hands-on knowledge necessary to act as an intelligent buyer or to offer useful advice to policymakers.

But the most compelling reason to let public providers compete is to maximize competition. As Goldsmith and others have discovered, when public employees face competition they often figure out how to slash costs below those of private competitors. They give the taxpayers a better deal.

In Indianapolis, government bidders won 37 of the first 86 competitive bids after Goldsmith launched managed competition. When the Australian Department of Defense initiated public-versus-private competition for 51 military projects worth about $500 million, government workers won 16 times. In Phoenix, where public-private competition began in 1979, city employees won 22 of the first 56 contests. And in the U.K., national government agencies won about two-thirds of the first "market tests" in which they competed directly with the private sector. No matter which side won, savings were typically 20–25 percent the first time a service was bid out—and more in subsequent rounds.

How does the lowly public sector win? By radically changing the way work is done. But public organizations also enjoy some financial advantages. Steve Fantauzzo, the AFSCME leader in Indianapolis, says his workers' costs are nearly one-third lower than those of private firms, because they pay no business taxes, make no profit, and don't pay sales taxes when purchasing items such as fuel. "If we still can't compete," says Fantauzzo, "shame on us."

Why Public Organizations Lose Competitive Bids

Unfortunately, most public organizations also face some real disadvantages, which must be addressed if they are to have a shot at winning. For example:

- ***They have excessive management overhead costs.*** Public employee unions frequently point to this factor. Mayor Goldsmith agrees: "The jobs that are often at risk are the middle-manager jobs. . . . [because governments] piled up levels and levels of control and supervision. To be competitive, we have to get rid of these." Delayering of management helps address this problem.

pp. V/112-113

- ***They lack technological expertise and advanced equipment.*** Government typically lags far behind business in adopting new technologies. Businesses invest in new technology because gaining a technological advantage can generate profits for them. In contrast, public officials view technology as a cost, not an investment that will pay for itself. "We have a lot of the wrong technology and we don't stay current," says Stitt, former deputy mayor of Indianapolis. As a result, business usually wins technology-intensive work, whereas public employees compete most successfully for "low-tech" work such as pothole filling and trash pickup.
- ***They are saddled with high-cost, low-quality "internal services."*** Public bidders are usually the "captives" of inefficient internal service monopolies that provide them with facilities, equipment, information technology, personnel, and other services. The solution to this problem is internal enterprise management.

pp. III/53-61

- ***They have higher labor costs.*** Public-private wage differences vary greatly. Business executives usually earn more than government's top managers, but some lower-level public employees earn more than their private sector counterparts. Increasingly, a big driver of government's higher labor costs is the health and retirement benefits it provides. To deal with these cost disparities, public officials can require private bidders to offer their workers wage and benefit packages comparable to what the public sector provides.
- ***They can't achieve significant economies of scale.*** Companies that operate in large markets are able to generate economies of scale that reduce their bidding costs. They can buy equipment in bulk, at discount prices. They can afford to invest in the development of new technologies. Most government organizations, in contrast, are limited to bidding on local work—and therefore cannot generate the volume that helps reduce marginal costs.
- ***Their rigid personnel, budget, and procurement systems deny them the flexibility they need.*** Private companies can usually hire faster, fire faster, use more part-time employees, move employees around as their needs change, and reward extra effort by employees. They can also purchase

pp. V/47-69

what they need when they need it and move funds between budget accounts when necessary. Until they reform their systems, public organizations can do little of this. Hence they are often slower and less efficient than their private competitors.

Public-Versus-Private Competition: Other Lessons Learned

pp. III/80

In addition to the lessons presented earlier, most of which apply here, the following lessons apply specifically to public-versus-private bidding.

1. Tone down the political rhetoric.

The inflated rhetoric that politicians use aggravates the hair-trigger anxieties of public employees. Beating up faceless bureaucrats on behalf of taxpayers scores easy political points, but it reinforces the wariness public employees feel toward elected officials. And it antagonizes their unions, which turn to their political allies and the public to stop the competition.

Old political dogs must therefore learn some new tricks. Goldsmith did. Six months after running for mayor on a privatization platform, he went out of his way to defend public employees. "Contrary to their undeserved poor public image most civil servants are hard-working and talented, and they know a lot more about how to do their jobs well than mayors or union presidents," the mayor wrote in a letter published by the *Indianapolis News.* "The problem is that [workers] historically have been trapped in a system that punishes initiative, ignores efficiency and rewards big spenders."

