Chapter 11

Performance Management

Using Rewards to Create Consequences

Using *Performance Management*, organizations measure results, establish standards or targets, reward good performance (financially, psychologically, or both), and penalize poor performance.

In 1996, the 304 county employees who clean up Greater Seattle's wastewater scrimped and saved every dime they could. Some cut back on the use of chemicals in the process of "decaking" the waste. Machinists made spare parts rather than purchase new ones. A facilities team recycled lumber. "We have people who wash their own gloves, because they don't want to spend the money on new gloves," says John Kruse, a senior operator in one treatment facility.

At year's end, the wastewater division returned more than $513,000 of its budget to King County. It was the fourth year in a row that it had given money back, without reducing service levels or effluent quality. The savings amounted to $2.4 million.

Until a few years earlier, the division had acted like most public agencies: it spent every dollar in its budget. If it didn't, its managers feared, they would get less money the following year. The pattern changed when management agreed to let employees take home half the savings they generated for the agency. This is called *gainsharing*, and like profit sharing in the private sector, it has an enormous impact on employees' behavior.

Before employees could pocket a share of savings, they had no reason to improve their efficiency. Performance had no impact on pay. "We were 'command

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stupid,'" says Kruse. "We did what we were told, no more, no less. Our initiative was not valued."

Then management and labor began to focus on performance, because private firms were winning bids to take over wastewater treatment in other places. First they cooperated to empower employees, giving workers better training and more authority to make improvements. Then, in 1993, they adopted gainsharing.

"We wanted a way to compensate workers for continuously improving things," recalls Kruse, then president of Service Employees International Union Local 6. There was no guarantee that gainsharing would pay off, but the union agreed to substitute it for an automatic 50–cents-an-hour pay increase. One mechanic, skeptical that he'd ever see a nickel, sold the right to his first gainsharing check to a coworker for $50.

But once financial incentives were introduced, workers had no trouble rooting out waste. "There was a lot of fat in the budget to cut," says Kruse. "So the first check"—for $732 apiece—"was easy to achieve." Once employees saw those checks, he adds, "everyone started talking about how to save money."

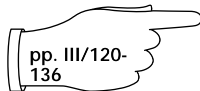
Bill Burwell, a division operations manager, saw a rapid change in employees' attitudes. Suddenly, he says, they were thinking, "It's my money out there. How can I save it?"

In March 1997, when the fourth-year gainsharing checks went out, the average check for yearlong, full-time employees was $1,061. Over four years, workers pocketed an average of $4,100 apiece—more than $1.2 million in all.

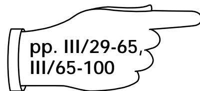
That is about 9 cents per hour better than the 50–cents-an-hour raise the union left at the bargaining table, according to Burwell. And employees gained more than money, says Kruse. "The people here are very proud of the work they do. We can point to what we did to earn the extra money."

LINKING PERFORMANCE TO REWARDS

Gainsharing gave King County's wastewater treatment workers a powerful incentive to improve their performance. It made clear what outcome was desired: reduced costs without reduced quality. And it made clear what the reward would be: half of the savings. Measurable performance outcomes linked to rewards—this is the heart of performance management. In addition to gainsharing, other performance management tools include awards, psychic pay, bonuses, shared savings, and performance contracts and agreements.



Reinventors use performance management when they cannot or should not create consequences for performance by using managed competition or enterprise management. Like these other two approaches, it upends the traditional bureaucratic paradigm, which offers public employees few if any rewards for above-average performance and imposes few if any penalties for below-average performance. Almost nobody in government gets bonuses or



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raises based on performance, and almost nobody is demoted or fired. In most organizations, seniority is a better protection against being laid off than high performance is.

This reality is a legacy of bureaucratic assumptions. Industrial-era bureaucracies control workers by specifying their tasks in detail. They assume that those who qualify for a job—because of educational credentials, work experience, or their performance on tests—are interchangeable: they all can and will perform the required duties. Therefore, employees in similar jobs should all be paid the same. Each civil service position is part of a class of jobs with similar duties. Each classification has a pay range that contains a number of salary steps from top to bottom. Employees advance up the steps, usually on the basis of longevity: another year, another step. Typically, civil servants also receive cost-of-living increases, across-the-board general raises, and annual longevity bonuses—none of which depend on their performance.

The system offers employees an implicit deal: if you do as you're told by management, you won't suffer negative consequences (such as firing), and your status and compensation will improve steadily.

Often a manager must certify that an employee's performance has been satisfactory. But most of the time, managers trivialize this process. They do not want the burden of giving an employee a bad rating; it means hassles with the employee and the unwelcome job of documenting and justifying the decision. Nor do they want to anger most of their employees by singling out a few for superior ratings. It is easier just to bless the performance of all but the absolutely worst employees. Thus, in most public organizations, the vast majority of employees receive positive performance ratings. In the first year of Australia's bonus pay program, for instance, 94.4 percent of the eligible senior officials got a bonus. This was also the norm in the U.S. and Canada, where most managers spread merit pay increases equally. Public management expert Robert Behn calls this the "Lake Wobegon syndrome," after Garrison Keillor's mythical town where "all the children are above average."

Although the bureaucratic personnel system is known as the "merit system," merit has little to do with it. Because it rewards marginal and superior employees equally, it promotes mediocrity and waste. Superior performers become demoralized when they are treated the same as marginal performers. When their organizations undervalue their contributions, people have trouble sustaining their commitment. They become cynical and either reduce their efforts or leave.

"Everyone wants to *matter*," says General Bill Creech, who initiated many of the incentives used by the U.S. Air Combat Command (ACC). "Policies that in effect tell people they don't matter are a big turnoff. . . . Conversely, those that make people believe they do matter inspire loyalty and commitment in return."

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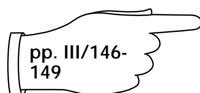
Performance management, a response to these and other ills, gives public employees a stake in their organization's results. It sends them unmistakable signals about which results matter, and it rewards employees who produce those results. Elected officials and top managers spell out what they want public organizations to accomplish, then create incentives to "pull" employees' behavior toward achieving those goals.

Performance management also creates pressure to change bureaucratic organizational cultures and administrative control systems. When employees start caring about boosting efficiency and effectiveness, they inevitably find that government's centralized purchasing, budgeting, and personnel systems stand in their way—and they begin demanding reform.

The Fine Art of Setting Performance Goals

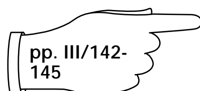
To use performance management, organizations must decide which achievements they will reward. Incentives for performance must be linked to some measure of performance: "if you produce *that,* you will get *this.*" Usually, bureaucracies measure the wrong *that:* whether or not employees comply with management requirements. In performance management, you must measure the *results* that government organizations and people produce.

As we explain in Chapter Twelve, on performance measurement (where we define all the terms used here in detail), reinventors can tie incentives to five kinds of results:

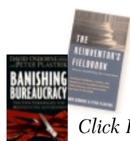


- Increases in the *quantity* of outputs produced.
- Increases in *efficiency,* which reduce the cost of work performed.
- Improvement in the *quality* of services produced, such as their timeliness, responsiveness, and accessibility.
- Improvement in the impact of an organization's work—its *effectiveness.*
- Reductions in the cost of producing that level of effectiveness, or *cost-effectiveness.*

In Chapter Twelve we also explain that you can measure these factors at several steps in the process of producing results. You can target your incentives on improvement in:



- *Processes:* the activities or production methods of employees, such as street sweeping.
- *Outputs:* the products of that work, such as miles of streets swept.
- *Strategy or program outcomes:* the direct results of the strategy or program used, such as the cleanliness of streets just after they have been swept.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- *Policy outcomes:* the longer-term results that citizens care about, such as clean streets, clean air, and low crime rates.

