Chapter 8

Introducing Consequences for Performance

Indianapolis: A Marketplace for Public Services

We are using competition to inject risk, believing that risk is an element that creates customer satisfaction and added value. We're dealing with organizations that don't believe risk should apply to them.

—Mayor Steve Goldsmith

Weeks after Steve Goldsmith became mayor of Indianapolis in January 1992, his new transportation director announced that a small portion of the city's street-repair work would be put out to bid. Local asphalt companies, which eventually stood to gain as much as $1 million worth of work, applauded the move.

The union representing city workers, the American Federation of State, County, and Municipal Employees, took a dark view of the decision. Alarmed by Goldsmith's campaign pledge to "privatize" up to 25 percent of city government (excluding fire and police functions), it had opposed his election. "Everyone knew Steve as the Prince of Privatization," says Steve Fantauzzo, executive director of AFSCME Indiana Council 62, whose locals represent more than 1,000 city workers. "It doesn't take a rocket scientist to figure out that he's coming after the people that I represent.... Initially we operated out of a high fear factor."

The union and the new mayor had been butting heads from day one. The bid for pothole and crack repairs threatened to escalate the skirmishing, until

Transportation Director Mitch Roob (pronounced "Robe") told the union that its workers were welcome to submit a bid for the work. "We told the union, if you don't bid you could lose your jobs. If you do, you might maintain them," Roob recalls.

Roob's offer challenged the union's oft-stated claim that it could best any private bidder. "Mitch asked if we were prepared to walk our talk," says Fantauzzo.

> *We had for years been saying in a lot of places that if we were given a level playing field, the public employees providing day-to-day services were more than prepared to deal with private competition.... When the mayor changed the rules of the game to allow employees to participate in the [bidding] process, the union was able to take a much less adversarial position...I thought we needed to position ourselves to be at the table and influence the factors that would determine whether we survived. We couldn't do that sitting on the outside.*

The union first told Roob it couldn't compete fairly if it was stuck with the overhead cost of the department's bloated middle management. For 90 crew members, the department had 36 supervisors. Many of them were politically active Republicans—people who had helped elect Goldsmith. When the union raised the issue, Fantauzzo recalls, "We felt that we had thrown a grenade back into [the administration's] lap."

Without any warning, Roob laid off half the supervisors. "It just looked to me like if we had 90 truck drivers, we needed less than 36 supervisors," he says. "Probably 18 was a good number." His move— blessed by the mayor—produced an uproar in the local Republican Party. "My political party thinks I'm absolutely irrational," Goldsmith told a gathering several months later.

The union had a different view. "When the mayor actually laid off the middle managers," says Fantauzzo, "it was a positive message to our local leadership." AFSCME agreed to work with the slimmed-down management team to put together a competitive bid. Roob paid an outside consultant $20,000 to help the employees figure out their true costs—information no one had ever wanted before. Working hurriedly, they developed an activity-based costing model and determined that it cost the city team $407 per ton to get hot asphalt into potholes.

Then they figured out how to cut the cost. In the past, street-repair crews had consisted of as many as eight workers, including a supervisor. They normally used two trucks. Under pressure to compete, union members decided to cut down to four workers, without a supervisor, and one truck. This cut their projected costs more than 25 percent, without reducing service levels.

Seven local asphalt companies also bid for the first contract, to repair a ten-block section on the city's northeast side. "They were convinced that their day had come," says Roob. But they were wrong. The companies knew how to resurface entire streets, not how to fill pot-holes; the city had monopolized that business for years. The private bids "were absurdly high, all over the map," says Roob—from a high of $450,000 to a low of about $20,000. But even the lowest was three times higher than the public employees' offer of $6,700.

Some Goldsmith supporters pressured Roob to cancel the competition. They argued that awarding the first bid to city workers would damage the administration's credibility with the business community. And they worried that the city team had underestimated its costs and would not stay on budget—a potential embarrassment for the mayor.

Goldsmith left the decision in Roob's hands. Eager to preserve the cooperation he had built with the union, Roob gave the contract to the city employees. He will never forget the reaction:

> *I caught a lot of flak for this. I disappointed the people in the administration for whom public employees were by definition bad. I pissed off the people who were the Republican establishment of the city. My friends were in the union movement. It was as difficult a time as I've had in my career.*

With the stakes so high, Roob also decided to hedge his bet. He hired private inspectors to monitor the quality and cost of the team's work. That contract cost more than the street repairs.

Drops in a Bucket

In the four years that followed, Goldsmith forced city employees to bid for their work more than 64 times. No one anticipated the powerful forces of change this would unleash—not the voters, not the union, not the local Republican Party.

As American cities go, Indianapolis had been a national showcase. Since 1968 it had been run by farsighted Republican mayors. It suffered from many of the economic and social ills that afflicted urban America, but it had a much milder case. "Most people were advocates for just incremental change," says Goldsmith. "They said, 'We're a successful city, why would we want radical reinventing?' "

The Republican establishment had anointed Goldsmith, a popular county prosecutor. But the new mayor believed his city was heading for fiscal and economic crisis. A persistent exodus of middle-class families and businesses was eroding its tax base. Inner-city neighborhoods were crumbling. The city was running a deficit; it couldn't keep up with demands for government to solve more and more problems.

"We viewed ourselves as at a real crossroads," says Charles "Skip" Stitt, an assistant to the mayor.

Goldsmith rejected the idea of a tax increase. "Cities today can't operate like they did 5 or 10 or 15 years ago," he says. "The tax bases are shrinking, the problems are exploding. You can't afford to tax your citizens more." Instead, he looked for a strategy that would "produce more services for less money." He chose competition.

Goldsmith acknowledges that competition is not the "privatization" he promised on the campaign trail. After he took office, he abandoned the simplistic view that business alone held the key to reducing government costs. He realized that private ownership and services were not the secret of success—*competition* was. It was the competition inherent in a market economy that drove businesses to innovate and improve.