See *Banishing Bureaucracy* pp. III/2-14

His approach, Goldsmith concluded, would "free [employees] from the shackles of bureaucracy." That was very different from trying to "free" them from their jobs. And it paid off. Goldsmith managed the minor miracle of staying friendly with AFSCME while phasing out 45 percent of non–public-safety jobs.

2. Create a level playing field.

We believe governments should go into competitive systems with two basic objectives: to maximize value for the taxpayer and to make sure that both sides are fairly treated. Sometimes, when governments let private companies bid below their costs, just to get into the market, the latter objective is sacrificed to the former. This saves the taxpayers money in the short run, but if it happens too often, public employees' anger may lead them to exercise whatever political muscle their unions have to attack the entire competitive process. In the long run, therefore, we believe bidding below costs should not be allowed. It is not only unfair, it is likely to undermine the competitive bidding system.

This means public and private bidders should be required to calculate their costs in the same fashion, and all financial advantages should be neutralized. Hence public bids should include pension costs, all operating costs, capital costs, in-lieu-of-tax charges, interest charges on capital depreciation, and charges for all overhead that is directly tied to the service.

3. *Help public employees become more competitive.*

Government employees don't always know how to develop a bid, cut costs, or improve quality, so smart reinventors help them learn how. They provide consultants and training, and they remove obstacles that get in the employees' way.

In Indianapolis, Michael Stayton paid consultants to help his wastewater division managers design their bid. That got them over a key technical barrier. "We do what we can to eliminate legal and purchasing barriers," says former deputy mayor Stitt. "If they need accounting help, more training—we do it."

In Charlotte, North Carolina, when the mayor and city council decided to make city employees compete with private providers, they initiated "Competition 101" workshops to prepare in-house units.

4. *Create a bidding process everyone can trust.*

Particularly in public-versus-private bidding, everyone worries that the process will be rigged against them. "You never know what hangs in the shadows," says AFSCME leader Steve Fantauzzo. "You may have somebody trying to whisper into a council person's ear. You may have people making pledges—you know, I'll donate to your campaign if, when you get into office, you don't forget that I was there for you."

Private bidders worry that insiders will manipulate the process to ensure that government providers win. This occurs, for example, at local levels in the U.K. Howard Davies, a former Audit Commission controller, says that in response to compulsory competitive tendering, "Many local authorities have sought... to rig the system in favour of their in-house workforces." Often, he charges, local officials have increased service specifications to make it more difficult for private providers to submit effective bids. By 1991, the national government had intervened with 16 local authorities that were acting in an anticompetitive manner. In several cases it had required local public service bureaucracies to "cease trading."

To keep the process free of manipulation, you need to give control over the bidding process to a neutral, nonpolitical party—for example, a civil servant auditor or purchasing chief. You should not let the government organization performing the services control the bidding process. "The key to a bid with credibility is the requirement that it be prepared or certified by an independent third party or 'cost referee' without a vested interest in the outcome of the bid process," explains Phoenix's Ron Jensen.

Phoenix's solution has held up well for nearly two decades. First, it has a division of the city finance department, which is independent of the operating departments, prepare bid specifications. This avoids the problems the U.K. has experienced when the agency bidding for the service designs the specifications. The division holds a preproposal conference to address questions from city staff and private vendors, then amends the specifications based on their feedback.

Second, the city auditor's office, which plays an independent watch-dog role, evaluates the city's bids. The audit staff checks to see if the costs in the city's proposals are reasonable and accurate. It looks at historical cost data, and it makes sure that inflation adjustments and future increases called for in labor agreements or the city's merit pay system have been included. It identifies costs that should not be included, especially those that will be borne by the government even if the private sector wins the bid. And whenever a city department wins the bid, within 12 months the auditor's office conducts a post-implementation audit to check on costs and service levels.

It also makes sense to use an oversight board, ombudsman, or inspector general to investigate complaints about bids. Bidders need a confidential body that will do an objective investigation of their complaints, without taking them public. Bidders often refrain from complaining publicly, for fear of alienating the very office that will be reviewing all future bids. They need a way to register complaints with confidentiality.

