Chapter 9

Enterprise Management

Using Markets to Create Consequences

Enterprise Management **forces public organizations to function as business enterprises, with financial bottom lines. They remain publicly-owned, but they must earn their budgets by selling services to their customers—citizens or other public organizations. Their success as enterprises depends on how well they meet those customers' needs.**

Sunnyvale, California, began to phase out taxpayer support for recreational programs in 1991. Like many cities, it decided that "leisure services" were not a high enough priority to spend so many taxpayers' dollars on them. Unlike many communities, however, Sunnyvale did not abandon its recreational programs; it turned them into a public enterprise. Instead of living almost entirely off tax revenues, the enterprise would have to rely increasingly on its sales to customers. It would have to compete with businesses also chasing the recreation dollar.

Several years earlier, reinventors in New Zealand used a similar approach to shake up their bureaucracies. Government departments there produced aviation, rail, mail, communications, hotel, banking, insurance, shipping, and weather forecasting services, plus electricity, coal, and forest products. The departments were rarely as efficient as private businesses. Some were notorious monuments to waste: many lost money year after year. Beginning in 1987, the government made them state-owned enterprises (SOEs): it withdrew monopoly status from all but two, and it forced all of them to earn their keep from sales to customers.

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At about the same time, the U.S. Congress did much the same thing to the General Service Administration's Federal Supply Service (FSS), a mammoth internal provider of office supplies. It took away FSS's monopoly and its appropriation, giving its customers—other government agencies—credit cards they could use to buy from FSS or from its private competitors. It even turned over one FSS region to a private office supply company to serve as a competitive benchmark for the rest of the organization. "When suddenly forced to confront head-to-head competition with the giant national office supply discounters, there was a rude awakening," remembers Gerald Turetsky, then assistant regional administrator for Region 2 in New York. "It was like being thrown into an ice-cold shower with your clothes on."

Call it the shock of the marketplace. That's what Turetsky's FSS, Sunnyvale's Leisure Services unit, and New Zealand's SOEs experienced: the "ice-cold" impact of having their survival depend for the first time on pleasing customers and besting competitors. Just like a business, some might say. Yes, but not exactly.

Like businesses, public enterprises have markets and customers, prices and profits, and financial bottom lines. This is an enormous change for government managers accustomed to operating in a bureaucratic environment. The rules are entirely different; customers are powerful, and financial performance is a life-and-death issue. That's why New Zealand's SOEs laid off half their workers; to compete, they had to cut costs. It's why Sunnyvale's recreation department invested in research about its customers. And it's why the FSS began to compare its services with Fortune 100 companies, killed off unprofitable product lines, and negotiated long-term agreements with its contractors. It's also why public enterprises often hire top managers from the private sector.

But some things about public enterprises don't change. Most important, the government still owns them; their assets and income are public property. As a result, they remain under the ultimate control of elected officials. The degree of direct control that politicians exercise may vary greatly, from *laissez faire* to constant intrusions—an issue we will return to shortly.

WHEN TO USE ENTERPRISE MANAGEMENT

Most government organizations that produce services that can be sold to their customers can be subjected to enterprise management. It can be applied to agencies, such as Sunnyvale's recreation department, that serve external customers, as well as to government's "internal" providers: agencies that supply other public organizations with printing, vehicle maintenance and fleets, data processing, and other products and services.

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But because it relies so heavily on markets, enterprise management is not appropriate for every public activity. Policy, compliance, and regulatory functions exist to benefit the citizenry as a whole, not to provide goods and services to specific consumers. They should not be charged to paying customers, nor held to market tests.

In addition, there are some services that should not be operated as enterprises funded by customers. This is true if:

- A service serves the public interest more than any specific internal or external customers (examples include national defense, public health services, and fire prevention).
- A service cannot be charged to customers, because nonpayers cannot be excluded (a municipal park without gates, for instance).
- Some customers who use the service cannot afford it, officials want the service to be available to all, and the only efficient or effective way to accomplish this is to provide it free or at a discount for all.

Some services are "natural monopolies," because they are more efficiently provided by one central source than by many. Sewer and water services are examples. These can still be organized as enterprises, but as regulated monopolies, like private utilities, rather than competitive businesses. They can be made accountable to their customers by placing customer representatives on their boards of directors, or through regulation by public commissions.

THE POWER OF ENTERPRISE MANAGEMENT

Forcing public agencies into a competitive marketplace changes their behavior almost overnight, because they *must* please their customers to survive. Suddenly, they have entirely new challenges: finding out what customers want, learning what competitors are offering, and reducing costs so their prices will be competitive. But this is just the tip of the iceberg: public enterprises eventually take on most of the management characteristics of businesses. Sunnyvale's Leisure Services unit invented new recreation services, marketed them to customers, and entered into business partnerships with the school district. The FSS developed a business plan and an activity-based accounting system to track costs. New Zealand's enterprises sold assets and borrowed money.

When the FSS was thrown into the marketplace after more than four decades as a monopoly, some observers thought it was a dead duck. "The folks on [Capitol] Hill said we'd soon be out of business," remembers FSS commissioner Frank Pugliese. "But we set out to prove them wrong." By 1996, the organization was selling products and services for 30 percent less than its competitors, on average. Annual sales were $13 billion. Year after year, customers of Turetsky's Region 2 rated its services a 10 on a scale of 1 to 10.

Before Sunnyvale's Leisure Services unit had to compete in the marketplace for its funds, about 75 percent of its money came from tax dollars. By 2000, taxpayers provided only about 20 percent; sales to customers brought in the rest. The reduction had saved the city millions of dollars.

In New Zealand, as we reported in *Banishing Bureaucracy,* the SOEs increased their revenues by 15 percent and quadrupled their profits in their first five years in existence. In 1992, they paid roughly $1 billion in dividends and taxes to the government.

See *Banishing Bureaucracy* pp. II/5-7

Enterprise management is so powerful because it combines four strategies: Core, Consequences, Customer, and Control. It uncouples public organizations, creates consequences for their financial performance, makes them accountable to their customers, and gives them control over their own operations, typically exempting them from bureaucratic administrative controls. This gives it enormous advantages over the other two consequences approaches.

PITFALLS TO AVOID: WHY SOME PUBLIC ENTERPRISES HAVE A POOR TRACK RECORD

Not all public enterprises have been as successful as those in Sunnyvale and New Zealand. Often, organizations are called public corporations but are protected from real consequences and are not given the freedom and flexibility they need to succeed. To benefit from the power of enterprise management, you need to use all four of the strategies it draws on. The following flaws in implementation are all too common.

- ***Government enterprises often face minimal or no competitive pressure.*** Many public enterprises are designed as statutory monopolies and therefore do not face competition. Even when they are not explicit monopolies, they often enjoy such substantial regulatory advantages that no competitors can emerge to take them on; the barriers to entry are too high. Before New Zealand's reforms, for example, the government's railway freight services benefited from the high rates that regulators imposed on its competitors, the private trucking companies. Public businesses also enjoy financial advantages: they pay no taxes and obtain free capital from the government.

- ***Government businesses are not always held accountable for their performance.*** Most public enterprises collect very little data that can be used to analyze their commercial performance. In New Zealand, as former finance minister Roger Douglas points out, their "information systems were designed to help government ration the annual resources voted to State-owned enterprises, not measure the value of what they were producing." In addition, most

Other Advantages of Enterprise Management

Enterprise management uses market forces, not contract bids or administrative performance targets, to create consequences for performance. This gives it a number of advantages over the other two approaches.

Enterprise management makes agencies directly accountable to their customers. A public enterprise's success or failure depends on its customers' decisions. Because customers can go elsewhere (or, in the case of natural monopolies, buy less), public enterprises are forced to listen carefully to what they want. In contrast, managed competition and performance management rely on decisions by government officials.