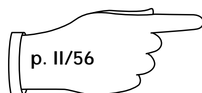
The key is to hold the right team or organization accountable for the right results. Some frontline teams may have little control over outputs but significant control over processes, for example. Consider the unit that controls the process of determining clients' eligibility for benefits. Other units may have to complete other processes before the basic output—payment of benefits—can take place. So the first unit should be held accountable only for the quality and efficiency of the process it controls.

Further up the chain, the welfare department may have some control over its program outcomes, such as how many recipients it places in jobs. But it may have little control over other program outcomes, such as how long those recipients keep the jobs and remain off welfare. And it probably has very little control over the broader policy outcomes, such as how much of the population is on welfare in the first place. Typically, that depends largely on the state of the economy and the welfare rules put in place by legislators.

The important thing is to build incentives around results a unit can significantly influence or control. If you ask frontline employees to become accountable for outcomes, you will only frustrate and confuse them. If you ask most operating ("rowing") organizations to be accountable for policy outcomes, they will object. They will rightly feel that they are at the mercy of events beyond their control, and they will become cynical about the entire performance measurement process.

At the same time, you want to motivate managers to look for new strategies that will produce better outcomes. If they have no responsibility for outcomes, most will not do this. They will concentrate on what earns them rewards. They may work harder, but they will have little incentive to come up with better strategies and work processes. They will improve, but they may not innovate.

What happened in Sunnyvale, California, the American pioneer of performance management, illustrates both the problem and its solution. Until 1994, Sunnyvale's system focused primarily on outputs and efficiency, as opposed to outcomes and effectiveness. It was powerful enough to produce 6 percent annual productivity increases. But managers complained that it drove people to focus on producing the desired numbers, regardless of whether they contributed to the overall result their departments wanted. Employees worked very hard—but at fairly traditional public service jobs. The one place where we found tremendous innovation—including a rethinking of the basic way the organiza-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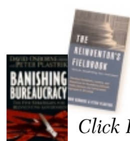
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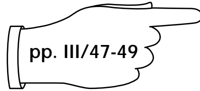
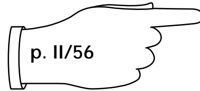


tion achieved its goals—was in the Leisure Services unit, which was reinvented as an enterprise fund. Because it depended on its customers for its revenues and faced real competition for their recreation dollars, this unit constantly dreamed up new ways to meet their needs. Its staff not only worked harder, they worked smarter.

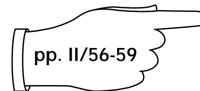
City Manager Tom Lewcock and his department heads recognized the problem and developed a solution they called *outcome management,* which shifted the key targets toward effective outcomes. With their businesses tied to improvement in outcomes, managers had a powerful incentive to rethink the basic strategies their organizations used.



There is a real dilemma here. On the one hand, if you go so far in this direction that managers feel their targets are unfair, they will run and hide. They will develop easy targets or vague targets; they will make sure no real measurement takes place; and some may even falsify data. Evaluation expert Michael Quinn Patton offers an equation that sums up the danger nicely:

Demand to produce outcome
− control over outcomes
+ high stakes
= corruption of indicators

On the other hand, if you don't go far enough, everyone will work hard to improve what they already do, but no one will question whether other strategies would be more effective.



As we said in Chapter Five, a performance budgeting system should focus more on outcomes than a performance management system does. Performance budgeting is about setting direction, telling everyone in the system the results policymakers want. Performance management is about creating consequences for performance, so people will produce those results. But as we explained in Chapter Five, if you try to combine the two systems, neither will work. You cannot hold everyone accountable for outcomes that are far out of their control. Top managers must translate the broad policy outcomes policymakers want into appropriate program outcome, output, and process goals at each level of the organization.

The challenge is to figure out which results you can reasonably ask each level of your system to produce. With the caveat that every situation is different, we suggest the following very rough guidelines:

Who Should Be Accountable?	***For What?***
Elected officials, city and county managers	Policy outcomes

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Department heads (for example, cabinet members)	Program or strategy outcomes
Operating agency executives	Program or strategy outcomes and outputs
Agency units and their managers	Unit outputs
Work teams	Processes and their outputs

Setting Target Levels

Your next challenge is to set the levels above which performance will be rewarded. W. Edwards Deming, the widely revered pioneer of Total Quality Management, railed against using numerical targets. Among his famous 14 Points, the tenth is "Eliminate slogans, exhortations, and numerical targets." Deming felt strongly about the matter, and as Creech notes, "Many of his disciples are holier than the Pope on the same subject."

Deming argued that you can know how much better performance can be only *after* you have improved your work processes. Hence, he reasoned, all targets are arbitrary. He also stressed the negative impacts targets can have. Arbitrary targets create cynicism among the workforce. When workers fail to reach targets that were set too high, for example, they are unfairly blamed. If they exceed targets, they are praised and rewarded—regardless of how difficult or easy the improvements were to achieve. In other words, when targets are pulled out of the air and incentives are tied to them, the results are often unfair. Thus, rather than building productivity, they can undermine morale.

We agree with much of Deming's analysis, but we believe he went too far when he railed against *all* performance targets. We doubt that the businesses he worked with eliminated all performance targets. They still measured profit and loss, market share, return on investment, net worth, customer satisfaction, and the like—and no doubt had performance targets for some. And they experienced real consequences if they succeeded or failed to hit their targets. Deming may have been right to say that they did not need performance targets for individual employees (although many high-performing corporations reject this advice). But that is not the same as saying that they did not need objective targets for their organizations—the entire corporation and its individual units.

This is an example of the danger of importing business management wisdom into the public sector without any translation. Most public agencies don't have to compete and don't measure any bottom lines. They need performance targets that are consequential—the equivalent of profit-and-loss, return-on-investment, and customer satisfaction measures in business.

The best solution to this apparent conundrum, in our view, is the one pi-

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oneered by Sunnyvale and other local governments. In most cases, these governments simply measure current performance and create incentives for managers and (in some cases) employees to improve those levels significantly. Managers in Sunnyvale whose units demonstrate significant improvement are eligible for raises and bonuses of up to 10 percent of their salaries. But the performance level they have achieved becomes their expected target from then on. If they fall too far below that level, they can receive up to a 5 percent pay cut. This system creates a powerful incentive for continuous improvement.

This approach has a number of advantages over setting specific performance improvement targets. First, it takes arbitrary judgment out of the process, and thus it minimizes employee cynicism. Second, it saves the time and energy that otherwise has to go into choosing and negotiating over performance targets. Third, it creates a process that gradually squeezes out the fat and forces the organization to stretch its capacity. This does not all happen immediately; but over time, it does happen. After three or four years, organizations can no longer game the system by setting easy targets. Finally, this approach avoids making central management set targets about activities it doesn't know much about—something that breeds cynicism among line employees.

This approach is insufficient in two situations, however. The first is when an organization is creating new activities, because there will be no "current level" of performance. In such cases we suggest that organizations set targets but wait to tie incentives to them until they develop enough experience to make sure the targets are realistic. This may take two or three years.

The second situation is when leaders want a quantum jump in performance—when they are not satisfied with 5 percent improvement per year. When reinventing a dysfunctional bureaucracy, it often makes sense to demand 25 or 50 percent increases in performance. The same is true when redesigning a program or reengineering a process.

A "stretch target," which sets a target just beyond the reach of easy improvement, forces employees to look for new ways to best performance. In New Zealand, for example, George Hickton, general manager of the Income Support Service, set a daunting target for his managers. In 1993, it took his agency an average of six days to decide if an applicant was eligible for welfare benefits. Hickton told his managers he wanted the average period down to one day, within a year. They couldn't believe it; they told him it was an impossible target. But he insisted that if they made radical changes, they could do it. One year later—without staffing or budget increases—it took *less than a day* to process applications.