The best defenses against corruption are maximum competition, solid performance contracts, a good system to track performance information and complaints, a capacity to investigate problems, and the threat of prosecution. The competition and performance information will expose and penalize firms whose contracts were not awarded for the right reasons, and the threat of investigation and prosecution will discourage fraud.

5. Make competition a two-way street.

This lesson raises one of the most intriguing issues in the design of public-private competition. The basic question is this: Should public workers be limited to bidding only on services they currently perform? Elected officials, who don't want local businesspeople on their backs, usually answer yes. But that answer has serious implications.

It means that when city workers lose competitions, they permanently lose the work. They cannot compete for it again, and they cannot compete for additional work. As Fantauzzo puts it, this creates a one-way street. Competition leads inevitably to increased contracting out with private vendors and reduced public employment. Fantauzzo argues that this approach is anticompetitive.

Instead, he believes, public workers should be allowed to bid for new work the government wants done, for work they previously lost or never had, and for work in other government jurisdictions or even the private sector. “The competitive ax has to swing both ways,” he insists.

We agree with the underlying principle Fantauzzo invokes: government is best served by maximizing the competition to provide public services. By creating a one-way street, governments undermine competition in three ways:

- They gradually take public competitors out of the picture, making it more tempting for private competitors to divide up the market and rig their bids.
- They make it impossible for some public organizations to minimize their costs, because they don’t allow them to achieve economies of scale. When owning expensive equipment provides a competitive edge, providers who can spread the costs of buying that equipment over as large a base of services as possible will win most of the bids.
- Finally, they undermine any sense among public employees that they are being treated fairly. This makes it much more likely that unions will work to elect politicians who will end competitive bidding altogether.

We have seen many situations in which public organizations are not allowed to bid for services they do not already deliver. But we have also seen situations in which public organizations do bid for other *public sector* work—in Indianapolis; in New York City, where the Sanitation Department’s Bureau of Motor Equipment created a “contracting in” program and went after repair work on other city fleets; and in Los Angeles County, where many municipalities contract with the county or other municipalities to provide dozens of services, including entire police and fire departments.

When public organizations go after work done by private businesses, however, the situation becomes far trickier. Local business leaders quickly get up in arms when they see government poaching on their turf. They immedi-ately invoke the traditional ideology: government should not compete with business.

In reality, governments have competed with businesses for hundreds of years. But public leaders who use this approach should recognize that the minute they cross the line into services formerly provided only by businesses, they will run into a hornet’s nest of opposition. If they choose to take the risk, we would advise them to do so with great care—*after* they have lined up the politics. When he was city manager of Visalia, California, Ted Gaebler learned to follow a rule laid down by one of his city councilors, Bonnell Pryor: They could go into any business that had no current local competitor. As Gaebler said, "If nobody else is operating a baseball team, whose toes are you stepping on, locally?"

Even when public organizations begin competing on turf formerly controlled by other public organizations, the politics can get difficult. But there is another issue to consider. When public organizations bid on work they do not currently perform, how can anyone be sure they will be able to perform it? What if they fail—after they have hired new employees and purchased new equipment?

Our answer is that public organizations that choose to expand into new markets should be treated just like private ones. They should be required to sign performance contracts with incentives and penalties, and in extreme cases they should be required to post performance bonds. The new employees they bring on to do the work should not receive lifetime tenure or seniority protection. Finally, when they win new contracts, they should drop their no-layoff policies for employees who work on those contracts. If they expand their market share, hire employees, and then lose a big contract, a no-layoff policy will cost the taxpayers money. We believe these expenditures are justifiable to protect regular employees whose organizations have lost traditional public sector work. But when organizations become entrepreneurial and move into new markets, we think they should bear the same risks private companies do. Ideally, such units should be required to form public corporations and operate under the same rules as businesses.

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6. Let the chips fall where they may.

The point of using public-private competition is to create greater value for the citizens and customers. It doesn't matter whether the public agency or the private provider wins. That's a tough pill for partisans of either side to swallow. Privatization ideologues don't want public employees to win; public sector unions don't want private firms to win. But public officials who implement public-private competition shouldn't have a preference. They shouldn't set targets for how much of the contracting private providers should win. They must be willing to "let the chips fall as they may," as Ron Jensen puts it. Otherwise, no one will trust the process.