Enterprise management forces continual improvement, because the competition is constant; it doesn't just happen at contract or review time. Agencies that compete for contracts have to beat the competition—but only once every few years. Agencies that must meet performance standards also face only periodic reviews. But agencies that depend on their customers for their income have to please those customers every day. They face continuous pressure to increase their quality and lower their costs.

Enterprise management sharpens the consequences of an agency's performance. If a public enterprise does a good job for its customers, it thrives. If it does not, it shrinks and potentially dies. The bottom line profit-and-loss numbers provide a simple, elegant, and accurate measure of the efficiency and effectiveness of the agency. The legislature doesn't have to wonder whether a unit is performing well: the financial statement says it all.

Enterprise management empowers public enterprises to make the long-term financial decisions necessary to maximize value for their customers. Public enterprises use financial methods customary in business, not government: long-term business plans, accrual accounting, depreciation of assets, borrowing to finance investments, and calculation of the return on those investments. Because they retain part of their earnings, depreciate assets, and borrow money, they can make the long-term investments in technology, training, and productivity improvements that are so difficult to make in the public sector.

Enterprise management saves money because it is simple to administer. It creates competition without creating a time-consuming bidding process to administer. In addition, the constant war between the budget and personnel offices and the operating agencies—over what they can spend, how many people they can employ, and what investments they can make—virtually disappears. Nor does the legislature have to spend time wrestling with appropriations levels and investment decisions; the competitive market creates accountability.

Finally, enterprise management radically simplifies the politics of improving performance. No one has to vote to eliminate or privatize an enterprise activity that is not performing well; the competitive market takes care of it. No one has to vote for a special appropriation to invest in new technologies. No one has to choose which bid wins a contract; no one has to defend the contracting process from cries of favoritism; and no one has to withstand a lobbying assault from disappointed contractors. Customers decide who offers the best deal, not administrators and politicians.

From *Banishing Bureaucracy, pp. 138-139*

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public businesses blend together the costs and benefits of their commercial and social activities. “This,” says Robert Anderson, a consultant for the World Bank, “inevitably leads to a complex monitoring system that is not likely to produce clear, unambiguous measures of performance.” Finally, the private sector has no reason to monitor the performance of public enterprises the way it does that of private firms offering stock or seeking to borrow funds.

It is also difficult to assign accountability to government managers if they have little control over the resources they use. Central agencies often control personnel, purchasing, and budgeting decisions. As Douglas found, “The authority delegated to managers of State businesses was therefore extremely limited. They were quite fairly able to evade all responsibility for the success or failure of the enterprises they were supposed to be running.”

• ***Government businesses seldom offer effective performance incentives to managers and employees.*** Government bureaucracies do not usually reward managers or employees for improving performance. Managers have reasons to spend more money and hire more staff, not to increase efficiency. Their “status and personal advancement,” says Douglas, are “directly dependent on the number of employees working under them in their departments.”

• ***Government businesses usually are required to pursue social as well as commercial goals.*** Elected officials ask them to provide services that cannot meet market tests, such as delivering a letter anywhere from Maine to Hawaii for 33 cents. These mandates send conflicting signals to the organizations’ managers, who wonder whether succeeding as a business is really a priority. They end up not focusing exclusively on economic efficiency and financial performance. And when they have financial problems they have an easy scapegoat: they blame their social obligations.

Often the conflict between commercial and social goals leads the government business to distort its prices. Some “cross-subsidize,” overcharging one customer to cover the cost of undercharging another. For example, rural postal services cost more than services to denser urban areas, so urban customers subsidize rural customers. Postal services rarely calculate or make public the true costs of each service, so no one can tell if the social objective can be achieved more efficiently some other way.

• ***Government businesses often face intervention from elected officials who want to override market signals.*** Most politicians take a "hands-on" approach to public enterprises. "Over the years," writes Douglas, state businesses "had often been required to hold prices below cost for favored political constituencies. Successive governments had targeted capital expenditures to politically sensitive regions."

The railroads "were run partly as an employment agency," adds Richard Prebble, one of his colleagues in the cabinet.

> *Every election year the general manager of the New Zealand Railways got a call from the minister. He was told he was going to hire people. He was given the number and told where.*

Enterprise management, when properly used, changes these realities. It makes public organizations accountable to their customers, lets them focus on their commercial goals, and insulates them from most political pressures. This last task is a constant struggle, however.

MANAGING ENTERPRISES: FOR PROFITS OR POLITICS?

Public business enterprises live—squirm, really—on the horns of a dilemma. On the one hand, they are supposed to make money. On the other hand, the politicians who govern them sometimes impose other priorities on them. In short, they are caught between profits and politics.

Using enterprise management leads inevitably to a tug of war between political and market forces. It creates public-but-private enterprises that inhabit what political scientist Donald F. Ketti calls "a murky in-between world." They live with one foot in the public sector and the other in the private sector. Sometimes these contending forces destabilize them.

The tugging is about two basic issues. One is over who controls the public enterprise, elected officials or managers. If elected officials are unhappy with the prices that an electric utility or city parks department or community college training center charges its customers, can they override the market and order a reduction? In other words, should market forces or political forces control the enterprise?

The other tension is over how completely to unleash market forces. If the enterprise is in trouble, will taxpayers bail it out instead of letting it fail? If certain services are unprofitable, can the enterprise stop selling them? Will the enterprise enjoy any regulatory advantages over private competitors? Will enterprise employees be protected from downsizing and other management efforts to reduce costs?

Confronted with these fundamental tensions, many public leaders vacillate when they use enterprise management. They thrust an enterprise into the marketplace, but then intervene in its operations when political advantage or concerns beckon. In effect, they put their faith in the market, but reserve the right to change their religion.

As a result, public enterprises occupy a continuum that stretches from extensive public control at one end to significant market control at the other.

At the public end of the continuum, elected officials fully control the enterprise. They determine what the product or service will be and the price that will be charged. They still subject the activity to government budgeting, personnel, and procurement systems. They make the enterprise at least partly dependent on paying customers, but do not give it the flexibility to respond to those customers the way a business would. Many enterprise funds inhabit this end of the continuum. They are barely distinguishable in their performance from other public agencies.

At the market end of the continuum, enterprise activities are run by independent directors, appointed by elected officials. They negotiate a basic charter with the politicians that spells out the enterprise's purpose and government's financial expectations. The directors hire managers, who decide which products and services to offer. Managers set prices and determine their own administrative systems, usually adopting private sector practices. State-owned enterprises (SOEs) in places like Australia and New Zealand inhabit this end of the continuum. The further toward true market discipline they go, the more their performance improves.

Between the ends of the continuum, there is a world of difference. Unfortunately, where an enterprise lands on this continuum usually depends more on circumstance and politics than on rational analysis. In some cases, as in New Zealand, public leaders consciously push government activities into the marketplace. (Occasionally they even use enterprise management to prepare public organizations for sale to private owners.) In other cases, public officials back into enterprise management; because money is short they ask public agencies to start charging for services. And sometimes governments take over bankrupt private enterprises because they want to preserve their services.

Given their many different origins, public enterprises take on enormous variety. "No two are exactly the same," says political scientist Donald F. Kettl. Most land somewhere in the broad middle of the politics-to-markets continuum. If you want to harness the enormous power of this approach, however, you should minimize politics and maximize market discipline. In some cases, you should go even further and privatize the organization. As the Labor Party discovered in New Zealand, creating an enterprise often clarifies whether a function needs to remain public or can be performed just as well by the private marketplace.

A closer look at the history of the U.S. Postal Service, the nation's largest government-owned business, illuminates some of the critical choices to be made in balancing profits and politics. Since it was made a public enterprise in 1971, it has been trapped in an ongoing identity crisis. Sometimes it has been a cumbersome, rule-bound, politicized federal bureaucracy. At other times it has been an aggressive business competitor that is—with $56 billion in revenues in 1996—bigger than many Fortune 500 firms.