Goldsmith's philosophical shift was driven home when he decided to turn the city's sewer billing process over to a private contractor. The private water utility offered to perform the work for 5 percent less than it was costing the city. Goldsmith was not impressed, so he decided to bring in other private bidders. Faced with competition, the water company offered *70 percent* savings—more than $2 million a year.

Goldsmith describes his shift to competition as a philosophical decision, but it was also pragmatic. He wanted to create change without disrupting city services. Letting city workers compete helped avoid a battle with AFSCME that might slow down or disturb services. At the same time, the bidding contests delivered the results he wanted. Whether the employees won or a business won, government cut its costs without having to lower service levels or quality.

At times, the city refused to allow public units to bid because it thought they could not win. This so angered AFSCME, however, that Goldsmith finally relented, and city workers can now bid whenever they choose to. Sometimes, however, no public unit chooses to bid. In some cases the employees providing a service, such as courier runs, are spread across several departments, so there is no one unit to develop a bid.

The mayor did give city employees one major break: when creating a level playing field between public and private bids, he did not require in-lieu-of-tax payments in the public bids. Since city units don't pay sales, property, or income taxes, they start with an advantage. "If we still can't compete," says Fantauzzo, "shame on us."

To keep the entire bidding process open to public scrutiny and immune from charges of corruption. Goldsmith created a commission to identify government services that could be put up for bid. Calling it the Service, Efficiency, and Lower Taxes for Indianapolis Commission (SELTIC), he asked nine of the city's most successful business leaders to serve on it.

The commission and the mayor chose to start with the low-hanging fruit: services that did not involve large numbers of employees. With some quick successes, they hoped, they could build public support for larger, more controversial competitions.

Gradually, like drops in the proverbial bucket, the savings began to mount. Contracting out microfilm services saved nearly $1 million over three years; window washing, $45,000 over the same period; printing and copying, $2.8 million over seven years. Public-private competition to service the city's swimming pools and utilities saved nearly $500,000 over seven years. When the city bid out trash collection for 10 of its 11 garbage districts, city crews won all three districts in which they were allowed to compete. (No bidder—public or private—was allowed to bid on more than three districts, because the city wanted to prevent a single provider from gaining a lock on the service.) Overall the city was to save $14.8 million over three years, but city workers have driven costs down so fast that the savings will actually be closer to $20 million.

The Solid Waste Division produced such dramatic savings in part because it invented a second, more positive, source of consequences: gainsharing. Union leaders proposed that if the division cut its costs below the level it had bid, its employees should share in the savings. Public Works Director Michael Stayton agreed, and they negotiated a deal in which employees would divide 10 percent of the savings—up to a maximum of $3,000 per employee per year.

Motivated both by this target and the competition, the Solid Waste Division beat its first-year bid target of $3 million in savings by a full $2.1 million. Though this entitled the 117 trash haulers and 26 administrative staff members to $3,000 apiece, department leaders balked at such a rich price. Ultimately they agreed to an average of $1,750 per employee, a sum that still set bells ringing throughout city government. Other units quickly copied the program, winning bonuses more in the $500-$1,000 per employee range.

Overall, says Deputy Mayor Skip Stitt, competitive bidding saved an average of 25 percent, no matter who won the bid. But it wasn't long before the low-hanging fruit was gone. In late 1992 Goldsmith reached for his first big plum—the city's wastewater treatment facilities. It proved to be a long and difficult stretch.

Wastewater Competition: "A Nice Piece of Change"

Goldsmith's first instinct was to sell off the Advanced Wastewater Treatment facilities, worth an estimated $300 million. But financial consultants told him no one would buy the plants unless sewer rates were allowed to rise to cover costs. Rates had not increased in eight years, and the city was losing $3-$4 million a year on the system. Without increased revenues, a business would also lose money.

Goldsmith didn't want citizens' sewer bills to increase, so he looked instead at bidding out the operation and management of the facilities. He hoped to save on the $30 million annual operating budget.

The two plants employed just over 300 people, nearly half of them union members. AFSCME objected vehemently to the possibility of losing jobs. Plant managers complained that such a radical move was unnecessary and risky—the plants were already award winners. Local environmentalists opposed the mayor, fearing private management would result in reductions in water quality. Even the city-county council had doubts about the idea; two of its members had been instrumental in developing the facilities. Then Goldsmith's own consultant, Ernst & Young, threw cold water on his plans. It reported that competitive bidding might generate only a 5 percent cut in costs, hardly enough to justify the political aggravation of a bidding process.

"It wasn't easy to sit in the council meeting and have AFSCME leaders read verbatim from consulting reports we had paid for," recalls Stitt, the mayor's assistant. "Nobody was clamoring for change."

But Goldsmith had a gut feeling. Deeply committed by now to competition, he was convinced that bigger savings were possible. "We were so wed to competition as a core strategy," says Stitt. "If in-house was the best way to go, they were going to have to prove it in the marketplace."

When the city announced the bidding process, plant employees reacted angrily. They confronted Stayton, the public works director. "We're well run," they told him. "Why are you doing this to us?" Stayton asked them to bid, too.

Division managers began to develop a proposal, and Stayton paid a local consulting firm to help them. But the union refused to participate. Fantauzzo complains that the city was late in inviting employees to join the process. "The bid team was put together," he says. "They had gotten far down the road, and *then* we were asked to participate."

To mollify AFSCME, the city made an unusual—but critical—decision. It specified in its request for proposals that if a private company won the bid, it would have to recognize the AFSCME local as the legitimate representative of the plant employees and negotiate with it in good faith.

Four private companies bid for the contract. Two of them, plus the public managers, survived the first round of scrutiny. Their bids reaffirmed Goldsmith's faith in competition: both private companies offered savings of about $50 million over five years—roughly 22 percent of projected operating and capital investment costs. Both planned to eliminate at least a third of all jobs at the plants.

Just a month earlier, the public managers had given Stayton a budget proposal for the next year that reduced costs by about 5 percent. Now, caught in a bidding war, they submitted a bid that cut another 10 percent, without eliminating any jobs. "After they gave at the office," Stayton wryly notes, "they still had 10 percent more to give."