7. Try to make sure both public and private bidders win some early competitions.

If you can do this without tilting the playing field, it is a pragmatic way to build trust in the competitive process. If the private sector wins all of the early

bids, public employees will complain that privatization, not competition, is the goal. If public providers win the early contests, private bidders will think the process is rigged against them. The answer is to share the wealth, by carefully selecting and sequencing the services bid out in the early rounds. There is a good chance that public employees can win certain kinds of bids—for example, trash collection. Similarly, private firms are likely to win services that rely on technological expertise or large-scale efficiencies. By mixing the contests up, you have a good chance of allowing both sides some early victories.

8. Phase in competition; start with services that are easier to bid out.

Once a government has decided to use private-public competition, it has to decide where to start, since it can't put all services out to bid at once. You need a plan for phasing in the bidding. In something as complex and contentious as public-versus-private competition, it helps to start with the low-hanging fruit, as Indianapolis did. That might include low-cost, low-employment services such as courier services and pothole repair, or services that could be easily automated, such as sewer or water billing. If you start small, you can take your organization up the learning curve while the risks are still low. You can score early victories that build public support for the bigger challenges. And you can avoid big fights before you have proof that competition works. It's much harder to defeat a competitive initiative if it has already been proven to save 25 percent of the cost of services.

The British did this with compulsory competitive tendering when they imposed it on local authorities. In 1980, Margaret Thatcher ordered it for all highway and building construction—one of the easiest areas to try, because the outputs were so tangible and there were many experienced private providers. In 1988, she added refuse collection, street cleaning, building cleaning, food services, grounds maintenance, vehicle maintenance, and recreation services. In 1992, the government added many white-collar services, including architectural, engineering, property management, legal, information technology, and personnel services—but allowed local authorities to phase in competition for each one.

Phasing in helped local authorities learn how to manage competitive bidding a step at a time. It also gave the private sector time to develop new capacities as new markets opened. And it made it difficult for local authorities to say the policy was unrealistic, because each time the government expanded the list of services, it could point to the success of competition in those that had gone before.

9. Deal with government bidders that fail to live up to their bids.

Sometimes government agencies exceed the costs of their bids. Sometimes they fall short on service levels or quality. If you catch these problems early enough, says Indianapolis's Stitt, you can get the agency to make a course correction. That's why it is important to continuously track the project's finances and results, especially customer satisfaction.

If you cannot correct the problem in time, you can take the work away from the organization and give it to a private firm—say, the next best bidder. If this is not an option, you can exclude the agency from future competitions, or at a minimum make sure that its next proposal reflects the real history of its performance.

What doesn't seem to exist yet is a way to make public agencies financially guarantee that they will meet the terms of the contract. Sometimes private firms are required to put up performance bonds or guarantees in case of a default on the contract. This is not done with public bidders, to our knowledge. But it could be.

10. Take action to ease unions' anxieties about competing.

Unions' typical first response to public-private competition is to attack. Thus the first thing most reinventors must do is win a political battle with public sector unions. To help build public support in Indianapolis, Goldsmith pledged that savings generated by competition would be reinvested in inner-city neighborhoods. Competition, he added, was an alternative to raising taxes. In Philadelphia, Mayor Ed Rendell enlisted private sector unions as important allies in forcing public employees to compete. He gave them fact sheets comparing city employees' pay and benefits with those in the private sector. "Guys would listen to this," says Rendell, "and say, 'Yeah, bingo! Privatize. Turn it over.' "

It helps diminish union opposition if you pledge that union workers will not be laid off as a result of competition. This was critical in Indianapolis. But you can also offer public employees real incentives for bidding. A good one is gainsharing, also an important part of the Indianapolis success story. If employees win a bid and come in under the contract's cost, let them keep a portion of the savings.

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Public-Versus-Public Competition

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It's not appropriate to put some public services into the hands of private businesses, as we discussed earlier. For example, governments are unlikely to contract out policing to businesses, because citizens would not stand for it. It is still possible, however, to bring the power of competition into play by using public-versus-public bidding. In Los Angeles County, local governments use such contests to cut costs and boost the performance of law enforcement services. Many municipalities bid out their police work every few years. The county sheriff's department and other local police departments compete for the work.