The postal service's political face shows in ways that give it competitive advantages and disadvantages. The enterprise continues to have a monopoly over regular, "nonurgent" first-class mail. Indeed, poachers in this market are subject to criminal penalties. This advantage is the basis of the service's financial success. However, the service is required to meet noncommercial objectives. It must provide six-day-a-week delivery to every mailbox in the country at the same price. It must operate thousands of branches, many of them in rural areas, that steadily lose money. It also subsidizes the cost of delivering third-class advertising mail out of revenues from first-class mail.

In competitive markets, the postal service has had a rough time. Competition from private companies has steadily increased. In 1970, package deliveries by United Parcel Service exceeded parcel post deliveries by the post office for the first time. In 1981, Federal Express took leadership in the overnight delivery market. By 1986, private competitors were dominating two-day delivery service. By the early 1990s, UPS was delivering 10 times the volume of parcels the postal service was delivering. By 1997, private companies claimed 96 percent of the overnight delivery market. At the same time, growth in faxes, e-mail, long-distance telephone calls, and computerized billing had completely transformed the postal service's marketplace.

In recent years, the postal service has fought back. In 1996, it went after a larger portion of the $7 billion market for two-and three-day deliveries by advertising its Priority Mail service. Its $20 million television ad campaign attacked competitors Federal Express and UPS—an unprecedented act by a federal agency. Federal Express and the National Advertising Division of the Council of Better Business Bureaus filed lawsuits, claiming false advertising and unfair competition. Meanwhile, the ads helped boost Priority Mail volume by 20 percent.

But there was a price to pay. Loren Smith, the postal service vice president who championed the advertising, was forced to resign by the service's governing board, because he overspent the agency's advertising budget. Smith denounced his critics as people wedded to postal service traditions.

In 1997, Postmaster Marvin Runyon asked the governing board of presidential appointees to give him greater price flexibility and to allow him to develop new products, such as mail packing services and an electronic "postmark" as proof of an e-mail delivery. His requests touched off a furor. Congressmen warned that the service should not compete with businesses, such as Mail Boxes, Etc., that offer packing services. The American Postal Workers Union expressed anxiety about changes that might affect its workers' bargaining power and job security. Business competitors argued that the postal service would never compete successfully in markets that increasingly rely on sophisticated technology.

As this story shows, there are many choices on the path from inefficient government bureaucracy to money-making public enterprise. You must decide exactly what you will put into the marketplace—an entire organization with many product and service lines, or just a specific product or service? You must determine how far the organization or service will be thrust into the competitive environment; will it have any government protections and advantages? You must judge how soon you expect the enterprise to become financially self-sufficient—quickly or over the long run? Finally, you must choose the degree of direct political control you want over the enterprise. In some cases, elected officials handcuff managers. As a World Bank study found, "Some governments have refused to give SOE managers the power to react to the new environment of heightened competition and hard budgets with appropriate measures, which may include laying off excess workers, seeking out cheaper suppliers, eliminating money-losing services or seeking new markets."

In using the tools of enterprise management, these choices are unavoidable. When elected officials create public enterprises, they lose some control over their operation. They have to decide just how much they can let go. In return, they get genuine financial and performance accountability and genuine savings. But they can no longer micromanage these organizations; indeed, they no longer even appropriate their budgets. They often experience this as a serious loss of control and are reluctant to let it happen.

The solution is to convince officeholders that in addition to saving them money, enterprise management will increase the real accountability of public organizations. Although legislative committees will no longer tell public enterprises how much to spend or what to spend it on, they can be sure those organizations will have powerful incentives to provide what their customers want at the lowest possible prices.

ENTERPRISE MANAGEMENT: LESSONS LEARNED

1. Give enterprises the flexibility to manage in a businesslike way.

Rigid rules and restrictions will quickly kill most public enterprises, because they must compete with private firms. (They won't kill monopolies, but they will hobble their efforts to improve quality and lower costs.) To capture the benefits of enterprise management, legislative committees, budget offices, and personnel agencies must eliminate things like appropriation limits, personnel ceilings, slow hiring processes, and restrictions on carrying funds over from one year to the next. They must allow enterprise funds to invest their resources themselves, retain some of their profits, and take some losses. They must have faith that competition and rate negotiations will control costs for them.

When Karen Sorber and Ronald Straight published an analysis of the barriers to internal enterprise management in the federal government, they reported that budget, finance, and personnel rules were the worst obstacles. Similarly, the Australian Finance Department concluded that the government's personnel system hindered progress toward commercialization:

> *It needs to be recognized that for some public sector service providers, their capacity to operate fully in commercial mode is limited because they are still required to follow APS [Australian Public Service] pay, conditions and practices. This can have a couple of adverse implications. One is that the organization cannot compete on an equal footing. The second is that they may lose skilled staff to the private sector because of a lack of flexibility in remuneration levels.*

2. Give enterprises full control over their businesses.

When you make something like a recreation department an enterprise, don't leave functions like maintenance in the hands of other public agencies. Former Indianapolis mayor Stephen Goldsmith tells a story about his city's golf courses that illustrates the problem:

> *The golf pros, who were closest to the customers, supposedly oversaw golf operations. But that did not mean much when the greens were mowed by the same parks employees who painted playground equipment, and the golf carts were maintained by the same people who repaired garbage trucks. During one walk-through I asked the pro at the city's premium course how he could let the restrooms slip into such awful condition. His response brought it all home. "The restrooms," he noted sardonically, "are maintained by* ***your*** *parks employees."*

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3. Make sure the legislature or council understands enterprise management and buys in to the basic "deal"—more accountability in return for more flexibility.

Because they no longer appropriate the budgets of public enterprises, elected officials often feel that they have lost control. Using the example of internal enterprise management in Minnesota, Michael Barzelay explains:

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> *Legislators were notoriously suspicious of revolving funds. During budget hearings, revolving funds were discussed only briefly since appropriations were not made to them. . . .*
>
> *For some legislators, in fact, the spectre of converting more operations to revolving funds intensified their existing sense of powerlessness to influence the operation of state government. Revolving fund financing of DOA [Department of Administration] activities meant that the legislature could not control what state government spent as a whole on computing services or printing, for instance. Moreover, because state agencies were granted some discretion in shifting funds among budgeted line items, an agency might choose to purchase large quantities of some DOA products without obtaining specific legislative approval, and DOA would have every incentive to meet the "consumer demand." Many legislators worried that an increased utilization of revolving funds would reduce legislative oversight on all fronts.*

The solution was to convince legislators that enterprise management would both save them money and increase the real accountability of enterprise units. Legislative committees still exercise oversight over enterprise funds, but the tools they use change. Instead of passing annual line-item appropriations, they review profit-and-loss statements, quarterly financial statements, and business plans. These are far superior tools for assessing the value public service entities are creating for customers and taxpayers.

4. Create authentic mechanisms to ensure that public enterprises are financially accountable.

These include accrual accounting, activity-based costing, profit-and-loss statements, quarterly financial statements, business plans, interest charges on loans, and in-lieu-of-tax payments. Unless you can prove that enterprises have real financial integrity, it will be difficult to survive the inevitable political pressures that arise. Private vendors will charge that public enterprises are not including all their overhead costs in their prices, for example. Others will argue that pub lic agencies are given free credit by the government. To withstand the resulting assault in the legislature or council, you must prove that the playing field is level.

The shift to activity-based costing can be difficult. It often requires a private consultant and up to a year of work. Minnesota short-circuited this process by simply using the "indirect cost plan" the federal government required states to develop when they received federal grants. Because this method of calculating indirect costs was familiar to the finance office and the legislature—and because the federal government used it to audit grant spending—it quickly passed muster.

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5. Secure buy-in from the budget office as well as from elected officials.

Enterprise management changes the financial oversight role of the budget office (or finance department or treasury). It takes away that office's authority to control public enterprises' spending, for example. But the trade-off—dramatic spending reductions and performance improvements without privatization—can be quite attractive to budget offices, once they understand it.