Stayton rejected the internal-management bid and set the two private companies against each other. They eagerly sweetened their proposals with $6 million in additional cost reductions. Eventually, the White River Environmental Partnership (WREP) won by offering an additional package capped by a commitment to contribute 5 percent of pretax profits to the city and to invest $1 million to develop a waste-water training center in Indianapolis. It also pledged to help the city find jobs for workers it did not need. WREP was 51 percent locally owned—a partnership between the Indianapolis Water Company, a private business that had supplied the city's drinking water for more than a century, and a gigantic French wastewater treatment firm.

When the city added up WREP's package, the savings topped $65 million over five years. A 29.5 percent reduction in wastewater treatment costs, it was the biggest score yet for competitive bidding. It amounted to almost 3 percent of the city's annual operating budget.

Although Goldsmith had the authority to award the contract, he and Stayton sensed that the community was not ready for such a big change. Instead they created a review committee, including two city-county councilors who had opposed issuing the request for proposals, to conduct a one-month "due diligence" investigation into WREP's qualifications and proposal. The group visited other U.S. cities where the French company operated facilities. They came home believers, and they recommended that the city contract with WREP.

At that point, says Stayton, all hell broke loose.

> *All of a sudden, the union and the environmentalists came out of the woodwork. They asked, "Why is the mayor hurrying into this?" We had*

to do six weeks of damage control.

Environmentalists and AFSCME tried to get the council to block the contract. The union sued the city to stop the deal, but it did not succeed. The council held a heated public hearing that was broadcast locally on television. But by then, Goldsmith and Stayton had gotten their story out and calmed the waters. Stayton kept reminding people that the city's respected water company would be taking over the wastewater facilities. "You trust the water company for your water," he told them, "so why not for your sewer?" The council decided not to derail the contract.

Goldsmith signed the contract in November 1993, making the Indianapolis Advanced Wastewater Treatment facilities the largest privately managed municipal wastewater operation in the U.S. The process had taken nearly a year—a long time for the more than 300 wastewater workers who had lived with the stress of economic insecurity. Over Thanksgiving and Christmas, they faced a more concrete threat: many would lose their jobs at the plant.

When WREP took over on February 1,1994, nearly 200 city workers made the transition to the new company. Their jobs with the private firm paid as much or more than they had earned with the city, and their benefits were better. Many of them were still represented by AFSCME. The new managers and the union had quickly struck an agreement—an unusual instance of a public employee union representing workers in a private company.

But 126 city workers did not make the shift to new management. The city offered to put all of them into a "safety net," which would guarantee them another job with the city or training and placement in a private sector job. It set up a job bank of vacant city positions and began moving people into them. About half chose this route, and WREP paid for placement and training for the rest. When the city got down to the last eight or nine people who had not been placed, it moved them into a new unit it was developing to improve overall customer service.

WREP has maintained wastewater quality, and in several respects it has improved on the city's high-quality performance of prior years. In its first year of operation it exceeded its discharge permit limitations only once, compared to 14 times in the city's last two years of operation. It cut the number and duration of overflows by 50 percent and the number of workplace accidents by 70 percent. Critics charged that it was responsible for two incidents in which fish died in the White River, but investigations by a county grand jury and an independent consultant hired by the city absolved WREP of responsibility. They blamed low water levels in the river and raw sewage overflows due to flaws in the city's sewer system. The state Department of Environmental Management charged that wastewater operations contributed to the problem, but local environmentalists disagreed. (Even if WREP had been responsible, the city-run system had experienced a much larger fish kill several years earlier.)

During WREP's first year, union grievances also fell—from 38 under city management to 1. Even sick time declined. "The majority [of former city workers] would say they don't want to come back," says AFSCME's Fantauzzo. "Economically, they've done better."

Managers who made the transition felt the same way. When Rick Farnham managed the wastewater facilities for the city, he was skeptical about using a private firm to do the job. "I had the same perceptions [as others]: that contract operation would lead to reduced water quality or cutting corners," he says. But a few months in his new job as WREP's technical services manager changed his mind: "I don't believe any of that is true at this point."

WREP met its contractual target for reducing the plants' operating costs. Changes in technology generated the majority of the savings. WREP substantially altered the plants' secondary treatment process, shifting more of the burden for processing fluids to less costly bio-towers.

WREP also streamlined the top-heavy, overstaffed organization by eliminating supervisory positions and overly specialized jobs. "There were people who had fixed pumps in one area of one plant for ten years," says Douglas B. Reichlin, a senior manager for WREP. "That's all they did, they couldn't fix other pumps." So WREP trained workers for multiple tasks and gave them additional responsibilities. The company invests far more in training than a typical public agency does.

Careful use of electricity helped cut the annual utility bill by $1 million. Ending an unnecessary buildup of inventories saved millions of dollars. Renegotiating the labor contract converted half of the automatic cost-of-living increase into performance incentives for individuals and teams. And WREP trimmed planned capital expenditures, saving the city an additional $1.8 million.

Stayton believes that competition was the only way to force such dramatic changes. "People in the plants and the technical staff were not willing to break their norms," he says. "You couldn't do it by just appointing a new manager for the division."

In the spring of 1995, a WREP official telephoned Stayton. He explained that the company was holding $45,000 in an account for the city. It was Indianapolis' 5 percent share of the company's profits for 1994.

"They told us it'll be about that number every year," Stayton reports. "It's a nice piece of change."

Business as Usual

By 1996, the city had held 64 public-private competitions, putting up for bid more than $500 million in work on 27 separate services. Public workers had won 16 bids outright and split 13 additional bids with private contractors. The competition had cut the city's costs by more than $100 million, projected over seven years. An additional $20 million in projected savings had come from contracts on which city employees did not bid.

Goldsmith and the city council have used the savings to repair infrastructure in the city's inner-city neighborhoods—a move that helped turn some inner-city councilors from opponents to supporters of competitive contracting.