Because public-versus-public competition is at heart a contract bidding process, the lessons about contracting out and competitive bidding apply.

pp. III/74-82

Activity-Based Costing (ABC): A New Competence

Everyone complains about how much government spends, but almost no one knows how much it actually costs government to do anything—fill potholes, collect garbage, deliver the mail, or operate a bus line. Governments rarely know because knowing has rarely mattered; in the absence of real demand to improve costs, they have had no reason to collect data about costs. Governments typically budget by organization, not by activity. And those organizational budgets rarely include overhead costs, such as employee benefits, central management, and internal support services.

See *Banishing Bureaucracy* pp. III/2-3

In 1992, Mitch Roob, then Indianapolis's transportation director, decided to let his employees compete with private businesses for a street repair contract. Right away he ran into an accounting roadblock: "We didn't know how much it cost to put a ton of asphalt down into potholes." Without that information, Roob's employees couldn't put together a bid.

The solution was activity-based costing (ABC), an accounting technique that has been used in the private sector for years. It allows an organization to specify what it actually costs to perform each of its activities. It not only helps in preparing bids for contracts, it also helps organizations discover their hidden costs and compare their costs over time.

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In a case study for the John F. Kennedy School of Government at Harvard, Howard Husock described how Indianapolis developed its ABC system. It started with potholes: a team of transportation workers and a consultant began by identifying *direct costs,* such as labor and materials. They found in the city budget the pay and fringe benefit rates of workers. But figuring out how much it cost for a repair crew to perform a typical day's worth of street repairs was tricky. Because of seniority policies, not all the laborers were paid the same. And no one was sure how much time was spent on the repairs.

The consultant looked at the workers' time sheets, interviewed the workers, and then estimated how long it took a crew to repair a typical block. Then the team investigated the market price of materials, mainly asphalt.

With direct costs accounted for, they turned to *indirect costs*—support for the street crews. Some, such as heating and lighting the workers' garage and offices, were easy. Others were not. The deterioration of city buildings and vehicles had never been counted as an expense, as it would have been in a business's accounting system. The team decided to use the cost of annual upkeep and repairs rather than any depreciation formula.

The city's central fleet maintenance shop took care of the repair crews' trucks. Those costs could be tracked, but everyone believed they were much higher than those of private garages. The team decided it had to count the city's real maintenance costs, even though they would put the city employees at a disadvantage.

Finally, there was the indirect cost of management. Roob had already cut this in half by laying off 18 supervisors. But should some portion of Roob's salary be included as a cost? And what about counting part of the mayor's salary, too? Roob decided not to include the cost of upper management, reasoning that no matter who provided the service, top management would be needed to request proposals and monitor performance.

With all the financial data in, the team concluded it cost $407 per ton of asphalt to repair Indianapolis's streets. That was too high, they decided. As employees developed ideas to cut costs, they tested them by plugging different numbers into the ABC formula. They drove their costs down to $301 per ton—a winning bid.

To develop your own ABC accounting system, we recommend that you do as Indianapolis did: hire a consultant. Have that consultant teach your own accountants the new system, so you will develop the in-house competence to apply it throughout your government.

COMPETITIVE BENCHMARKING

Competitive Benchmarking **measures and compares the performance of public and private organizations. It publicizes the results in "report cards," "performance tables," and other types of scorecards. This creates psychological competition between organizations, appealing to their members' pride and desire to excel. It can also be used as the basis for financial rewards.**

The British Employment Service periodically publishes comparisons of its regions' performance. Former chief executive Michael Fogden held four meetings a year in which, he said, regional managers "had to account to their peers. If there was one that was holding up the organization, his or her colleagues may very well have wanted to know what was going on."

The comparisons had a big impact on Martin Raff, who ran one of the regions. "I certainly was humiliated when for three years we had the worst record," he told us. "It was very humiliating, and it was a strong motivator." Several years and many reforms later—including the widespread adoption of Total

RESOURCES FOR COMPETITIVE BIDDING

The Reason Foundation. This nonprofit public policy research and educational organization in Los Angeles offers a catalog of publications, how-to guides, and studies concerning privatization. The foundation holds conferences, issues an annual report that examines international trends in privatization, and has a Web site chock full of information: www.reason.org. The foundation is located at 3415 S. Sepulveda Blvd., Suite 400, Los Angeles, CA 90034–6064. Telephone: (310) 391–2245.