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6. Help public enterprises listen to their customers.

The most important skill that ensures survival is the ability to understand what customers want. This is foreign territory to many public organizations. When he joined the Minnesota Department of Administration as deputy commissioner, Babak Armajani remembers, "I'd ask many people in DOA who their customer was. Many had no idea." So he began requiring the managers of each service unit to meet with their customers. They heard an earful. The process was painful, but it began to wake people up to the needs of their customers.

Jim Masch, the fleet manager in Sunnyvale, did something similar. "When I arrived in 1982," he remembers, "there was some conflict between our guys and the customers." Employees were thinking more about "knocking down the complaints" than about listening to their customers. "It just became the shop pointing at the users and the users yelling at the shop."

So Masch immediately set up liaison meetings with the shop's customers. "Every manager who is a support manager has a fear of getting all his customers together," he admits. But Masch did it once a month for years. When his customers had complaints, he and two of his supervisors would verbally commit to a date when the problem would be solved.

Today Masch makes it a point to see all his customers—about a dozen people—daily. The shop also does a regular customer survey. He would still be holding the monthly meetings, he says, but the daily communication has become so good that there aren't any big issues left to deal with at the end of the month.

7. Never forget that even when elected officials are no longer your customers, they remain important stakeholders.

Accountability to those elected by the citizens will always remain an important part of the management equation. Public enterprises must give elected officials—both legislators and executives—the information they need to be sure the public interest is being served. The tools may change from line item budgets to profit-and-loss statements, but the need remains.

TOOLS FOR ENTERPRISE MANAGEMENT

Corporatization turns government organizations into publicly-owned businesses that are semi-independent from government. Public corporations focus on business goals, such as generating profits and returns on investments. Usually they have nongovernment directors and top managers who set the organization's direction and policies and are accountable for its performance. Often they operate outside of the government's budget, personnel, planning, and procurement systems. See below.

Enterprise Funds, also known as *revolving funds, trading funds,* or *enterprise centers,* are government-owned business activities funded with customer revenues rather than tax dollars. However, enterprise funds are not converted into public corporations with independent governance. See p. III/47.

Internal Enterprise Management is the use of enterprise management to make internal service units accountable to their customers, the line agencies they serve. See p. III/53.

CORPORATIZATION

In the mid-1980s, New Zealand's post office, with 40,000 employees, was the nation's largest employer. It delivered the mail, provided and serviced all of the country's telephones, and ran a savings bank. When Richard Prebble became a cabinet minister for the Labor Party, the post office was in his portfolio, so he took a look at its operations.

"I was absolutely horrified by what I found," Prebble remembers. "It was so inefficient that it was crippling the country." The Postbank was bankrupt. The mail service was losing nearly $40 million a year in New Zealand dollars, which were worth 50–70 percent of U.S. dollars in the late 1980s. And the telephone service was worse. It took an average of six weeks to get a phone installed. The post office had bought so much phone equipment that most of it was obsolete before it could be installed.

Prebble surveyed business leaders, and a large majority of them said the telephone system was holding their businesses back. "That was a bit of a shock," he recalls. "We asked the post office what was wrong and they said there was nothing that a billion dollars couldn't fix." Then the Post Office Department asked Prebble to approve a large public expenditure for new equipment and facilities. Although it would strain the government budget, he was inclined to agree with the request—until he asked the department managers how many employees they had.

"They couldn't answer the question," Prebble remembers. "I said, 'Give us figures next week.'" The numbers stunned him: the department employed 1,100 more people than the management plan authorized by ministers just three months earlier. Prebble concluded that "this monster was out of control."

Prebble and his Labor Party colleagues decided that the nation's troubled economy could no longer tolerate the chronically poor performance of its post office and other government businesses. Taken together, they produced one-eighth of the nation's economic output. Their inefficiency was a drag on New Zealand's overall economic performance. Labor was not prepared to sell these public businesses into private hands, but it did want to tackle the main reasons they performed so poorly. So its leaders decided to create public corporations that would be truly commercial. The government would provide them with initial capital—equity and short-term loans—and would expect a market rate of return on its investment. At the outset, these SOEs would be wholly owned by the government. They would be governed by independent boards that, along with their top managers, would control all of their operational decisions.

Labor also designed the SOEs to overcome or at least minimize the factors that cause government businesses to perform so badly. To end the debilitating conflict between social and commercial goals, Finance Minister Roger Douglas insisted that SOEs pursue only commercial ends. Labor separated government's commercial from its noncommercial activities. For example, it created an SOE to run the government's television network, but a separate Broadcasting Commission funded television programs that promoted the nation's identity and culture. The SOE law, passed in 1986, required SOEs to try to be as efficient and profitable as comparable businesses. It also forced the government to pay for any noncommercial activities it asked SOEs to undertake.

To ensure that SOEs would face competition, Labor ended statutory monopolies, removed regulatory barriers to competition, and stripped SOEs of unfair business advantages. The new entities had to pay taxes and had to borrow money from commercial lenders rather than receiving taxpayer funds.

To minimize attempts to influence the actions of SOEs politically, Labor assigned all relationships with SOEs to just two ministers, rather than spreading them across the cabinet. The minister for state-owned enterprises and the minister of finance had no responsibility for social issues; their role was to advance the commercial success of the new entities. These "shareholding ministers" negotiated with each SOE board an annual statement of corporate intent that specified the corporation's business activities, its financial and other performance targets, and the dividend the government expected from it. It did not deal with operational issues, including prices and investments; these were left up to the boards. In addition, Labor kept politicians off the SOE boards; instead, it appointed businesspeople with the expertise necessary to monitor their performance.

To give SOEs flexibility, Labor exempted them from government administrative systems. Their boards were free to hire and fire top managers. These executives were free of government's civil service and personnel systems, procurement policies, and budgeting systems; they had full control over their organization's resources. To stimulate private sector scrutiny of SOE operations, the law allowed the government to sell nonvoting stock in SOEs.

Lastly, to provide managers with performance incentives, Labor permitted the SOEs to tie financial rewards for managers to their organization's performance.

The Results of Corporatization in New Zealand

Until February 8, 1988, local post offices in New Zealand seemed to be immortal. Before then, no politician had either a reason or the nerve to close any of these cherished institutions. But on that date, Richard Prebble signed a death warrant for more than a third of the nation's 1,200 post offices. He even closed half of the post offices in his own parliamentary district.

The simultaneous demise of these post offices, most of them in rural areas, resulted directly from the passage of the SOE Act less than a year earlier. Labor had separated the Post Office Department into three government-owned corporations: one each for mail, telecommunications, and banking. In the new postal SOE's effort to become profitable, it had identified 600 post offices that were losing money; they accounted for only 5 percent of its total business. The SOE directors had announced that without a subsidy they would close 432 of them, so the government had agreed to provide about $30 million (U.S.) to keep them open for a year, while it decided if they met an indispensable social need.

In late 1987, Labor decided not to provide additional funds. Making the real cost of the subsidy visible had forced Parliament to decide if this was really the best use for the money. They decided it wasn't, so Prebble closed the offices.

While the post office still provided some delivery services and community mailboxes, private stamp retailers opened up in the 432 rural areas. Still, Prebble recalls, "There was considerable public outrage at the closures. Many people have still not forgiven me." But a parliamentary study found that no community had been adversely affected by the change, and many were getting better service.

Within a year, the postal service was registering solid financial gains. It moved from an annual loss of more than $25 million to a profit of more than $50 million. It cut staffing by 20 percent, from 12,000 to 9,800. It began a new, next-day delivery service. It improved on-time delivery of high-priority mail from 80 percent to more than 95 percent. By 1992, it had cut staffing by 30 percent and paid about $125 million in taxes and dividends to the national treasury.