In 1996, the city had more competitive bids—and more savings—in the pipeline. It had begun final negotiations with a private company to manage the city and county's information systems, with projected savings of $37 million. It had launched bids for work in ice-skating rinks, mowing, buildings and grounds maintenance, solid waste billing, and sewer maintenance. And it was scheduling bids for street cleaning, tree removal, locksmithing, emergency shelter care, parks upkeep— and pothole repair, again.

By 1996, the mayor had eliminated more than 1,025 of the 4,416 city jobs that existed when he took office. Almost all of the reductions were outside the police and fire departments, where Goldsmith chose not to bid out work. The rest of the city's workforce shrank by more than 40 percent—much of it because of competitive bidding.

Although the city does not keep these figures, Skip Stitt guesses that about 20 percent of these 1,025 people were laid off. The rest went to work for private contractors, were moved into vacant city jobs, were placed in private sector jobs, or took early-retirement packages. Yet not one union member was laid off. Goldsmith never made a "no-layoff" pact with the unions, but his administration implemented a de facto no-layoff policy for the 20 percent of the workforce that belonged to unions.

Goldsmith's successes with competition attracted attention world-wide. Big-city mayors, governors, foreign officials, and journalists flocked to Indianapolis. The visiting traffic got so heavy that the city finally organized regularly scheduled conferences to share its story. Then it began to tell callers it could no longer host other visits.

The visitors found that competition had produced unexpected changes. City employees had feared competition but discovered they could win bids. "The bidding process is telling you that you've got to dig down and make every effort to maintain your job," explains Jeffrey Thomas, a ten-year employee in the Solid Waste Division. His unit increased daily workloads and redesigned trash-collection routes in order to win its bids. Through competition it even expanded its "market share" of the city's garbage-pickup routes.

Black politicians had feared that minority employees in government would be laid off, but local minority entrepreneurs found that competitive bidding opened up business opportunities. For example, George Pillow's fledgling courier service won a city contract that he says boosted his revenues by about 30 percent and gave him the credibility to land a handful of additional contracts. By 1996, according to Stitt, the city had increased its minority contracting 20 times over 1991 levels—to $40 million—in part because competition had opened up bidding opportunities.

And the public employee union found it could use competitive bidding to improve its members' pay and benefits, through gainsharing. The Solid Waste Division's $1,750 gainsharing payments sent a loud message to city employees. Another unit quickly submitted a bid that waived its right to a cost-of-living increase because it feared the pay boost would make its proposal uncompetitive, for instance. Instead, it convinced the city to agree to gainsharing, if it brought the work in under the proposed price.

By 1995, the combination of gainsharing, competitive bidding, and job security had begun to produce employee behavior that would be unthinkable in most governments. In Fleet Services, where the employees negotiated a 25 percent share of any savings below the price they bid, employees were beginning to *suggest* outsourcing when it would save money. In auto body work, for example, the city shop was not competitive with private shops. So it began outsourcing that work and moving the displaced employees into more competitive areas. In 1994 it outsourced only 15 percent of body work; in 1995 it increased the amount to 37 percent.

"The outsourcing issue used to be a big fight with the administration," says Skip Stitt. "But now it's not. There's no bickering if the employees can save—and make—money on the deal."

Fantauzzo confirms this change:

> *Those employees and their managers are determining what they do best, their core activities. We don't do body work best, so let's get out of the body work business. The next step is what they're looking at now: expanding what they do well and doing more of it.*

Fantauzzo is referring to a trend that began to emerge in 1996. Motivated in part by the prospect of gainsharing, his members and managers such as Michael Carter in Solid Waste are teaming up to go after new business—from other city departments, from other public organizations, and from nearby governments. Solid Waste, which has already won contracts with municipalities in the neighboring county, is looking at private sector opportunities and pushing for the right to bid in more than three of the city's garbage districts.

Fantauzzo wants the city to allow other units to do the same. He finds himself in an unfamiliar position for a union leader: marketing his members' services.

> *Going after new business is something we've never done before. I find myself going to WREP and saying, "Why are you going to a private garage to get your trucks fixed? You should contract with the city garage for fleet services."*

Fantauzzo says that gainsharing has not changed employees' attitudes toward competition, which are still mixed:

> *On the one hand, there is a lot of apprehension about whether they'll be employed...But on the other side of the ledger, for the first time in a long time, employees have been asked to stop parking their brains at the door when they come to work. They actually have been empowered to participate in the decision-making process. Workers are being asked how to do the job more efficiently and more effectively.*

But combine that empowerment with gainsharing and you get an entirely different attitude about *productivity,* he says. "Look at what happens in the eleventh month of a budget in traditional government: everyone is looking to spend the last dime to justify that plus more next year. Here, people are looking to save every dime because they figure a piece of the pie is going into their pocket."

In 1991, Fantauzzo was looking for ways to keep Steve Goldsmith out of the mayor's job. At his union's annual preelection convention, the members booed Goldsmith. But in 1995, at the same convention, they gave him a standing ovation. The city workers wanted to endorse him, but the teachers, who opposed a reform slate of school board candidates Goldsmith was promoting, did not. So the union endorsed no one. (Goldsmith won reelection with almost 60 percent of the vote.) Meanwhile, Fantauzzo partners with Skip Stitt at conferences to explain the city's competition process. "I suspect some union colleagues in other areas of the country are raising their eyebrows," he muses.

There's little doubt about that. But in Indianapolis, at least, competition seems to have become an accepted way of doing business. Following the success of the wastewater treatment competition, the city's airport authority bid out the operation and management of Indianapolis International Airport, where costs had risen 38 percent since 1984. No one caused a political ruckus; no environmental issues emerged; public meetings were sparsely attended. The union stayed out of the process because the 300 affected employees were not union members. Those workers submitted a bid. Like the city's wastewater division managers, they tried to compete by cutting costs sharply. But so did four private firms.