These kinds of stories are becoming common. But setting targets this way is an art, not a science—and it does not always work. Derek Volker, the for-

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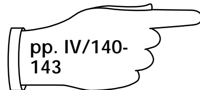
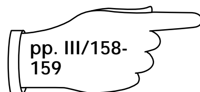
mer secretary of the Australian social security department, recalls what happened when he tried to cut the target for how much time it took to answer the phone from three minutes to 30 seconds. "We'd say, you go and be on the phone and see how long three minutes is, see how long two minutes is, see how long one minute is," he remembers. "*A minute is a hell of a long time when you're waiting for some public servant to answer the phone.*" When the union resisted, arguing that it would take more resources to hit the target, Volker simply mandated that employees pick up the phone within three rings. But that didn't work: "They were picking up the phone and saying good day and then putting it down." So finally he compromised: he set a new target of one minute but agreed that only 85 percent of all calls had to be answered in that time—as long as 98 percent of all calls were answered within two minutes.

Negotiating Performance Goals



The process of setting performance goals should ideally involve at least three parties: the organization in question; a neutral agency committed to performance improvement, such as the U.K.'s Cabinet Office; and something like a customer council or board. Many managers already use feedback from customers as they develop performance targets; we're talking about going a step further, by giving customers a place at the table as goals are developed. If possible, all those involved in working out performance goals should have information about the performance of comparable organizations, including those in other cities, counties, states, or countries.

Negotiating an organization's goals requires a great deal of give-and-take, especially on the part of central agencies accustomed to dictating to other organizations. In the U.K., for example, executive agencies now operate on the basis of five-year "framework" agreements, which include key performance goals, and annual business plans, which include annual targets. The framework agreements are negotiated between the agency, its department, the Next Steps Team (in the Office of Public Service), and the Treasury Department. The Treasury acts as a kind of gatekeeper: the agreements are not finalized until it is satisfied. Later the Next Steps Team reviews the annual targets.



The danger is that this central control will go too far. The U.K. has a good balance: "We don't give ourselves the power to parachute in and say, here are some better targets, do them now," Sonia Phippard, who ran the Next Steps Team during the mid-1990s, told us. "We feel it is very important for the agency to own the [performance measurement] process." Instead, the team conducts informal conversations with the agencies to build their confidence to take on more aggressive targets.

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Organizations can circumvent some of this work if (in all but new or special cases) they simply define the target as "improvement" and create incentives to reward it, as Sunnyvale does.

Whichever approach they use, they should also make certain that they structure the incentives so the target does not become a ceiling. Whatever the target, incentives should encourage employees to go far beyond it. In Sunnyvale, managers' bonuses increase as their performance increases. In Indianapolis, employees can earn more money by cutting costs more.

Finally, you need to understand that occasionally, elected officials will decide that the quality of a service or compliance activity has been improved enough. Once they are satisfied with the quality, they may prefer that all further improvements focus on cutting the cost, so they can free up resources for other priorities. In such cases, managers simply announce that rewards will now go exclusively for efficiency and productivity improvements—and that the quality and effectiveness goals will remain at current levels.

PERFORMANCE MANAGEMENT: OTHER LESSONS LEARNED

In *Banishing Bureaucracy* we spelled out several other lessons that bear repeating here, in briefer form. In addition, we offer a few new lessons.

1. Don't underestimate the power of psychological incentives.

Money matters, but so do psychological rewards such as recognition and increased responsibility. In the ACC, the generals can't use cash incentives, so they offer other rewards for performance. Top-achieving airplane mechanics get a ride in the back seat of the two-seat F–15 fighter jets they maintain, for example. "Those rides go a long way in convincing our young folks of how important they are," says Brigadier General Gregory Martin. The organization also gives out trophies, plaques, and certificates of recognition to teams that win ACC competitions in gunnery, aircraft maintenance, and the like. The military agency's biggest incentive is a three-day weekend. Each month, every ACC squadron—big teams of employees—can win a long weekend by meeting the organization's tough standards for performance.

2. Magnify the power of incentives by applying them to groups as well as individuals.

Results rarely depend on the work of just one person; they are normally created by groups of employees. An important part of improving performance, therefore, is to increase cooperation and collaboration among workers. Unfortunately, incentives for individuals may undercut this.

Usually, team-based incentives are preferable. In Indianapolis, Hampton,

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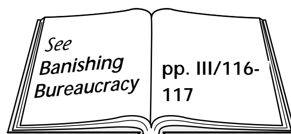
and the ACC, many employees must pull together in order to win the rewards. As more and more government organizations shift control and accountability to work teams, they should use performance incentives that reinforce the value of teamwork.

Individual incentives have their place when individual performance can be distinguished and measured. This is possible with some jobs: keypunch operators, CEOs, highly trained professionals such as physicians, and many others. Individual incentives may also make sense in organizations that cannot organize themselves around stable teams. The Employment Service in the U.K. found that many of its work teams had very high turnover rates, for instance. As unemployment fluctuated, the organization constantly brought people in and out. When its leaders researched private sector experience, they discovered that team incentives when teams were not stable created turmoil, because of debate over how much someone who arrived or departed partway through the year should receive. So they decided to reward employees on an individual basis.

3. Tie financial incentives to objective measures of performance, not to subjective appraisals.

Using measures on cost savings, program effectiveness, customer satisfaction, and the like avoids the concern that subjective measures, such as employee appraisals by managers, are inconsistent and possibly unfair. We offer one caveat here, however: you need to allow some room for adjustment to compensate for realities outside the organization's control. If there is a bad winter, for example, snowplowing crews may do a heroic job, but their numbers may look bad. Conversely, if there is little snow, they will almost inevitably look good. Within a system focused on objective measures, top managers must have some leeway to adjust for such circumstances, using common sense. This may open you up to employee cynicism, admits Tom Lewcock, former city manager of Sunnyvale and an expert on performance management. But if you don't adjust for common sense realities, you'll encounter even more cynicism.



4. Be careful what you target—you might get it.

Because performance incentives have a powerful effect on employees, you must carefully select which results you reward. If your goals are all short-term, then short-term improvements are all people will work on. If you emphasize productivity but not effectiveness, then that's all you'll get. We recommend a "balanced scorecard" approach: a mix of targets that promote longer-term results, including the quality of outputs and the effectiveness of outcomes.

"The wrong measure of performance can be—and has been—more harm-

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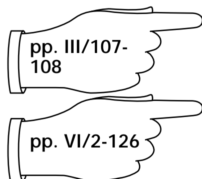
ful than no measure," says Roger Vaughan, a veteran consultant to state and local reinventors. "Most program administrators will do whatever they can to generate good numbers."

Consider the elementary school that set itself stretch targets and met them. To do so, it had to squeeze out art, music, storytelling, and virtually everything else the students enjoyed. The result, says Harvard's Patricia Rogers, is that "most of the students hate school and have lost interest in learning, and most of the teachers are wanting to leave."

A striking example of unbalanced targets occurred at the Internal Revenue Service. In January 1998, an internal audit revealed that the agency routinely measured employees' performance on the basis of how much money they collected. Evaluations of agency managers were tied to how well they achieved these goals. And the IRS's 33 districts were ranked by how well they did on meeting collection targets. These practices, auditors said, pressured employees in ways that placed "taxpayer rights at risk in the collection process"—leading to congressional hearings in which politicians painted the entire affair as a scandal. The IRS's new top official, Commissioner Charles Rossotti, ended this narrow targeting and adopted a balanced scorecard that includes business results, customer satisfaction, and employee satisfaction.