In similar fashion, the Postbank SOE cut staffing by 30 percent, reduced retail outlets by 40 percent, and turned an expected loss into a profit. The telephone SOE, which gradually lost its monopoly over phone equipment and services, cut overall prices by 20 percent. The average wait for telephone installation dropped from six weeks to two days.

These improvements were comparable to those registered by the other SOEs. "The gains in efficiency brought about by these structural changes dumbfounded even the most skeptical opponents," says Douglas.

Encouraged by this enormous success, Labor continued creating SOEs—and when the National Party came to power in 1990, it followed suit.

Corporatization: Lessons Learned

New Zealand pushed corporatization at a breakneck pace—much more aggressively than most governments do. It demonstrated that government businesses can accomplish leaps in productivity and quality of service—when they are allowed to focus exclusively on business outcomes and abandon bureaucratic ways. In the process, its leaders learned some important lessons.

1. The success of public enterprises depends on getting very good people to govern and manage them.

"Quality outcomes start with quality people," says Douglas. "Getting the policies right will not be enough unless you also get quality people into all the strategic positions at the right time." By avoiding tokenism and the test of party affiliation, he adds, Labor recruited "some of the country's most dynamic and experienced business people as directors."

2. The price of corporatization is usually significant cuts in public employment.

Many public employees lost their jobs as New Zealand's government businesses sought competitiveness and profitability. From 1987 to 1992 the seven larger SOEs cut their staffs by 53 percent. In Australia, government businesses reduced their payrolls significantly as well.

With so many public employees involved, New Zealand could not absorb them into vacancies in the rest of government. It provided laid-off workers with severance payments. As we discuss in Chapter Ten, there are other ways to soften the blow when workers lose their jobs—including retraining and placement in private jobs.

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3. You can't always keep the politicians' hands off of the business.

Labor tried to minimize the potential for political interference in SOE decisions, but it was not always successful—even within it own ranks. The Labor-controlled parliament balked at further reductions in money-losing rural mail services. When the postal SOE's board of directors decided to raise the price of rural delivery, the National Party, which had taken power in 1990 and represented a large rural constituency, immediately attacked it. "All hell broke loose within the government, which was trailing in the polls," observed Douglas. The price increase, he wrote, was "a heaven-sent opportunity to win electoral credit by attacking the avarice of the company."

When the electricity SOE also raised prices, National Party leaders attacked the SOE model and threatened to fire the company's managers. Overall, Douglas observes, the political environment for SOEs became highly charged under the National Party Government.

> *State corporations were subjected to annual investigation by parliamentary select committees with the power to ask questions about any detail of operations, well beyond the limits allowed [for private companies]. . . . Information was sought with the sole intention of turning it to discredit the SOE. An atmosphere of confrontation was deliberately fomented by the government to deter SOEs from taking politically difficult decisions.*

In 1992 the chairman of the postal SOE, Michael Morris, warned that the political skirmishing would lead the company and the government to sacrifice "economic efficiencies and sales proceeds which would otherwise have been available to improve the nation's competitive position."

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4. Corporatization is not as powerful a remedy for inefficiency as is the sale of government's business assets.

Corporatization does not shift public businesses fully into the marketplace, as we have seen. In addition to suffering political interference, their directors and managers are immune from the threat of takeover, which so influences private corporate behavior. Nor do they have shares on the market and private investment analysts who aggressively track and assess their performance. Public corporations are unlikely to slide into bankruptcy, since elected officials who want to avoid the embarrassment of market failures are all too willing to bail them out at taxpayer expense. Thus, says Douglas, they "are under significantly less pressure than private sector companies to maintain competitive levels of performance."

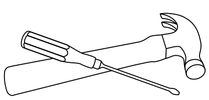
Douglas and his Labor Party allies concluded that state-owned enterprises should serve mostly as a "halfway house" to privatization. By wringing inefficiencies out of government operations, SOEs paved the way for selling public assets to the private sector. In 1988, the Labor Government began to sell some of its SOEs to the highest bidders.

RESOURCES FOR CORPORATIZATION

Roger Douglas. *Unfinished Business.* Auckland, New Zealand: Random House New Zealand, 1993. See Chapter Eight, "SOEs—A Half-way House." In this excellent analysis of New Zealand's reinvention in the 1980s, Douglas tells how he—a Labor Party minister—came to recognize the importance of enterprise management and designed New Zealand's state-owned enterprise strategy.

World Bank. *Bureaucrats in Business: The Economics and Politics of Government Ownership.* New York: Oxford University Press, 1995. An insightful study on the track record of public corporations around the globe.

ENTERPRISE FUNDS



***Enterprise Funds*, also known as *revolving funds*, *trading funds*, or *enterprise centers*, are government-owned business activities funded with customer revenues rather than tax dollars. However, enterprise funds are not converted into public corporations with independent governance.**

When Sunnyvale turned its Leisure Services unit into an enterprise fund, as we described earlier, it saved the taxpayers millions of dollars. But cutting the city budget's support for the agency was only part of the story. Although its tax support declined, the Leisure Services unit grew rapidly—by increasing its base of paying customers. "A lot of cities have been cutting recreation services and loading on new fees," said then–city manager Tom Lewcock. "They find they end up doing less. We've been doing the opposite—we're growing the programs."

It took a "huge amount of market research," new service offerings and "smart pricing" to increase the organization's market share, Lewcock said. "We are competing with zillions of businesses for the recreation dollar, but we offer things that others don't."

The key was listening closely to the customers. Shortly after Parks and Recreation Director John Christian arrived in Sunnyvale, he sent a team of managers, frontline employees, and professionals to Disney's customer service training program. He then made them an internal customer service training team. He also began sending similar teams on benchmarking trips, to learn from other cities and counties.

One of the first innovations to result was a customer satisfaction guarantee. Christian described it this way: "No matter what we do, if you're not satisfied, you get your money back." They also shifted from offering programs on a quarterly basis, with three-week breaks in between, to continuous programming. And rather than forcing people to come in and reregister for a continuing program, they now assume people will continue in the next session. "We'll assume you're registered, and we'll bill you," said Christian. "If you want to continue, just send it in."

Because the schools were in a fiscal squeeze and were cutting back on things like music and art, Leisure Services developed a series of high-quality after-school classes for middle and high school students. Acting as a broker, it recruited dozens of other organizations—from community colleges to music schools to dance studios—to run the programs. "The parents—our customers—say, 'Don't you dare take those away,' " said Lewcock.

Leisure Services also cut business deals with the schools. One lets the city use school playing fields for its programs for 25 years, in exchange for maintaining and redeveloping the land. Another involves the school's indoor facilities. Whenever the gyms, auditoriums, and multipurpose rooms are not reserved for school use, the city can rent the space out to the public. The schools get 20 percent of the fees collected by the city. The arrangement not only increases use of school facilities, it provides citizens with one-stop shopping for facilities.

Christian credited all these innovations to the fact that Leisure Services had to sell programs to its customers to generate 80 percent of its revenues. “That has changed our way of operating,” he said.

> *We have found ways to do business differently, particularly with partnerships. We’re forced to look at the bottom line. People talk about bottom-line stuff, people talk about being market-driven, people talk about being customer service-driven.*

The city’s success with its Leisure Services enterprise prompted it to develop another public business in 1996: selling services to people who are researching patents. The city’s patent library decided to install a video link to the Patent and Trademark Office in Washington, which provides powerful new computers and services such as teleconferences with Washington experts. As Sunnyvale’s patent library becomes the most advanced in its region, it plans to phase out tax subsidies and expand services to paying customers.

Local governments have long used enterprise funds to finance operations at convention centers, golf courses, airports, and the like. They institute user fees, segregate the accounting of those revenues from the government’s general fund, and use the customer revenue to support the services. By shifting costs to service users, the tool allows governments to undertake activities their budgets won’t support. Often, however, governments use the tool simply to shift costs. They neither force the enterprise funds to raise all their own revenue nor free them to respond to their customers’ needs.