One bid came from BAA USA, Inc., the American subsidiary of BAA, the British company that owns and operates London's Heathrow, the largest international airport in the world. BAA had once been a government agency—British Airports Authority—but Margaret Thatcher's government sold it in 1987. It manages airports that serve 80 million passengers yearly—nearly 30 times Indianapolis's volume. "They've forgotten more than we know about airports," says Public Works Director Stayton.

In mid-1995, the airport authority's board of directors approved the British subsidiary's bid. The authority's May 11 press release crowed that "Private Management of Airport Could Save More than $100 Million, Improve Service." The savings will go to airlines that use the airport—not taxpayers—since landing fees fund most of the airport's operations. But they will help make the Indianapolis airport more attractive to airlines, which could lead to more jobs in the region.

When BAA assumed management of the airport on October 1, 1995, it took on the largest private airport contract in the U.S. This would have been big news anywhere else in the country. Four years earlier it would have been big news in Indianapolis, too. But by 1995 it was just another transaction—business as usual—in the city's bustling marketplace for municipal services.

THE CONSEQUENCES STRATEGY

Steve Goldsmith forced city employees to compete against contract-hungry private companies. Suddenly, public workers had to prove they were a better buy for the taxpayers.

This unwelcome risk pressured the employees. They quickly reexamined their traditional ways of doing things. Most learned for the first time how much it cost to do their work; many devised less costly, more effective methods. Even those who did not face competition took a second look at their operations—because, in Skip Stitt's words, they were "preparing for the prospect of competition."

Goldsmith was not the first to use competition between public workers and private firms to stimulate new behaviors in government. In the United Kingdom, Conservative Party leaders in 1980 and 1988 had forced local governments to put a wide range of services out for bid. By 1992, when the

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Conservatives extended "compulsory competitive tendering" to white-collar services, thousands of public-private competitions had been held for nearly £2 billion of local public services.

When Mayor Goldsmith took office, he told his managers to read *Reinventing Government.* It told the story of the Phoenix Department of Public Works, whose director, Ron Jensen, had spearheaded public-versus-private bidding for many services 14 years earlier. But in Goldsmith's hands, competition was more than a manager's tool for cutting costs in one department. It was part of a citywide strategy of introducing consequences for performance.

Goldsmith believed that a megadose of competition would be a powerful antidote to a key poison that causes government's inefficiency and ineffectiveness: *monopoly.* Public agencies should have exclusive control over certain activities, as we argued in chapter 4. But politicians overuse their power to create public monopolies. In response to community needs, they often turn without thinking to government agencies rather than private markets. They do this, in large part, because they are captives of the bureaucratic paradigm; some barely realize there is an alternative. They also do it because building monopolies enhances their power. It gives them direct control over the enormous resources of government agencies. By manipulating the use of public money, employment, and purchasing, they gain credit for responding to public needs and constituency demands. They can also reward allies and punish opponents.

Government employees support public monopolies for more obvious reasons. They and their unions have a direct economic stake in preserving or expanding their corner on the market.

The problem with government monopolies is that they have no real reason to improve their performance. They receive no reward for getting better. Because their customers cannot desert them, they risk nothing if they perform badly. And they rarely die. Their fate is independent of their performance. They seldom innovate, because they don't *have* to.

Goldsmith used competition to alter these dynamics, and it very quickly boosted government's performance. "We say it's 'antitrust' for government," explains Mitch Daniels, chairman of SELTIC.

> *Monopolies tend to abuse their customers, overcharge their customers. They're not pressured by any competition...Competitive government means that whoever's providing the service knows they've got to keep on getting better, keep on serving the customer, or somebody will replace them.*

Mayor Goldsmith used consequences—economic risks and rewards—as a *lever* to give government workers a stake in the outcome of their efforts. Competitive bidding and gainsharing forged a tight, unprecedented link between the quality of government's performance and the economic well-being of government workers. As a result, employees began to change management structures, work processes, union activities, and their own attitudes. No one had to mandate or specify these changes.

Once competition becomes the norm, explain Phoenix Auditor Jim Flanagan and Deputy Auditor Susan Perkins, employees become self-directed. "Discussions of unit costs, customer complaints, downtime, and other production-line events occur with interest and energy. There is no need to build bureaucratic reporting, regulatory, and oversight devices."

These self-propelling dynamics are characteristic of the consequences strategy: reinventors introduce performance-based incentives, then let nature take its course. They make consequences an extremely powerful strategy.

Three Approaches to Introducing Consequences

Public leaders introduce consequences into government in three basic ways. The most powerful approach is to force public service-delivery organizations to function as business enterprises with financial bottom lines, preferably in competitive markets. We call this *enterprise management.* Rather than acquiring their revenues from government appropriations of tax dollars, these public enterprises earn money by selling goods and services directly to their customers. To earn their keep, in other words, they must succeed in the marketplace. Failure brings financial loss, which can lead to job loss. Success can result in increased economic rewards. When New Zealand replaced government bureaucracies with state-owned enterprises that operated like private companies, a process we described in chapter 4, it was using enterprise management.

Enterprise management is the most powerful of the consequences approaches, because the competition it creates is automatic and unrelenting. No contracting process is necessary; no one has to impose the consequences; the politicians are not even part of the decision-making. Instead, the organization's customers impose the consequences directly.

However, enterprise management doesn't work for all public organizations. Sometimes a financial bottom line is not the appropriate indicator of success, because the activity—whether protecting the environment, managing the parks, or protecting the public safety—is not one that should be charged to customers in a marketplace. When this is the case, the next best choice is *managed competition*, the approach Goldsmith used in Indianapolis. Its consequences are less automatic than those of the marketplace, but they are still powerful. Managed competition requires potential providers of government services—private firms and/or public agencies—to compete against one another for contracts, based on their performance. When contracting is not possible, public officials can measure and compare the performance of similar organizations through competitive benchmarking, then create psychological and financial consequences.

When neither enterprise management nor managed competition is appropriate—whether for the rational reasons we will discuss later or because of political obstacles—the alternative is *performance management.*

This approach uses performance measures, standards, rewards, and penalties to motivate public organizations. The rewards and penalties can be financial, like gainsharing in Indianapolis. They can be quasi-economic, like the Air Combat Command's practice of giving three-day weekends to squadrons that hit their monthly performance targets. Or they can be strictly psychological, like recognition and award programs.