5. *Work hard to create a culture of learning, not fear.*

If you push too hard to achieve narrow results, you will create enormous anxiety and fear. People will concentrate on reaching their goals at all cost, regardless of whether that makes sense for the rest of the organization or system. This is the opposite of what you want. To use a manufacturing metaphor, factories will meet their quotas even it means shipping junk.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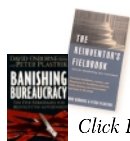
The solutions include focusing on outcomes, using rewards far more than penalties, and rewarding innovation and experimentation. Most important, mold a culture of learning, not blame. "Put ten good professionals in a room and they will devise your outputs and outcomes," says Sylvie Trosa, a veteran reinventor who has worked in France, the U.K., and Australia.

> *But what they won't devise is the rules of the game with your staff, and how confident your staff are not to hide bad results, not to cheat on . . . targets, and to talk about problems. Are you in a culture of fear, or a culture of trust? . . .*
>
> *At some stage there must be something like a trust contract where basically you reward more those people who have the courage to talk about problems than those who hide them.*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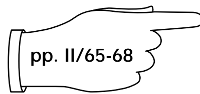
6. *Don't assume the numbers alone will tell you why you are or are not getting the results you want.*

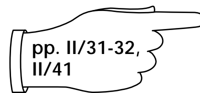


As we explain in Chapter Five, you may need evaluation to discover what is behind the numbers. At the least, you need some written explanation to go with the performance report, from those who understand the numbers. You also need to train your managers and elected officials about the limitations of the data: why they cannot always draw conclusions without knowing more.

"If an agency or organization is small enough, then performance monitoring will be supplemented by on-the-spot discussions, meetings," and so on, points out Jerome A. Winston, director of the Program for Public Sector Evaluation at the Royal Melbourne Institute of Technology. "The measures will not be misinterpreted because their context is well understood. The risks associated with performance monitoring appear to be greatest when used to report simplistic measures 'up the line', where they are used by people who are quite distant from the activities that give meaning to the measures."

7. *Overcome resistance to paying for performance by starting with rewards for saving money.*

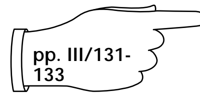
Elected officials and citizens are often reluctant to use financial incentives. They wonder why they should pay *more* to get better results—aren't public employees already being paid to do well? The simple answer is that incentives work. "You get significantly better performance," notes Bill Burwell, the King County wastewater manager. "Do you want better performance or rhetoric?"



(The tougher question is how to get elected officials to care about performance in general. For this discussion, see Chapter Five.)

The best way to address concerns about offering incentives is to start by rewarding increases in productivity, as King County's wastewater division did. That way, the incentives pay for themselves, out of savings generated from improvements. After the politicians and the public become accustomed to this, you can move on to other forms of performance bonuses.

Hampton, Virginia, offers a good example. First, reinventors there sold the city council on bonuses for employees who came up with money-saving ideas. "That was not a hard sell," says Michael Monteith, a former assistant city manager who runs the city's information systems. "The council saw that first there had to be some hard savings; it was truly an incentive to do business differently."



Several years later, the council agreed to try a one-year experiment with shared savings: letting departments keep part of budgeted funds they didn't spend. Elected officials liked the results—they got 30 percent of the money departments saved. So they adopted the incentive permanently. Then the city manager asked the council to approve an incentive that did not yield financial

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savings: a bonus for every employee if citizen satisfaction hit a certain level annually. This time, says Monteith, the pitch was different. "We had a major emphasis on restructuring city government. We said we needed this incentive so employees would pay attention to what we thought was important, citizen satisfaction." The council, already convinced that incentives worked, adopted the bonus plan, which costs several hundred thousand dollars a year.

Often there is a backlash after prominent officials get performance bonuses. In Houston several years ago, when scores in the school district went up by a larger margin than the average improvement in the state, it triggered a performance bonus for Superintendent Rod Paige. When he accepted the $25,000 award, equivalent to 16 percent of his salary, he also took some heat. Teachers wrote letters to the newspapers complaining that they were only getting a 2–3 percent raise. The president of the Houston Federation of Teachers, Gayle Fallon, griped that Paige got "$25,000 for raising test scores, but I don't recall a single student that Rod Paige taught. I fail to see where he earned it."

Paige and the school board defended the bonus, as they should have. The superintendent said that he deserved some credit for the district's improving test scores and observed that some teachers were also getting bonuses. "We should reward people who can and will get the job done," Paige said.

8. Overcome union opposition by rewarding large teams, not individuals.

Labor leaders typically oppose certain kinds of financial incentives, but not all of them. Usually, they don't want their members to be paid differently for performing similar work. They fear that such differentials will erode the workers' shared economic interests and, therefore, their need for a union. They also oppose giving managers discretion over how much money individual workers earn, because they don't want managers to have the power to play favorites or to get workers to compete with one another.

These concerns can be addressed. To have a shot at union support, use incentives for groups or teams of workers, not individuals. And use objective performance measures; don't leave performance evaluation in the hands of managers. In King County, the union blessed gainsharing because it provided incentives to teams and used an objective measure, dollars saved by teams.

The Delicate Matter of Negative Consequences

Although you should rely primarily on positive incentives, it is difficult to create a truly entrepreneurial, innovative, high-performance organization if that is all you use. This is because you need effective ways of signaling that performance is not good enough. Still, you must be very careful that penalties are fair, sure, and swift, and that they do not create barriers to risk taking and ex-

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perimentation by employees.

We suggest that you stay away from using financial penalties for poor performance. The threat of losing income fuels fierce employee resistance to performance management. Employees object strenuously to giving managers the power to cut individuals' pay. In Sunnyvale, for instance, this led the union to block performance pay for non-managerial employees.

Financial sanctions also tend to curb employee innovation. If failure means losing pay, employees are less likely to take risks and try new things. Managers in Sunnyvale, for example, sometimes avoid experimenting for fear that the effort might fail and drive up their costs, leading to a pay cut. "I've had discussions with people — "maybe you could do it this way"—and the big fear is, what if my unit cost goes up?" says Jim Masch, Sunnyvale's fleet manager.

Finally, financial penalties are not necessary. The opportunity to make money is a powerful enough signal, even in the absence of a financial downside.

Organizations do need some form of sanctions, however. Most organizations already use some type of "progressive discipline" to address unacceptable behaviors such as substance abuse, theft, absenteeism, and sexual harassment. But these personnel processes are not very good at dealing with employees who consistently perform poorly but have not crossed the line behaviorally.

One important answer is training—making sure employees have the skills and knowledge they need to perform well. Another is motivating them with incentives. If these options don't work, you need to impose negative consequences.

Organizations that use work teams find that peer pressure can be a powerful disciplining force. "It's one thing to be called in by your boss—and another when five of your colleagues ask to meet with you to discuss why you haven't held up your end of the bargain," explains Tharon Greene, Hampton's human resources director. It's important, she adds, to provide employees with "nonpunitive exit routes" so they can move to other jobs in or out of government.

We should make clear that there is a big difference between chronic poor performance and occasional mistakes. The occasional error does not require discipline. Sometimes, when performance suffers because employees tried something new and it didn't work, they should be rewarded, not disciplined. At a minimum, your evaluation system needs to create room for innovations that fail. If employees feel they might lose out on a bonus because they spent money on an innovation that failed and their unit costs went up, they may not take that risk.

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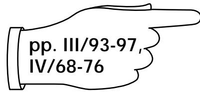
Several types of negative consequences can be designed into performance agreements:

• ***Negative Publicity.*** Most people don't want the world to know they are failing. In Kentucky, where the state offers substantial cash bonuses to schools that meet improvement targets, educators say they are more motivated by the fear of negative publicity about their school's performance than by the bonuses. Poor performance damages their standing in the community and their professional pride.