Sunnyvale’s enterprise funds are designed to become virtually self-sufficient, and their costs are fully accounted for. They cannot escape the discipline of the marketplace. They are also free to change their day-to-day operations. Christian told Lewcock that he would have to “organize like a business, not a traditional public recreation department,” Lewcock recalls. “I said, ‘John, you can do most anything you want to do. We’re going to focus our attention on your bottom line.’ ”

Sunnyvale uses enterprise funds mainly to make existing government employees more customer-oriented, cost-conscious, and business-minded. Reinventors also use the tool to start up new activities the government cannot fund by itself. This allows public agencies to create exciting opportunities for public entrepreneurs, as Fox Valley Technical College in Appleton, Wisconsin, discovered.

In the late 1980s, Fox Valley’s president, Stanley J. Spanbauer, noticed his calendar was filling up with educators who wanted to learn how his institution was implementing Total Quality Management. “It began to drain our resources, because they were coming in and taking my time and a lot of people’s time," he recalls. But Spanbauer had an entrepreneurial bent. Perhaps, he thought, the demand signaled a money-making opportunity for the college. So he created the Quality Institute—a college-sponsored business designed to serve customers from outside the college's enrollment boundary—and signed up two faculty members to run it.

By 1994, as many as 50 Fox Valley staffers were working at least part-time for the institute, conducting seminars, workshops, and training sessions. That year, according to Spanbauer, the institute generated $650,000 in contract fees—enough to cover its costs and return a $28,000 profit to the college.

By the time Spanbauer retired from Fox Valley in 1994, entrepreneurial faculty members had created 16 enterprise centers. Each was a separate business, complete with a business plan and monthly income statements. Each was managed by faculty who controlled their operations. None cost the taxpayer a dime.

Enterprise Funds Versus Corporatization

Unlike public corporations, enterprise funds remain under the control of elected officials and government administrators and stay within the government's traditional institutional framework. Because enterprise funds do not require a separate institutional structure with a governing board and new administrative systems, they can be set up and dismantled with relative ease and speed. However, they can also become the victims of bureaucratic controls that reduce their flexibility, effectiveness, and incentives. In addition, they are more susceptible than public corporations are to intervention by elected officials, who are inevitably tempted to set their prices. In Sunnyvale and many other communities, for example, setting greens fees for public golf courses involves interminable political maneuvering, since elected officials do not want to offend senior citizen golfers.

In general, corporatization is the better tool. But if elected officials swear off controlling prices or services—and if you use business accounting and financing procedures—an enterprise fund will give you most of the advantages of a public corporation.

We have identified only three situations in which we would recommend an enterprise fund over a corporation:

1. When it is politically impractical to create a corporation.

2. When there are public interests at stake that conflict with the bottom line. For example, in creating an enterprise to operate a park such as Yosemite or Yellowstone, stewardship of the land, water, and wildlife to protect it for future generations would be more important than generating a re-

turn on investment. The recent return of wolves to Yellowstone provides a classic example: a public corporation driven to break even would rarely spend the money to do such a thing; hence its decisions might sacrifice the quality of the park for future generations.

For this reason, elected officials might want to keep some control over park policy, while sacrificing efficiency and return on their investment. This would be perfectly appropriate. It could also be done by having elected officials control the board of the corporation and by providing subsidies for stewardship purposes. But the inevitable tensions might be easier to manage if the park remained an enterprise fund.

3. When important synergies would be lost by moving the activity into a corporation. Enterprise funds operate inside public agencies or departments and report to their directors. Hence it is easier to ensure that their strategies are congruent with those of the rest of the organization than it would be if they were corporatized. A state might want to make sure that its telecommunications network used hardware and software standards that were compatible with other technologies used by state agencies, for instance. Public corporations would care far less about such issues than about their bottom lines, so resolving them would require extensive negotiations and formal contracts or partnerships. Collaboration with enterprise funds would normally be far easier.

Using Enterprise Funds: Do's and Don'ts

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All the general lessons outlined earlier apply to enterprise funds. The following "do's and don'ts" round out the picture.

Create a business plan with measurable objectives. "You must know what your markets are and put a business strategy together with customer input," says Lewcock. The plan must be clear about what the enterprise is supposed to accomplish. The best way to do this is to articulate measurable objectives such as return on investment, percentage of operating costs that must come from customer revenues, and customer satisfaction levels. In addition, Lewcock says, set high targets for the fund's service levels, so it cannot make a profit by cutting back on its services—particularly if it is not in a very competitive market. Demand for golf courses so far exceeds supply in many places, for instance, that a public golf course could maximize profits by cutting its staff and letting the quality of the course suffer.

pp. V/47-69

Change organizational structures, processes, and administrative systems to fit the business you're in. Government's control systems impede commercial behaviors. If you want enterprise funds to succeed in the marketplace, you have to change those systems. In the process, give them power-

ful incentives to improve their performance. Let them keep all or a portion of their profits to invest in equipment, training, and gainsharing bonuses.

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Don't plunge into enterprise funds; do careful market research first. Playing hunches will more than likely backfire. Starting a new business—even a public enterprise—is risky; most private business start-ups actually fail. Initial success depends in large part on how well you understand the market you are getting into. Take the time to do your homework.

Don't underestimate the anxiety your managers and employees will feel. People in public organizations often resist the change to a commercial basis. Many worry that they will fail. Some argue that the organization is losing its public purpose. They will need help making the transition—strong leaders willing to change the way the organization operates and its basic culture.

Don't shoot for instant success; build the business deliberately. "Do not attempt to move from your present business environment to the new one overnight," cautions Lewcock. "People need time to understand how to change the organization, and to begin to work with customers." Some enterprise funds, such as golf courses, can turn a profit their first year. Others may take more time. Some may need generous start-up loans; others may not.

Don't let elected officials set the prices enterprise funds charge. Many enterprise funds are, in effect, controlled by elected officials, who approve all fee levels and increases, all new services offered, and the like. This destroys the most important value of creating an enterprise fund: its accountability to its customers. The beauty of an enterprise fund is that it can respond to what its customers want, charge what they will pay, and quickly change its service offerings and fees if its customers indicate dissatisfaction. The minute elected officials control new service creation and fee increases, that responsiveness is gone.

In addition, an enterprise fund that can't set its own prices cannot be held accountable for its performance. Rather than being required to prove its value to its customers by making a profit, it can—rightly—blame the council or legislature for its financial problems. As we said earlier in discussing public corporations, if elected officials want to subsidize an activity, they should do so explicitly—not by forcing the entity to keep its prices below its costs.

If an enterprise fund has a monopoly on services, elected officials should set up a mechanism to regulate its prices, just as they would with a private utility. The fund's customers should be part of the process. We suggest a way to do this later in the chapter when we discuss the treatment of monopolies under internal enterprise management.

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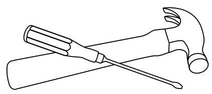
Don't make enterprise funds pay for customers who can't afford the service they are offering. You can always decide to subsidize some customers' access to public services, even when those services are provided on a commercial basis. For example, Sunnyvale offers discounts to senior citizens who use city golf courses, and it waives service fees for "dependent" parents who want their children to attend after-school recreational programs. However, do not make an enterprise fund cover the cost of such subsidies. That would lead to cross-subsidizing, which distorts the fund's pricing, causing it to overcharge some customers to cover the costs of those who don't pay their way. Instead, make the subsidy part of an explicit government appropriation.

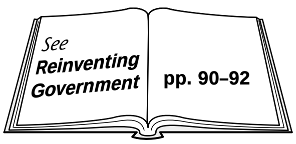
INTERNAL ENTERPRISE MANAGEMENT



***Internal Enterprise Management* is the use of enterprise management to make internal service units accountable to their customers, the line agencies they serve.**

Government's internal service monopolies—its print shops, personnel offices, information technology offices, maintenance shops, even its vehicle fleets—are notoriously insensitive to their customers' needs. Line managers often detest them. Over the past decade, reinventors at every level of government—from cities like Milwaukee to the national governments of Australia, the U.K., and New Zealand—have used enterprise management to solve this problem.