United Kingdom Audit Commission. *Realising the Benefits of Competition: The Client Role for Contracted Services.* Local Government Report No. 4. London: Her Majesty's Stationery Office, 1993. An excellent guide to contracting, available for £8.50 from Audit Commission Publications, Bookpoint Ltd., 39 Milton Park, Abingdon, Oxon OX14 4TD, or by telephone at 0800 502030.

United Kingdom. Cabinet Office. *Better Quality Services.* A comprehensive handbook on contracting out and public-versus-private bidding. Available on the Web at www.servicefirst.gov.uk/index/publications.htm (scroll down to "Quality Awards/Schemes and Tools").

The Carnegie Council Privatization Project. The Carnegie Council is a nonprofit research and education institution that conducts and publishes a set of excellent briefings on privatization worldwide. The briefings are free. To order them, write to the Carnegie Council Privatization Project, 170 East 64th Street, New York, NY 10021.

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Quality Management—Raff's region reached the top ranks of performance.

The Employment Service was using competitive benchmarking to prod its regions to improve. Later it applied the tool to local offices, posting comparisons of each local office's performance with that of neighboring offices.

"When performance is measured, it improves," says Bill Creech, who used competitive benchmarking in the U.S. Tactical Air Command (TAC). "When performance is measured and compared, it improves further."

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The psychological consequences of competitive benchmarking are not as powerful as the economic consequences created by competitive bidding. But you can use competitive benchmarking when these other tools are not an option—and you can combine it with performance rewards. As Creech goes on to say, "When performance is measured, compared, and appropriately recognized and rewarded, it improves even more—dramatically more."

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Competitive benchmarking works best in organizations that have many similar units—service organizations with many local outlets or local school districts with many schools, for example. But cities increasingly benchmark against other cities. The International City and County Management Association is benchmarking fire, police, neighborhood, youth, and internal business services in 120 large cities and counties. Some organizations, including the U.S. Air Combat Command (ACC), even benchmark against private firms. That's what East Lansing did with its wastewater treatment operation.

This tool can also be used by those *outside* an organization, to create pressure for improvement. For example, some U.S. states issue annual report cards on the performance of their public schools. In Australia, the federal Industry Commission publishes comparative performance information on 12 services in eight states. Under the Citizen's Charter, the British Audit Commission and other entities measure performance and publicize comparisons of five separate services: local government services, hospitals, police forces, fire brigades, and schools. They compare them within "families"—London boroughs against London boroughs, cities against cities, rural areas against rural areas. Their annual reports receive massive coverage in the media, with major newspapers often devoting several pages to the results and reprinting some of the charts. Although officially titled *Performance Indicators,* the press has dubbed these reports "league tables"—the British name for league standings in professional sports.

The power of this tool is that it reveals variations in performance between similar organizations. Suddenly citizens, customers, elected officials, and managers can understand how their organizations' performance stacks up. They talk about it, analyze it, complain about it, defend it—and in the process create real pressure for improvement. As Wisconsin governor Tommy Thompson told the *Washington Post,* "Nothing drives a governor faster than a report

that says you don't measure up."

In the U.K., the *Local Authority Performance Indicators* have caused an enormous stir. When the Audit Commission had a public opinion survey done, 80 percent of the public said they supported publication of the comparisons. Simply because they knew the comparisons would be embarrassing, the worst-performing councils made dramatic improvements in the year leading up to publication of the first *Performance Indicators.* Hospitals and schools have also improved significantly since comparative data on their performance was published—though it is of course impossible to isolate the impact of the comparisons, given all the other reforms taking place simultaneously.

Clearly, however, the annual publicity creates very real pressure on elected officials and their top managers to pay attention to actual performance—something they don't always do. "This exercise is very much in the public interest," says Audit Commission controller Andrew Foster, "because it makes politicians deal in facts rather than assertions."

Using Competitive Benchmarking to Improve Your Organization

We recommend Chapter Twelve, on performance measurement, and the Customer Information Systems tool in Chapter Forteen for anyone planning to use benchmarking. A few high points of those discussions follow:

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1. In choosing what measures to benchmark, be sure you ask customers what is most important to them.