The trick, then, is to ensure full public disclosure of performance results. In Michigan, one way this is done is through an annual school accreditation report, which rates every school on several performance standards. This sends loud signals to school staff—and to parents. One year, Kimberly Gonzalez, a parent in Lansing, learned that the lowest rating had been given to Grand River Elementary School, where she had three children. "I was over at the school in a half hour when I heard about it," she says. "I was worried. I wanted to know why."



• ***Loss of Privileges.*** Performance agreements can specify that if performance falls below certain levels, managers will lose certain privileges—a city-owned car, the right to travel on the job, the right to waive certain regulations, and so on—until it improves.

• ***Loss of Autonomy.*** When organizations fail to perform, you can take away the managers' control over their budgets. This inevitably gets their attention. If you then provide the coaching or training they need, things sometimes turn around.

• ***Loss of Income.*** In general, we don't suggest using financial penalties for poor performance for most employees, because they trigger fierce resentment and resistance. They also curb innovation, because they make managers afraid to try new things, for fear they will not work and performance will suffer. But when it comes to the top manager in an organization—a city or county manager, a school superintendent, a cabinet member in a state or national government—financial penalties signal that there is accountability for performance at the very top of the organization. The message is "that we're deeply committed to a hard-edged accountability system that will hold my feet up to the fire," says David Hornbeck, who risked losing up to 5 percent of his salary as superintendent of schools in Philadelphia, if he missed his performance targets.

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• ***Intervention from Above.*** In education, it is now common for school districts, states—even national governments—to threaten to intervene if schools fall below standards. In 1996, for example, Chicago's school board put 109 of the city's lowest-scoring schools (20 percent of the district) on probation because fewer than 15 percent of the students performed at grade level on national reading tests. The board sent a team of experts into each school to develop improvement plans. If the schools then failed to improve, the board could replace principals and teachers. As a last resort, it could close the schools.

This can be a big stick, if the stick holder has the nerve to use it. In the mid-1990s Kentucky's education department targeted 53 schools for failing to improve performance. The state assigned a "distinguished educator" to help the principal and teachers in each school. Within a year, all of the schools showed measurable improvements. This tactic has also been effective in the U.K.

• ***Takeover.*** This is a favored tool of politicians, particularly in education. In many American states, if students in a school or district perform poorly enough for long enough, the state government can take over. Although such laws make politicians look tough, they unfortunately do little for children.

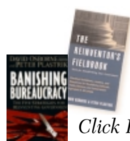
First, they offer few consequences and little help until things are desperate. They are like safety systems for the space shuttle that only kick in after a shuttle blows up. Second, they are difficult to impose, because local politicians usually fight them. Hence they are applied only in the worst cases. This leads to the third problem: they help very few schools. Finally, takeovers offer no guarantee that the new management will be able to improve performance—and no consequences if they don't!

By takeover time, things are usually almost beyond repair. In New Jersey, the state has run the Jersey City schools since 1989 and the Patterson schools since 1991. By 1996, neither showed improvement in student test scores. But the governor was stuck with them. By now, it has no doubt occurred to the governor that "owning" sick school districts is a no-win proposition.

pp. IV/36-86, III/65-103

As the list above indicates, however, there are alternatives to takeovers. In addition, elected officials can create powerful consequences for every school (or organization) through competitive customer choice and managed competition—making every school, in effect, a charter school. They can use the threat of regular takeovers—by competitors—to force continual improvement. Why wait until things are desperate?

• ***Loss of Employment.*** This is the ultimate sanction: firing people who consistently fail to perform, even after coaching and training. For years, gov-



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ernments have been notoriously reluctant to do this, but that is changing. Increasingly, managers at the top of government agencies, including school principals, are being given fixed-term contracts rather than lifetime tenure. If they don't work out, their contracts are either not renewed or, in some cases, cut short. In some schools, it's also getting easier to oust incompetent teachers, who traditionally have been protected by tenure systems.

THE PERFORMANCE MANAGEMENT TOOLKIT

Performance Awards provide employees with nonfinancial recognition for their achievements. This lets workers know their performance is appreciated, respected, and valued. See p. III/120.

Psychic Pay provides employees, teams, or organizations with quasi-financial benefits of real value, such as paid time off or new equipment, to reward them for high performance. See p. III/122.

Performance Bonuses are one-time cash awards provided in addition to salaries. They go to individuals or teams that achieve specified performance targets. They do not become part of an employee's compensation base. See p. III/122.

Gainsharing gives employees a guaranteed portion of financial savings their organization achieves while continuing to meet specified service levels and quality. It gives workers a clear economic stake in increasing productivity. See p. III/127.

Shared Savings is gainsharing for organizations. It allows them to keep a portion of the funds they save during the fiscal year (or biennium) to use in the future. It creates an organizational incentive to save money. See p. III/131.

Performance Contracts and Agreements put managers and their organizations on the hook for performance. They build in rewards and penalties, and they give public leaders the freedom to get rid of top managers—or entire organizations—that do not deliver the desired results. See p. III/134.

PERFORMANCE AWARDS

In the mid-1980s, the director of the Michigan Department of Commerce, Doug Ross, started buying advertising space in a monthly statewide business magazine. The full-page ads didn't contain the usual pitch to businesses about why they should invest more money in the state. Instead, each ad told a story about department employees—"associates," they were called—who had helped businesses solve their problems. The message tried to persuade companies that the department was on their side. But Ross was also sending a message to his employees: he valued their achievements. To underscore the point,

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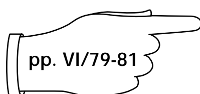
he had a copy of each ad framed and presented to the employees at an awards ceremony. Then he hung the framed ads in the agency's main hallway.

Most of the civil servants, Ross says, were surprised that he was willing to spend money—even small amounts—on making them feel good. "It didn't cost much, but to them it was a meaningful form of affection," he recalls. And by recognizing his employees' accomplishments, Ross's ads reinforced the behaviors that he valued.

Performance awards have this double effect: they show employees that they are valued, and they signal what kind of behavior and achievement matters. Very small sums can go a very long way with people. "There is no limit on plaques, parties and pictures," notes public management scholar Robert Behn.

Awards can be made by outside entities too. In Texas, for instance, the state comptroller's office started issuing "Breaking the Mold" awards in 1992 to state agencies that had reinvented themselves. Since 1985, the Ford Foundation has given Innovation Awards to 10 government programs every year, each worth $100,000, plus far more in prestige and publicity.

Here are some tips for using performance awards: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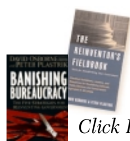
- Make celebrating success a big part of the organization's culture.
- Recognize teams as well as individuals.
- Make awards ceremonies exciting.
- Publicize performance achievements in the local media.
- Use peer-to-peer awards, in which an employee can instantly call attention to another employee's "beyond the call" performance.
- Don't feel you have to spend a lot of money on awards. It's more important to make the award meaningful than to make it expensive. It's the thought that counts.
- Make department-to-department awards. Honor the performance of agencies that share responsibilities with yours or that you depend on for support.
- If the success of the organization or system depends on the effort customers make (as in schools, training programs, economic development programs, and welfare programs), give awards to outstanding customers, too.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POSSIBLE PERFORMANCE AWARDS

1. Awards ceremonies for employees
2. Plaques
3. Certificates of achievement
4. Photos and stories in organization newsletters
5. News stories about achievements
6. Breakfast, lunch, or dinner with the CEO
7. Lapel pins
8. Engraved objects like nameplates and coffee mugs
9. Employee of the Month awards
10. Vouchers, gift certificates, or tickets for cultural or sporting events

PSYCHIC PAY

***Psychic Pay* provides employees, teams, or organizations with quasi-financial benefits of real value, such as paid time off or new equipment, to reward them for high performance.**

When government managers cannot offer additional income as a reward, they can turn to popular substitutes that also have economic value. The ACC, for instance, uses paid time off for units that perform above targets. "It's a big incentive, a very big incentive," says General Michael Loh, the former ACC commander.