Reinventing Government told the story of Minnesota's Department of Administration, which pioneered the development of this tool during the 1980s. Led by Commissioner Sandra Hale and Deputy Commissioner Babak Armajani, the department took ideas that were already in some use, both in Minnesota and elsewhere, refined them, and knit them into a coherent whole they called enterprise management.



As with external enterprise management, the first step in implementing this tool is borrowed from the Core Strategy: uncoupling steering and rowing. Many internal staff units combine policy, compliance, and service functions. In Minnesota, for example, the same organization that sold agencies time on its mainframe computer also told them whether they could buy their own computers. The conflict of interest was obvious, and most Minnesota agencies resented it. Many suspected that the Information Management Bureau denied purchase requests to make sure it could sell enough mainframe time to meet its budget.

Armajani and his staff solved the problem by dividing the organization. They put the policy and compliance function in a new Information Policy Office, which set standards for computer systems and reviewed agency purchase requests. They put mainframe and other information technology services in a separate InterTechnologies Group.

They called policy and compliance functions "leadership activities." These

benefited the citizens of Minnesota more than individual state agencies—by providing standards that would guarantee the best value for the dollar, for example. Their real customer was the public at large, represented by the governor and legislature. So Minnesota financed them from the general fund, and both the commissioner of administration and the appropriate legislative committees oversaw their operations. As we argued earlier, policy and compliance functions should not be managed as enterprises operating in markets.

Marketplace Services

Armajani and his colleagues put most internal services into enterprise funds. Armajani wanted to corporatize them, but the administration and legislature were not ready to go that far. (Technically, under generally accepted accounting principles, internal enterprise funds are called internal service funds. Both these and "external" enterprise funds are subsets of a category called "revolving funds." We have chosen to stay with the phrase *enterprise fund,* however, to make it clear that when we talk about internal enterprise funds, we mean organizations that operate on the same principles as external enterprise funds.)

They divided the internal enterprise funds into two groups: those that should face competition from private firms and those that should remain monopolies. The former group, which they labeled "marketplace services," included copy centers, data entry, computer programming, electronic equipment rental, micro graphics, voice mail, electronic mail, internal management consulting, printing, Central Stores, the motor pool, and some training functions. They made a series of changes to force true market discipline on these funds:

- They allowed state agencies—the customers—to buy these services wherever they chose, from public or private sources.
- They shifted funding for the services from the internal service agencies to the customer agencies and made the former earn all of their revenues from sales to the latter.
- They required marketplace service units to pay the state for all of their overhead, including rent, utilities, and a share of statewide overhead, such as the governor's salary and the attorney general's budget.
- They allowed marketplace units to set their prices, because they were now in competitive markets. If market conditions allowed high profits on some services and kept profits low on others, that was fine.
- They required marketplace units to return a portion of their profits to the general fund, based on an annual business plan negotiated with the department and reviewed by the legislature. These units could invest the rest

of their profits in productivity improvements—new equipment, performance rewards, or anything else—as long as they followed guidelines spelled out in their business plans.

- They allowed marketplace units to borrow from the state treasury to make further investments. The Finance Department charged interest and demanded proof that the returns on these investments would be adequate to repay the loans, as any bank would.
- Finally, they allowed marketplace units to carry over all unexpended funds into the next fiscal year. (Since these units now used accrual accounting, their cash balances at the end of a fiscal year were different from their profits or losses.) Previously, managers of these units had joined in the traditional end-of-the-year spending rush—getting rid of all excess cash before the Finance Department could take it back.

The legislature still performed an oversight function, but it no longer controlled marketplace units as it did others—through the appropriations process. Indeed, these units received no appropriations; they made their money by selling to their customers. Nor did the legislature regulate inputs—their prices, staff levels, or investments. Instead, it relied on market competition to ensure that they were providing the best value possible for the dollar. They were free to manage their own operations, to get maximum productivity out of their staff and resources, without interference. If they did a poor job, the consequences were clear: their customers would go elsewhere, and they would shrink or die.

Internal "Utilities"

For some services, monopolies are more efficient than competition. In the private sector these are called utilities, and they have traditionally used them to operate local telephone and cable television systems and provide water, gas, and electricity. Armajani and his colleagues decided to use the word *utility* to describe internal government services that are more efficiently provided by monopolies. They believed that telephone service for state agencies would be cheaper as a monopoly, for example, because the state could negotiate bigger discounts with private phone companies if everyone were on the same system. In other areas, such as the State Records Center, they wanted to ensure standardization—to make sure all records would be available in the same place, in the same form.

These internal utilities operated under rules similar to those governing marketplace services, but without customer choice of service providers. The legislature shifted appropriations to the customer agencies, leaving the internal utilities as enterprise funds. The agencies could choose what volume of services to buy from utilities but not where to buy them. Instead, Minnesota gave customer agencies a voice in setting prices. Specifically:

- The commissioners of finance and administration set utility prices annually, in negotiation with each utility, after getting advice from customer panels. These panels—normally made up of executives from customer agencies—compared the utilities' rates to those of other public and private providers of similar services and advised the commissioners. They also advised the administration and finance departments on the types of services each utility should produce, the service levels their customers required, and the wisdom of proposed utility investments in new technologies and the like.
- The commissioners exercised control over rates, types of service, and investments by negotiating annual rate packages and reviewing quarterly financial statements. Otherwise, they left the utilities free to manage as they saw fit. The legislature exercised oversight on the same basis.
- The utilities negotiated service contracts with each of their customer departments or agencies, specifying the estimated volume of services each agency would buy, the quality to be delivered, and the price. These contracts let the utilities estimate their projected volume, which in turn helped them know where to set rates.

Utilities retained their profits. Decisions on how to use them—whether to lower rates, invest in productivity improvements, give rebates to customers, or do some combination of all three—were made during negotiations on future rate packages. When a utility showed a loss, it had to raise rates the following year to make up for the deficit.

Like marketplace units, utilities were allowed to roll over all unexpended funds at the end of the fiscal year, to eliminate the spend-it-or-lose-it incentive.

Internal Franchises

In Minnesota, the Department of Administration (DOA) had only one provider for each internal service. But in some governments there are multiple internal providers. In the U.S. government, for example, most departments have multiple personnel, procurement, and travel offices.

In 1993, the Clinton administration's National Performance Review (NPR) suggested a new wrinkle on the internal enterprise management model, in which marketplace services in one agency could compete to sell their services to other departments and agencies. The result would be competition among both internal service units (dubbed "franchises" by the NPR) and private businesses. One model was the Federal Systems Integration and Management Center, which has helped more than 50 different agencies acquire and manage information technology since 1972.

The NPR suggested that internal franchising could be applied to many different services, including budget, finance, personnel, procurement, payroll, information technology, engineering, facility management, quality assurance, alternative dispute resolution, training, travel, workmen's compensation, security, and printing services. The NPR convened a franchise planning committee, and Congress authorized the Office of Management and Budget to designate six "franchise fund pilot programs."

In 1996, the selected agencies launched three-year pilots. Among them were the Veterans Affairs Department's automation center in Austin, Texas, which provides data processing services, and the Interior Department's payroll and personnel processing and accounting services. About a year later, the Department of Agriculture (DOA) computer center in Kansas City, Missouri, surprised four computer companies, including IBM, by outbidding them to operate the Federal Aviation Administration's computer system. The DOA center's bid was nearly 15 percent lower than those of the private firms.

Advantages of Internal Enterprise Management

Internal enterprise management typically saves those who use it a significant amount of money. More important, it forces their internal service units to continuously improve their services. It is "funny how clearly focused the condemned prisoner becomes when he walks up those steps to the gallows and the hangman's noose comes into view," says the General Service Administration's Gerald Turetsky.