Performance management is less powerful than the other two approaches because the consequences it imposes are rarely as compelling or unavoidable as the consequences of competition. It also leaves the job of judging performance to public officials, who have an inherent interest in proclaiming the success of the organizations they fund and run. Finally, performance management sets relatively weak standards for performance. An agency's performance is usually measured against its past record or against a predetermined performance target. This tells us if it has improved, or if it has achieved an established objective. But because there are no comparisons with competitors, it doesn't tell us if someone else could have done better, nor just how good performance *could* be. Consider Mayor Goldsmith's experience with the wastewater treatment system in Indianapolis. After a long study, a respected private consulting firm told him the maximum savings from private management would be about 5 percent. Using managed competition, however, he generated savings of *29.5 percent.*

These three approaches are not mutually exclusive: organizations that operate as public enterprises or that compete for contracts typically use many performance management tools to maximize their competitive advantages. Indeed, we believe that every public organization should use performance management, whether it is a public monopoly, a competitive enterprise, or a competitor for contracts.

We have not listed performance measurement as an approach because we do not believe that the act of measurement itself has enough power to force fundamental change in most public organizations. It is a critical *competence* organizations need if they are to use the consequences strategy, and we will devote a chapter to it in our next book. But some public organizations have measured performance for years, with virtually no impact. Until the Guiliani administration began using New York's performance data, for example, the city's annual performance reports gathered dust on most shelves. To reinvent public bureaucracies, the key is to attach consequences to performance measurement.

Protecting Employees Who Are No Longer Needed

Both enterprise management and managed competition often force public organizations to downsize, sometimes rapidly. When they lose contracts or market share, they have to get by with fewer employees. How should they deal with this reality?

This is one of the most important questions reinventors face. We believe governments should protect employees from the threat of unemployment, unless they are in a fiscal crisis so deep they simply cannot afford to do so. Employees did not create the bureaucracies in which they work, and they should not pay the price of reinventing those bureaucracies. We recommend adopting a no-layoff policy and creating a menu of options for employees whose jobs disappear.

This is not only the right way to treat human beings, it is the pragmatic thing to do. As the Indianapolis experience demonstrates, it allows public leaders to use competition far more extensively, because it reduces resistance from employees and their unions. It also makes it far easier to change the culture of public organizations, because employees' minds are not riveted to the possibility of losing their jobs.

The key is to use attrition to downsize, shifting displaced employees into jobs vacated by those retiring or departing. The typical government has a 5-10 percent annual attrition rate, which fluctuates as economic conditions change. If your personnel system has too many rigid job classifications and rules, you will probably need to change it to give yourself the flexibility to move people around. The United Kingdom has shrunk its national civil service by 33 percent with few layoffs over the past 18 years, using a variety of techniques. The menu of options includes the following:

Shift dislocated employees into other public jobs. One useful method is a "job bank," through which organizations hold open a certain number of vacancies to be filled by dislocated public employees. In Phoenix, the city forecasts possible employee displacement; normally, unless budget cuts are forcing layoffs, it shifts at-risk employees into the new jobs. In Philadelphia, when a private contractor took over prison food services, the city gave displaced workers the opportunity to enter a new job classification—correctional officer trainee—and develop new careers in government.

When a government moves people to other jobs, it must decide whether to protect them from wage loss. Indianapolis and Phoenix don't guarantee equal wages, but they try to put people in roughly comparable positions.

If job dislocation is large and rapid, a job bank will not be enough. To ease the pain, some governments consciously manage the pace of dislocation. As Indianapolis's Skip Stitt explains, "If you recognize that you're going to take a big hit, you might postpone it a few months" to build up vacancies that can be filled.

Shift public workers into private firms taking over the work. Some governments build into any competitive bid a requirement that a winning private bidder must give preference to dislocated public employees in any hiring. In Philadelphia, Phoenix, and the U.K., virtually *all* contracts contain a "first hiring preference" clause, which requires contractors that need new employees to give displaced public employees the opportunity to be hired.

Require that contractors pay comparable wages and benefits. In the U.K., European Community policies require that in most cases, private contractors hire public employees to fill all positions they need to fulfill the contract, at the terms and conditions of their previous employment (with the exception of overtime pay). When they leave, the contractor does not have to replace them at the same wages and benefits. And if they do not perform, the contractor can fire them, using the same procedures required for any other employee. Some American governments require contractors to pay certain wage levels, and Phoenix now requires them to provide their employees with comparable health plans. In Philadelphia, when Mayor Ed Rendell contracted out work, he allowed some workers who were shifting to the private contractors to stay on the city payroll long enough to become vested for pensions—and got the contractors to pay the extra cost.

While we see no reason taxpayers should be forced to subsidize wages and benefits far above market rates, some communities will choose to protect the pay and benefit levels they feel their employees deserve, even after they go to work for private contractors. This is a question of values each community must decide on its own.

Help managers take their organizations private. Governments sometimes institute management "spin outs" to shift workers into the private sector. Usually, the government provides them with an initial contract for services to help them get established.

In the London borough of Bexley, the local authority's architects, street

sweepers, grounds keepers, and refuse collectors had taken this self-privatization route by 1995, and other units were looking at it as well. Terrence Musgrave, Bexley's chief executive, describes how this developed. As a unit prepares for competition, he says, it usually experiences "about 15 months of complete anxiety." Then they win the contract, and "the anxiety is replaced by beads of perspiration."

> *Then about two and a half years later they knock on my door, and what do they ask for but freedom? They now know they are running a successful business. They've won the competition; they've worked hard to increase productivity; and they know the only way they can grow is to escape from being a local authority. Once they're in the marketplace, they can seek business anywhere.*
>
> *Now as part of that process of freedom, all sorts of deals can be extracted by the council. They'll take all employees, so there's no redundancy [unemployment]. They'll give us a discount, so they can seek profits elsewhere.*

Offer economic incentives and outplacement services to those who choose to retire or look for jobs elsewhere. Public officials often offer workers severance packages and early retirement incentives, as well as placement services to help them find jobs in the private sector. These options cost extra money in the short run—a disincentive if departments are required to pick up the tab. In the U.K., the government set up a special fund to cover 80 percent of the departments' costs.