Other quasi-economic incentives include throwing parties, buying new office equipment, refurbishing facilities, and paying for people to take college or graduate school classes or attend conferences or workshops.

Psychic pay can go to organizations, too. In 1984, South Carolina began giving cash awards to schools that exceeded student achievement standards and teacher and student attendance standards. The money—$15,000 to $20,000 per school in 1995—can't go into anyone's pocket, only into things that will improve school performance, such as new equipment or materials.

PERFORMANCE BONUSES

***Performance Bonuses* are one-time cash awards provided in addition to salaries. They go to individuals or teams that achieve specified performance targets. They do not become part of an employee's compensation base.**

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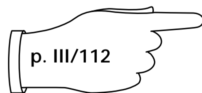
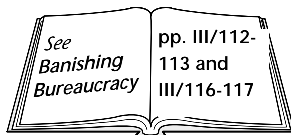
In the late 1970s, public organizations began borrowing the idea of performance pay from the private sector. The U.S. and Canadian federal governments both tried it. By 1995, ten state governments reported tying at least some employees' pay to performance. School districts and states began experimenting with merit pay for teachers. In 1995, Cincinnati became the first U.S. school district to link raises for all central office managers to student test scores, dropout rates, and other objectives.

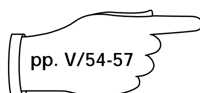




In short, the days of automatic pay raises are over in an increasing number of public organizations. Unfortunately, these performance pay systems fail more often than they succeed. We have already identified some of the problems: most performance pay systems use subjective ratings of employee performance, and most reward individuals, not teams. Most managers are afraid to use the tool, and those that do find themselves sowing envy, resentment, and jealousy in their ranks.

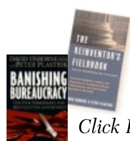
Most systems also use salary increases rather than bonuses to reward performance. This often becomes expensive, because the salary increase costs money not just for one year but for every year thereafter. Legislatures, councils, school boards, and budget offices usually get nervous about escalating personnel costs and push to keep both the number of performance pay increases and the dollar amounts low, which undermines the value of the tool. In addition, if an outstanding employee earns several performance pay increases, he or she often hits the top of the salary range—and the tool becomes useless, because further salary increases are impossible. When that happens, good employees often begin looking for other jobs that pay more—an unintended consequence of the worst kind.

The solution is to use bonuses, which avoid many of these problems. In our opinion, salaries should be determined by market conditions: what it takes in your labor market to attract and keep the talent you need. They should be adjusted for groups as inflation rises and market conditions change, and for individuals when necessary to keep a valuable employee. (To do this, you need a broad-band pay system, as we describe in Chapter Seventeen.)



After an exhaustive study of performance pay plans in public education, performance management expert Harry Hatry and his colleagues at the Urban Institute also concluded that bonuses work better. They are becoming quite common. In 1995, Kentucky handed out $26 million in bonuses to teachers in 38 percent of the state's public schools—those that had improved student performance by more than 10 percent over two years on key measures targeted by the state. Their 13,500 teachers decided how to use the money, sometimes sharing it with other school employees or investing it in their schools.

Since 1990, Dallas teachers and principals whose students' test scores have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improved have won $1,000 each, with $500 going to each of the schools' other staff members. In the U.K. and New Zealand, chief executives are eligible for bonuses as large as 20 percent of their salaries. And more than a dozen British executive agencies have used group bonus schemes, some awarding as much as £500 (about $825) to each staff member. A few government organizations even use "lightning bonuses"—on-the-spot cash awards that managers give to employees who do something of extraordinary merit.

Money is a powerful incentive. It is not "the most important driver" of behavior, says former Sunnyvale city manager Tom Lewcock. "But it's important enough that when a person's income is contingent upon how well they've achieved certain outcomes—not things like maintaining their turf or getting at least as much money as last year—their behavior changes." In 1980, Sunnyvale announced that managers could get up to a 10 percent bonus for exceeding their performance targets or up to a 5 percent pay cut for falling short.

> *That's when it started to get real serious. All of the traditional ways bureaucracies cover their butts flew out the window as a result of that shift. Lots of folks started looking at the world in a different way. That catalyst was a giant step forward—the consequences were absolutely powerful.*

This is true not only for managers; it works just as well with the lowest-paid public employees. In 1991, then governor Lawton Chiles convinced the Florida legislature to turn the Revenue Department and the Division of Worker's Compensation free from civil service and line item budget restrictions, as an experiment. For years, the division had been plagued by a backlog that multiplied its expenses, because workers whose claims lay dormant often filed suit. Labor Secretary Frank Scruggs used his new freedom to eliminate 20 middle management jobs and put the savings into a monthly bonus program for 500 line employees who processed the claims—some of whom were paid so little that they qualified for food stamps. If they increased their productivity significantly, they got an extra check.

In the first month alone, productivity shot up 30 percent in one unit, 50 percent in another, and 60 percent in a third. By the third month, 265 employees were earning bonus checks, and the backlog was gone. At its former productivity rate, the division would have had to hire 52 new employees to achieve the same increase in output.

"A dollar for a good deed works," said Scruggs.

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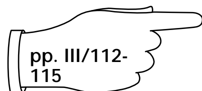
I remember handing a check to one of our employees. She quivered when she took the check. She said, "It's real." That's the goal—to be able to communicate that there will be a reward.

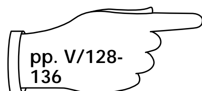
Using Performance Bonuses: Lessons Learned

Because bonuses are add-ons to compensation, you don't need to change the entire compensation system to use this tool. They are relatively simple to design, quick to implement, and easy to eliminate. As with any financial incentive, they usually work best if they are based on objective measures of performance, not managers' appraisals. Our research found several other keys to their effective use:



1. *When outputs are produced by teams, use your system to reward teams.*

Unless individual workers' activities lead directly to outputs you can measure—as in the case of the keypunch operators and claims processors in Florida's Division of Worker's Compensation—you are better off giving performance pay increases to teams than to individuals. Why? Team-based bonuses reinforce all the virtues of teams that we describe in Chapter Eighteen. They bind people to the collective purpose. They give employees a powerful reason to make sure each team member pulls his or her own weight—by pressuring laggards to improve. And they drive employees toward job flexibility: people quit caring whether something is in their job description and start caring about producing results.

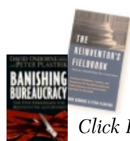


This works best, of course, if employee teams have real control over their work. Can they get rid of a bad apple? Can they change their work processes? Can they hold staff agencies—their internal suppliers—accountable for their performance? If they can do these things, they can usually improve their performance dramatically.

2. *Don't limit bonuses to managers; push them down into the ranks.*

Introducing bonuses for managers can drive improvement, but not as much as making all employees eligible can. In Sunnyvale, managers and employees alike report that managers-only bonuses fuel divisions between them. "It causes me more problems than it's worth," says Robert Walker, director of parks and recreation. "All you get from employees is, every time you start improving the product, they understand the system well enough to say, 'Oh, I see, so *you* can get a raise.'" One manager was so concerned about the problem that he used any bonus he received to throw a barbecue for his employees.

(Sunnyvale's leaders did try to negotiate a performance pay system with the union for six years during the 1980s, but they failed each time. The key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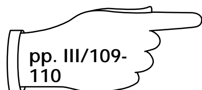
sticking points were fear of subjective ratings and negative financial consequences. The union wanted nothing similar to management's potential 5 percent pay cut for poor performance, and City Manager Tom Lewcock felt employees should share the same risks as managers. This experience is one reason we suggest you avoid imposing negative financial consequences.)