Internal enterprises have to respond quickly to their customers' needs. In Minnesota, for example, Armajani reports that the purchasing office responded to competition by stocking dozens of items it had long ignored.

> *The documents division liquidated obsolete titles and began to stock many new books about Minnesota or by Minnesota authors. . . . Plant management experimented with differentiating its product into three different levels of service quality and cost. The printing operation began to offer quick-turnaround photocopying services at locations near its customers.*

Internal service enterprises also become more accountable for their performance. The Minnesota Department of Administration shut down several operations that could not break even, including typewriter repair and computer programming. Other units shrank dramatically.

At the same time, internal enterprises are freed to make the long-term financial decisions necessary to maximize value for their customers. Because they retain part of their earnings, use accrual accounting, depreciate assets, and can borrow money, they can invest in technology, training, and other productivity improvements.

The vehicle fleet in Sunnyvale, which operates as an internal utility, offers a good example. Managers project their spending needs out 20 years, to cover all vehicle replacement costs. Out of an annual budget of $2.7 million, all funded by rental fees paid by other agencies, roughly $1 million goes into a vehicle replacement fund. Fleet Manager Jim Masch describes Burbank, California, where he formerly worked:

> *The fleet manager didn't control the fund, so you'd save up a couple million dollars, and they'd end up using it to renovate a park. I meet with other fleet managers, and some of them don't even have a replacement fund. They go to council every year and beg for police cars. I can't imagine managing like that.*

Internal enterprise management also has a profound impact on the behavior of line agencies, because it forces them to pay for internal services. Under the traditional approach, public agencies don't have any idea how much their employees are spending on telephone service, car rentals, print shops, and other internal services. They have every incentive to use these services, because they are free. When enterprise management changes that, line agencies suddenly become cost-conscious. As Australian reinventors put it, the new "price signals" influence the agencies' "consumption patterns." When Minnesota made government telecommunications services an internal utility that charged its customers, for example, usage dropped by 50 percent. Suddenly, everyone became a cost cutter—rather than leaving that job to the administration and finance departments.

When customer panels help set utility rates, they not only become more careful about their own costs, they become more vigilant about everyone's costs. Customer panels ensure that utilities are managed for the collective interest. They push to keep rates low, and they make decisions based on the customers' interests, not the utilities'. At one point, for instance, the Minnesota Department of Natural Resources (DNR) asked the government's telecommunications utility to put a special voice and data line into its research facility in the northwest corner of the state. The utility did a cost analysis and reported the results to its customer panel. "At that point," says Armajani, "everybody turned to the utility manager and said, 'What are you going to do about this?' He turned back to them and said, 'What are you going to do about it? You set the rates.' "

They scheduled a special meeting to consider the issue. The utility's larger customers didn't like the idea of paying for the DNR's special line. After some debate, they worked out a deal: DNR would pay most of the cost, and the utility would pay the rest. "It was negotiated between the customers, in the true fashion of a cooperative," says Armajani. "The Finance Department and the utility really didn't get involved in deciding, 'Yes, there should be a special line, or no, there shouldn't.' "

Even the powerful Finance Department lost out at times. At one point, it wanted the mainframe computer center to buy a particular database program. The customer panel told the department it should use the software everyone else used. But the finance commissioner was adamant—so the customer panel made Finance pay for the special software itself. "You got much tougher discussions, much stronger oversight than would have been provided under the old system," says Armajani, "because the customers knew more about this stuff and had a strong interest in keeping rates low."

Internal Enterprise Management: Lessons Learned

The pioneers of internal enterprise management have learned a great deal, often the hard way, about what it takes to use this tool successfully. The general lessons on enterprise management all apply to this tool, and the following lessons add a few more relevant points.

pp. III/39-42

1. Be prepared to close down internal enterprises that can't compete.

To prove to elected officials and finance departments that internal enterprise management is serious, you must be willing to let competition take its course. In Minnesota the legislative appropriations committees were suspicious of enterprise management until the department proved it would allow the ultimate consequence—business failure. "We had a typewriter business," says Armajani.

> *No one believed that it was really going to go out of business. It was doing poorly, and we gave it all kinds of support, hired consultants, and so on. We went a year, and we couldn't fix it. So we actually put it out of business, laid off employees, shut it down, and took responsibility for the red ink on the books. People at Harvard, from their interviews, say we got an enormous amount of credibility from this—that*

this was serious. It was after that, in the next legislative session, that they agreed to support the strategy more extensively.

2. *In deciding which units should be leadership activities, which should be marketplace units, and which should be utilities, be pragmatic.*

Compromise is sometimes necessary. A perfect example is building maintenance in Minnesota, which became a utility. When legislators realized that the charges for offices in the capitol building would be quite high—because it was marble, with fancy grounds and lots of ceremonial space—they rebelled. So the department agreed that since the capitol and its grounds were "the front door of Minnesota," their maintenance should become a leadership service, financed by the general fund.

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WHEN TO CREATE AN INTERNAL SERVICE ENTERPRISE: RULES OF THUMB

Policy and compliance functions should always be classified as leadership activities, rather than enterprises. But not all services can be run as enterprises. As we noted earlier, those that serve the general interest, rather than specific interests, should not be charged to specific customers. Specifically, internal services should not be placed in enterprises if any of the following are true:

- They serve a broad public purpose distinct from the interests of the agencies that actually consume the service (for example, central procurement offices, which work to prevent fraud and secure the best value for the taxpayers, in addition to meeting individual agencies' needs).
- Legal requirements such as laws, court orders, or privacy issues give agencies no choice but to use them.
- There is no practical way to measure the service in finite units, making it impossible to attribute charges directly to specific users of the service.

If services do benefit specific customers and can be charged to them but are more efficiently provided by one central source than by many sources, then they should be classified as utilities.

All others services should be classified as marketplace activities. (See pp. III/50-51 for a discussion of when to structure them as enterprise funds and when to structure them as public corporations.) One useful test to use before putting an internal service into a competitive market is to ask, "Would we be willing to let this unit go out of business?" If the answer is no, it should not be made a marketplace enterprise.

3. Keep reexamining your classification of leadership functions, utilities, and marketplace activities over time.

Sometimes circumstances change over time—particularly when technology advances. Thirty years ago, for example, both computers and copying machines were quite expensive, so most jurisdictions required central approval for any purchases of either item. Today you can buy a serviceable copy machine or computer for $1,000, so central control no longer makes sense.

RESOURCES ON INTERNAL ENTERPRISE MANAGEMENT

Michael Barzelay. "Introducing Marketplace Dynamics in Minnesota State Government, A & B." Case studies prepared for the John F. Kennedy School of Government at Harvard University, 1988. The story of enterprise management as it unfolded in Minnesota.

Michael Barzelay and Babak Armajani. *Breaking Through Bureaucracy.* Berkeley and Los Angeles: University of California Press, 1992. The best primer on internal enterprise management, based on the Minnesota reforms. See especially Appendix 1, pp. 137–160.

The National Academy for Restructuring School Districts, a part of the National Center on Education and the Economy. This organization collects information on school districts that use internal enterprise management, such as Edmonton, Alberta. The director of its high-performance management program, Michael Strembitsky, was Edmonton's superintendent of schools for 22 years. The National Center can be reached in Washington, D.C., at (202) 783–3668 or by fax at (202) 783–3672.

The Public Strategies Group, a consulting firm specializing in the reinvention of government. Babak Armajani is chief executive officer of the firm, several of his former colleagues from the Department of Administration also work for the firm, and David Osborne is a partner in the company. They can be reached at 275 E. 4th St., Suite 710, St. Paul, MN 55101. Phone: (651) 227–9774. Fax: (651) 292–1482. Web: www.psgrp.com. E-mail: reinvent@psgrp.com.

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 Nine

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