How to Make No-Layoff Policies Work

- Retrain workers and place them in other government jobs.
- Hold vacant positions open as a "job bank" for workers whose jobs disappear.
- Require private contractors to hire dislocated public employees before anyone else.
- Require private contractors to pay comparable wages and benefits.
- Carry people who are close to becoming vested with pensions—but make the private contractor pick up the cost.
- Help public managers take their organizations private.
- Offer severance packages or early-retirement incentives.
- Provide outplacement services.

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CHOOSING THE BEST APPROACH FOR EACH FUNCTION

Which approach works best for which government functions? Enterprise management works only for services that can earn all or part of their revenues by charging their customers, whether those customers are citizens, private organizations, or other public organizations. Hence it is not appropriate for "public goods" that benefit the community as a whole more than specific customers. These include policy-making functions, regulatory and compliance functions (like environmental protection and public safety), and services that are consumed collectively (like national defense, public health services, and fire prevention). Since customers cannot be charged for collective services, the market will not produce them on its own. Governments can produce these services themselves, contract with private companies to produce them, or give grants to private companies to produce them, but they cannot create enterprises that charge customers for them.

As we noted above, enterprise management is inappropriate for compliance functions. It makes no sense to put a compliance organization in a market and let its compliers fund it through fees. Imagine an environmental permitting agency funded through permit fees, or a police department funded by traffic tickets, and the problem becomes obvious. The agency would have a powerful financial incentive to crack down on every infraction, real or imagined.

When delivering "private" goods, which benefit individuals or discrete groups, you can use enterprise management as long as you meet several criteria. You must be able to exclude nonpayers from benefiting; collect fees efficiently; ensure that customers have enough information to make intelligent choices; and minimize equity problems. For example, if low-income people cannot afford the fee but the community wants to give them access to the services, there must be a practical way to identify them, so you can admit them for free or give them vouchers.

Moving to managed competition, any organization that can measure its performance can use competitive benchmarking, a tool that compares the performance of organizations. And virtually any *service* can be contracted, as long as you can define fairly clearly what you want done; generate sufficient competition; measure or evaluate performance; and replace or penalize poor performers. If you want to include private firms in the competition—as most governments do—you must be willing to trust them with the service. As we argued in chapter 4, most communities prefer that highly sensitive functions—those involving state-sanctioned violence, due process rights, security and privacy issues, or an absolute necessity of fair and equal treatment—remain in public hands. Governments can use competitive contracting for these functions, but most communities are more comfortable when only public organizations compete.

Some compliance functions can also be contracted out to competing organizations. For instance, revenue departments often contract with private companies to collect overdue tax payments. And a few communities in southern California contract with police departments in other communities—or from Los Angeles County—to provide their police services. There is no reason such contracting cannot be done competitively. It is often wise in such cases to contract with only one organization at a time, but to rebid the contract regularly to ensure competition. If a revenue department contracts with three firms and each treats people differently, some compliers will feel they are being discriminated against. In other activities, such as police work, the solution is to contract only with public organizations—and only one at a time.

Finally, performance management can be used with any public organization. It is far more difficult with some than with others, depending upon how well the outputs can be measured. But the New Zealanders have even managed to use it with their ministries that supply policy advice to ministers.

QUESTIONS PEOPLE ASK ABOUT THE CONSEQUENCES STRATEGY

Q: Doesn't creating consequences cause fear in government organizations, undercutting efforts to develop innovative organizational cultures and to support innovators?

Employees of any monopoly—public or private—fear the imposition of new consequences for their performance. They worry that they will not generate enough revenues from customers; that they will not compete successfully against other organizations; that they will lose their jobs.

However, these anxieties have desirable effects. Government organizations take a new interest in pleasing their customers. They pay much more attention to how they spend taxpayers' money and what elected officials and the public want them to accomplish. These effects—caring about customers, efficiency, and effectiveness—are important drivers of a healthy organizational culture. They create pressures that push a bureaucratic culture to focus on accomplishment and improvement, not procedures and compliance.

There are several keys to minimizing employee anxiety and maximizing improvement. One is to take away the fear of job loss, as we explained earlier in this chapter. Another is to use the control strategy to give ownership of the improvement process to the employees. If employees feel in control of their organizations—if they feel like owners, not victims—they will more quickly move past their anxieties and make the most of their opportunities to succeed. A third is to give them a meaningful "upside" for improving their performance. Tie bonuses and promotions to improved performance, or let employees keep part of the money their organizations save by increasing efficiency, as Indianapolis does.

Q: Won't making employees compete with one another prevent collaboration and teamwork?

Public employees facing competition may hoard information about their successful innovations to keep their competitive edge, rather than sharing the knowledge with others. Of course, they will still work harder to find the secrets to better performance than if they faced no competition. But you can get the benefits of competition and collaborative learning at the same time, if you structure the incentives carefully. If done right, competition can stimulate greater information sharing and learning.

First, make organizations and teams—not individuals—the competitors. This promotes the cooperative behaviors that are part of teamwork. Indeed, the most intense teamwork we have ever seen takes place in teams that have to compete.

Second, be careful how you define success in competitive situations. For example, sometimes you can reward all teams that show improvement, or that exceed a specified performance target. This way everyone can win, if they all improve. Hence every team has an incentive to learn everything it can from other teams that are performance leaders. And those leaders have no reason to hoard their secrets. Indeed, by sharing information they can usually learn something that will help them improve as well.

Q: When public organizations become intensely focused on their own performance, don't they quit collaborating with other public organizations for the greater good?