More important than the resentment the managers-only system creates is the fact that it fails to motivate employees to improve performance and cut costs. When we last visited Sunnyvale, its employees worked very hard, but they didn't actively look for savings and process improvements the way employees eligible for gainsharing in, say, Indianapolis did. "We are not tapping into a real important part of the organization to get new ideas and real breakthroughs," Assistant City Manager Ed James told us. "Most of the breakthroughs have been in management, not [among] line employees."

3. Create winners, not losers.

Some bonus programs limit how many eligible employees can actually win. They allocate less money than it would take to pay out bonuses to everyone. This creates competition for bonuses. It turns some employees into losers—even though they are improving their performance. We agree with Robert Behn, who argues that creating losers this way is a bad idea. As we discussed earlier, it's much better to tie bonuses to improvement over past performance. Those who improve *more* than others can get bigger bonuses. That way, people compete against themselves, rather than each other.



4. Give organizations the flexibility to tailor their bonus programs.

When instituting bonuses throughout a government system, allow organizations to adapt the plan to their own cultures and structures. No single model will be best for every agency.

5. Involve all key parties in designing and implementing performance bonuses.

Because bonuses can be controversial, you need to develop buy-in among those who will be affected.

6. Don't make your system too complex.

The temptation—to make sure the system is fair—is to measure all possible objectives, then weight each of them according to their importance. If you do this, the result will be a Rube Goldberg contraption no one can understand. Make it fair, but try to keep it simple.

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7. *Make bonuses big enough to get people's attention.*

You need bonuses large enough to capture your employees' imaginations. We recommend a minimum of $500 per employee—and at least $1,000 for highly paid employees.

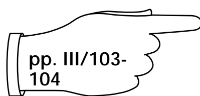
RESOURCES ON PERFORMANCE BONUSES

Harry P. Hatry, John M. Greiner, and Brenda G. Ashford. *Issues and Case Studies in Teacher Incentive Plans.* 2nd ed. Washington, D.C.: Urban Institute Press, 1994. A careful review of these issues in public education.

Carolyn Kelley, Allan Odden, Anthony Milanowski, and Herbert Heneman III. "The Motivational Effects of School-Based Performance Awards." *CPRE Policy Briefs.* February 2000. Useful research on what makes bonuses work, from the Consortium for Policy Research in Education (www.upenn.edu/gse/cpre).

GAINSHARING

***Gainsharing* gives employees a guaranteed portion of financial savings their organization achieves while continuing to meet specified service levels and quality. It gives workers a clear economic stake in increasing productivity.**

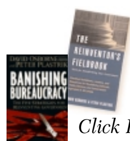

pp. III/103-104

The King County wastewater division is not alone in giving workers a financial stake in increasing their productivity. In Indianapolis, garbage collectors saved more than $2.1 million in 1995, taking home gainsharing checks of $1,750 each. As word spread, other union locals negotiated similar deals. In 1996, the fleet services team split $75,659—one-quarter of what it saved in the previous year.

As a result, workers "are looking to save every dime," says Steve Fantauzzo, the city employee union leader who helped design the gainsharing agreements. "They figure a piece of the pie is going into their pocket."

Workers responsible for sealing cracks in roads wondered why the city spent $22 for a gallon of vulcanized rubber for sealing. They said, "If we go to the local junkyard, we can get tires and melt them down for 30 cents a gallon, and it's ecologically more sound," according to Fantauzzo.

They also started questioning the performance of their suppliers. For instance, the private business that repaired transmissions on Indianapolis's city vehicles took two weeks to do each job. It felt no hurry, since the city was always slow in paying the company's invoices. So the fleet service workers got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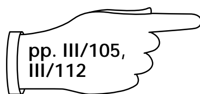
their union leaders to meet with the company and work out a more rapid response. Then they persuaded the city to arrange for backup suppliers in case performance did not improve. "We did all the troubleshooting," Fantauzzo says.

The fleet service workers even realized they couldn't perform some of their work as efficiently as the private sector could. So in areas like auto body repairs, they suggested outsourcing their work. When public union members push to contract work out to private companies, the bureaucratic model has been turned on its head.

In Portland, Maine, public works department employees get $100 each when they reduce a construction project's cost by 10 percent, and $250 for a 25 percent cut. In New York City, the Sanitation Department gave the union gainsharing in return for a shift from three workers per truck to two.

In Michigan, the state used gainsharing to reduce the cost of employee health benefits. It calculated the average cost of health benefits in the preceding seven years, then offered to give employees half of the savings if they drove costs below that average. In the 1997 fiscal year, the state saved about $40 million. Half of it went to 36,000 employees, whose checks averaged $555. "By working with employee groups, we cut costs and increased wages," says Mark Murray, the state treasurer.

The Benefits of Gainsharing



Gainsharing encourages employees to demand a role in rooting out systemic waste. Because they can gain financially, workers begin to question costs and come up with new, less expensive ways of doing things. They become less willing to let others—managers and central administrative agencies—make decisions that drive costs. As Fantauzzo says, employees take more ownership of their jobs.

Gainsharing promotes a collaborative, results-oriented culture. Gainsharing is a team sport; since everyone shares in the gains, it promotes employee collaboration.

Gainsharing can be used to defuse tension over downsizing and to encourage unions to work with management. Because it relies on positive group incentives and objective performance standards, gainsharing often appeals to unions. They don't have to worry about workers competing with one another for bonuses handed out by managers. Sometimes they oppose gainsharing because they don't want one group getting higher bonuses than another. But this flies in the face of their members' self-interest, so it is a difficult position to defend.

When leaders of the New York City Probation Department sought to reengineer and automate work processes, tensions developed with employees

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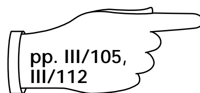
and their union, a local of the United Probation Officers Association. Management eased the conflict—even while slashing budgets and staff—by agreeing to share a third of the savings with union members, as cash bonuses. Pittsburg, California, dealt with resistance by making its gainsharing program voluntary.

Gainsharing avoids the problem of subjective appraisals of performance. As we discussed earlier, subject appraisals create many problems. With gainsharing, employee performance is rewarded based on something very objective: how many dollars they have saved.



Finally, gainsharing saves money. This is the bottom line: workers only gain when they cut costs, and they only get to keep a portion of what they save. The organization—and the taxpayers—keep the rest. The process doesn't cost them a dime.

Gainsharing: Lessons Learned

Gainsharing is a flexible tool that can be tailored to fit most organizations. To use it, you must first decide who will gain and how much they can gain.

1. Use gainsharing to reward teams, not individuals.

Although a big part of gainsharing's appeal is that it works as a team incentive, the tool can be—and often is—used with individuals. For instance, a few organizations have employee suggestion programs that share with employees a portion—usually 10 percent—of the savings their ideas generate. This is definitely worth doing. But it usually generates one-time innovations by individual employees rather than a steady stream of cost-saving reforms by groups of workers. And typically it leaves managers in control of decisions. Hence it has far less impact on the organizational culture.

2. Reward units that feel mutual ownership of an identifiable type of work.

To reward teams, you have to decide what size unit makes the most sense. Indianapolis started with work units involving 75 to 150 employees, such as sanitation and fleet services. Fantauzzo predicts that future gainsharing agreements will cover larger groups of employees, however—perhaps even entire departments. One reason is that few work teams are really self-sufficient; they depend on people in support services and on other work teams. Yet those people rarely get to share in the rewards.