Organizations that skip this step often find themselves comparing how efficient and effective they are in doing things their customers don't particularly care about—while ignoring the big issues. Hence they may get better and better at doing the wrong things.

2. Make the information a focus of discussions within the organization.

It's not enough to distribute the information and leave it at that. Take a page out of Michael Fogden's book: make your managers deal with the comparative data and identify causes of weak performance. This increases the psychological stakes for them. General Loh of the ACC also used competitive benchmarking to spread best practices. When he assembled managers to review performance data, he prodded those running low-performance units to learn from those that were doing better.

In the U.K., the Audit Commission assists local governments that want to improve their performance. It holds conferences and seminars and issues management guides about improving particular public services.

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3. *Publicizing the performance data outside the organization increases the pressure it creates.*

The point is to get many people talking about the information—analyzing it, debating it, figuring out how to make sure it's better next time. One way to build awareness of the data is to get the media to use it in news reports. Another is to publish and distribute the information yourself.

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4. *Enhance the power of competitive benchmarking by rewarding high performance.*

Some organizations use psychological and economic rewards to further spur competition. For example, they recognize units that rank at the top of comparisons—honoring them at an awards ceremony, publicizing their accomplishments in internal newsletters. Or, more rarely, they provide financial bonuses to top competitors.

Awards for competition must be carefully tailored to support collaboration among employees and to avoid stimulating the wrong behavior, such as hoarding of information about successful innovations. This problem can be avoided if competition is managed properly. First, reward teams of employees, not individuals, because this promotes the cooperative behaviors that are part of teamwork. Then carefully select benchmarks that promote collaboration. For example, Inland Revenue, the giant tax agency in the U.K., rewards local tax offices for working well with other offices with whom they share clients.

Some organizations reward teams that show the most improvement over previous performance levels. Others have teams compete to exceed a specified performance standard—such as an efficiency target. This gives every team a chance to succeed; the number of winners is unlimited. Such competitions help identify which teams are doing best and give weaker performers an incentive to learn how they do it, without encouraging high-performing teams to hoard their secrets.

RESOURCES FOR COMPETITIVE BENCHMARKING

Bill Creech. *The Five Pillars of TQM: How to Make Total Quality Management Work For You.* New York: Truman Talley Books/Dutton, 1994. Creech explains the power of psychological competition to spur improvement and describes his successful use of competitive benchmarking at the Tactical Air Command.

Comparative Performance Measurement: FY 1998 Data Report. Washington, D.C.: International City/County Management Association, December 1999. This is the fourth annual report of the ICMA Center for Performance Measurement, which offers comparative data on 15 services in 120 American and Canadian cities and counties (with pilots in New Zealand and Australia). It is updated every year. This and other ICMA titles related to performance measurement are available at www.bookstore.icma.org (type *performance measurement* in the search engine).

Steering Committee for the Review of Commonwealth/State Services Provision. *Commonwealth/State Services Provision.* Melbourne, Australia: Productivity Commission. An annual two-volume report offering comparative data on Australian state government services. Available for download at www.indcom.gov.au/service/gsppubs.html, or in printed form from AusInfo, at www.pc.gov.au/ausinfo.html (catalog number 9812 595).

United Kingdom. Audit Commission. *Local Authority Performance Indicators; Using Your Indicators; Watching Their Figures: A Guide to the Citizen's Charter Indicators; How Is Your Council Performing*? London: Her Majesty's Stationery Office, published annually. The annual *Local Authority Performance Indicators* and other Audit Commission publications are available on the Web at www.audit-commission.gov.uk (click on "National Reports," then "Online Catalogue") or from Her Majesty's Stationary Office Publications Centre, P.O. Box 276, London, SW8 5DT. Phone: 0170 873 9090. Fax: 0171 873 8200. The others are available directly from the Audit Commission at 1 Vincent Square, London, SW1P 2PN. Phone: 0171 828 1212. Fax: 0171 976 6187.

Also see the resources on performance measurement (pp. III/162-164) and customer information systems (pp. IV/68).

Notes

All quotations that are not attributed in the text or in these endnotes are from interviews with the authors or their associates. Only in cases where there might be some confusion about the source of a quotation have we indicated in a note that it came from an interview.

Chapter Ten

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