Results-oriented governments from New Zealand to Sunnyvale, California, have wrestled with this problem. If you give organizations powerful incentives to produce specific outputs, they will concentrate all their energies on doing just that. In the process, they may start ignoring the needs of other public organizations, or the larger collective welfare. Sunnyvale Personnel Director Liz Birch puts the problem into concrete terms: "One of the criticisms of our system is that it has not fostered cross-departmental assistance, because whenever you ask someone to do something for you, they want a task number."

The solution, as we argued in chapter 4, is to focus the entire system first on key collective outcomes, then make sure the outputs you want organizations to produce contribute to those outcomes. This is precisely the challenge Sunnyvale is struggling with, as it revamps its performance management system. If your incentives are forcing narrow, noncollaborative behavior, you need to broaden your output and outcome targets. You may even need to create some funding that policy makers can use to purchase collaborative work from a variety of organizations.

TAKING COMPETITION TO A NEW LEVEL

In 1996, Indianapolis put managed competition to use in a new way.

Several years earlier, city leaders had realized that the U.S. Navy would probably shut down the Naval Air Warfare Center on the city's east side. Established during World War II, the center employed about 2,550 people, more than half of them engineers and scientists who developed electronics and software systems for the military and NASA. Mayor Goldsmith estimated that losing the center would cost the region $1 billion in payroll, contracts, purchases, and economic explore options for keeping the facility alive.

Hundreds of American communities have faced similar threats. Most have struggled in vain against the death sentence, calling press conferences and calling in political favors. Indianapolis, whose leaders were now in the habit of using competition, instead made the government a novel offer.

The Navy's plan to give the facility to the city and disperse its workforce to bases on the East and West Coasts would cost an estimated $400 million. Why not, Indianapolis asked, let businesses compete to take over the facility and perform the Navy's work at reduced cost?

Since the Navy had no experience doing something like this, Indianapolis volunteered to handle the process. The city persuaded the federal Base Closure and Realignments Commission to overturn the center's death sentence and recommend privatization.

After President Clinton and Congress approved the change, Indianapolis issued a request for proposals. It asked companies how they would use the center and its workforce to spur the city's economic development and to save the Navy money. Seven companies submitted proposals, and the city invited four of them to develop more detailed bids. Fairly quickly, it became a bidding war between two firms.

The winner, Hughes Technical Services, got a 10-year lease on the center and its equipment for $1 a year. In exchange, it guaranteed that it would cut the Navy's costs by $225 million over five years. (The Navy would also save its $400 million in closing costs.) It pledged to keep nearly all the center's employees on for at least five years, at no loss in wages or benefits, and to relocate four divisions from California— adding 730 jobs and $100 million in annual business to the Indianapolis economy. Hughes also agreed to invest at least $7.5 million in capital improvements annually; to set aside $500,000 to assist workers in finding new jobs; and to invest 1 percent of its gross revenues (or at least $3 million annually) to upgrade its workers' skills.

The company will pay taxes on the center's property and equipment, which were tax-free when operated by the federal government. Hughes will also reimburse the city for the $1 million it spent to develop the privatization plan and contribute 1 percent of its gross revenues to charitable grants, gifts, endowments, and economic development projects in Indianapolis.

Announcing the agreement in May 1996, Goldsmith claimed it was the first full-scale privatization of a U.S. military base. The mayor thanked the federal officials who allowed him to use competition to keep the Naval Center viable. And he welcomed to town Hughes Electronics—the newest player in the city's marketplace for public services.

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 Eight

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Money for City," *Indianapolis Star,* March 18, 1995.

p. III/8: "A 29.5 percent reduction ...": In a November 11, 1993 letter from Michael Stayton, director of public works, to Mayor Goldsmith, on behalf of the Advanced Wastewater Treatment Contract Management Review Committee, the city estimated the five-year city government operating and capital investment budget for AWT at $221.8 million. The WREP proposal for that period cost $156.9 million, a reduction of $64.9 million.

p. III/9: "In its first year of operation ... by 70 percent," and ". .. union grievances also fell...": Details of first-year operations are contained in White River Environmental Partnership report to the Indianapolis City/County Council, *Indianapolis Advanced Wastewater Treatment Facilities: One Year Summary,* March 20, 1995.

p. III/9: "The state Department of Environmental Management...": See Welton W. Harris II, "Environmental Board Member Defends City in Fish Kills," The Indianapolis News, June 22, 1995; and a letter to the editor from William Beranek Jr., president of the Indiana Environmental Institute: "Phase Out the Overflows," Indianapolis Business Journal, Oct. 17-23, 1994, p. 7A. "The cause of the kill is inherent in the design of our storm and sanitary sewer systems," Beranek wrote. "It was not the fault of anyone."

p. III/11: "By 1996, the city had held 64 public-private competitions .. . did not bid": Indianapolis does not keep separate records of public-versus-private com petitions. However, the mayor's office maintains a spread-sheet of innovative projects and the savings they will generate over seven years, known as "Enterprise Group Activity." It includes competitive bidding, as well as outsourcing, consolidations, asset sales, and reengineering proj ects. Typically, published accounts of savings achieved in Indianapolis reflect the total of all these activities. Our data on public-versus-private competi tions were developed by identifying such projects on the Oct. 5, 1995, spreadsheet, from interviews, and from an Oct. 5, 1995, memoran dum to Peter Plastrik from Deputy Mayor Skip Stitt."

p. III/11: By 1996, the mayor had eliminated ... because of competitive bidding": Job elimination data is from an Oct. 4,1995, memorandum from Deputy Mayor Skip Stitt to Peter Plastrik. Indianapolis does not keep records of employment changes resulting solely from public-versus-private competi tions. However, in the Oct. 4, 1995, memo Stitt estimated that since Dec. 31, 1991, as many as 1,365 city employee positions had been subject to either public-private competitive bidding or to outsourcing.

p. III/13: "Following the success of.. .": In aMay 11, 1995, memorandum to the Indianapolis Airport Authority, board members Gordon St. Angelo and Michael W. Wells reported that from 1984 to 1994 the airport had experienced a 38 percent increase in costs charged to airlines.

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