3. Let employees keep enough of the savings to motivate them.

The gainsharing split between the organization and the employees is ne-

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gotiable. Indianapolis's sanitation workers negotiated 10 percent of savings, but its fleet service workers negotiated 25 percent in the first year and 30 percent in each of the following two years. New York City's probation officers got 33 percent, whereas workers in the U.S. Air Force PACER SHARE project received 50 percent. The rate does not have to be fixed forever. In Indianapolis, Fantauzzo anticipates that his union will negotiate for larger shares as the amounts of potential savings decline.

4. Let the employees in each unit decide how to divide up the money.

Sometimes the workers split the gains in equal shares. Sometimes they take other factors into account. For example, the Indianapolis fleet service team allocated gains according to how many hours each member of the team had put in during the year. People who worked overtime received bigger bonuses.

We recommend letting the employees decide how they will split the money. The point is to engage them in the process as fully as possible. Letting them divide the savings reinforces the message that they are empowered to make more of their own decisions.

5. Specify required service levels and quality even as costs are being cut.

This prevents corner cutting to boost financial gains. King County's wastewater workers, for example, had to meet the same requirements for effluents that existed before gainsharing.

6. Guarantee that employees will not lose their jobs because they improve productivity.

When organizations make their work processes more efficient, they usually end up needing fewer workers. But employees won't make changes that will cost them their jobs. And their unions usually want some type of assurance that workers will not be laid off as a result of productivity increases due to gainsharing. So it's best to adopt a no-layoff policy and use natural attrition to downsize, or move employees into other government jobs when theirs become obsolete. Neither King County nor Indianapolis put their policies in writing, but both adopted a no-layoff approach. This is a critical ingredient in Indianapolis, says AFSCME's Fantauzzo. Workers there know that even if they cut staffing levels, they will be retrained and relocated to other government jobs. Research about gainsharing confirms the importance of providing workers with job security, as well as a voice in workplace decisions, if you want them to push for increased productivity.

7. Be flexible when extraneous events change costs.

Gainsharing should apply only to costs that are under the employees' con-

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trol. In King County, for instance, a supplier's cut in the cost of chemicals for wastewater treatment did not count as savings, since it was not due to employee efforts. When a problem on a construction site that was not caused by employees boosted costs, the increase was not counted against the employees.

8. *Don't create other conditions for receiving the gainsharing bonus.*

If there are too many conditions, employees will become skeptical that they will ever get the bonus—and their motivation to save money will vanish. For example, the most common temptation is to say, "Gainsharing bonuses will only be paid if the budget ends the year in balance or surplus." This immediately makes most employees cynical. They assume that even if they work hard to save money, they'll never get their bonuses; instead, the savings will be used to bail the government (or school district) out of a deficit. Yet gainsharing, by definition, never contributes to a deficit, because it is only paid if a unit has not spent all of its budget. We recommend that governments always honor gainsharing bonuses. After all, when a unit earns a gainsharing bonus, it has already helped balance the budget, because part of the savings reverts to the general fund. To cope with deficits, we recommend that governments use the same methods they would use if gainsharing did not exist, rather than raiding employees' gainsharing bonuses and thereby destroying any incentive to save.

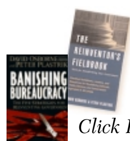
9. *Once employees embrace financial incentives, look for ways to reward more than efficiency.*

John Kruse says his colleagues began to worry that they would run out of new, big cost reductions. "In some things, you get as efficient as you can," he says. That may look like a problem, but it's actually an opportunity. Once employees buy into rewards for performance, why limit them to improving efficiency? When efficiency gains slow up, negotiate bonuses for improving quality and effectiveness.

After all, the whole point is to motivate every employee to commit to improving performance. Gainsharing is probably the single fastest way to create a culture of continuous improvement, and bonuses based on quality are the logical next step. Once employees realize it's in their self-interest to improve their organization's performance, the battle is half won.

SHARED SAVINGS

***Shared Savings* is gainsharing for organizations. It allows them to keep a portion of the funds they save during the fiscal year (or biennium) to use in the future. It creates an organizational incentive to save money.**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In the closing month of a government fiscal year, many public agencies engage in a senseless spending frenzy. They quickly spend money on low priorities—before their authority to use the funds expires. If they don't use it, they lose it. What's worse, they may get less in the next budget cycle. Edwin G. Fleming, an Internal Revenue Service district manager, described the perversity of the system in a letter to the National Performance Review. "Every manager has saved money, only to have his allocation reduced in the subsequent year," he wrote. "This usually happens only once, when the manager becomes a spender rather than a planner."

In this way, traditional government budget systems encourage every manager to waste money. We have asked tens of thousands of public employees whether they agree with this statement. Very few have disagreed.

The solution is relatively simple: let organizations keep some of what they don't spend. In the U.K., Australia, Canada, Sweden, and an increasing number of state and local governments in the U.S., this is now the norm. Unless the legislature adopts a policy change requiring more or less of a service, each organization gets to roll over at least part of what it doesn't spend into a future budget cycle. The percentage varies from organization to organization. But as long as it is enough to motivate managers and employees to look for savings, it works.

There are three basic ways to do this. You can let organizations keep all or part of what they save, as local government pioneers such as Fairfield, California, did. You can force everyone to reduce spending a set amount and let them keep all of what they save beyond this, as Visalia, California, the U.K., and Australia did. Or you can cut spending across the board and let agencies compete to get some of the money back by proposing specific investments in productivity improvement, as Florida did under Governor Lawton Chiles.

There are several keys to making shared savings work:

Let agencies spend their savings as they see fit. Don't prescribe how agencies can use money they save. The point is to create a powerful incentive to eliminate unneeded spending. The more you limit what agencies can do with their savings, the more you weaken the incentive. Let them give gainsharing bonuses, buy technology, refurbish their offices, or throw a party to celebrate their success—whatever they prefer. As long as you have consequences for their performance, you needn't worry about how they spend every penny.

Require that they maintain or improve their performance levels. As in gainsharing, you don't want to reward agencies that save money by cutting back on customer service or their volume of production. If their performance

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falls, they should not receive the shared savings (unless the decline results directly from factors outside their control, such as a recession).

Minimize retroactive raids on their savings. If you let agencies carry over some of their year-end savings but then give them less money in the next budget cycle because they saved money in the last cycle, you will destroy their incentive to save. Hence shared savings programs must erect protections against this impulse. At the same time, they must recognize that elected officials—who face constituencies demanding that they spend money on new priorities—will not stand by forever and watch agencies accumulate large reserves.

There are at least two ways to walk this tightrope. In Fairfield and Visalia, the council agreed that it would not cut departmental budgets unless it also cut their workloads. Every five years or so, however, the city manager would examine accumulated savings and departmental efficiency increases and recommend adjustments in budget levels to the council. Departments that had begun the process "fat"—and had thus been able to save a great amount—found their budgets cut more than departments that had begun the process "lean." This satisfied the council, without doing undue damage to the departmental incentive to avoid unnecessary spending.

The second approach is to give agencies two-year budgets. This gives managers some assurance that retroactive raids will come, at most, every second year.

Convert your budget or finance officers and key appropriations committees. Shared savings is simple common sense, but it flies in the face of years of conditioning of budget officers and appropriators. From where they sit, there is never enough money. They face so many competing demands for funding—many of them not only legitimate but also urgent—that they feel compelled to reallocate any savings. You may be able to convince them that if they let agencies keep 50 percent of their savings, everyone will benefit, because half of something is better than all of nothing. But given the urgency of the demands they face, they will find it very hard to leave that other 50 percent on the table. They are like the greedy monkeys who reach into a jar for a handful of sweets and find themselves caught because they cannot remove their fist when it is full. They may know that if they let go of the sweets they can get free, but the temptation to hold on is too great.

If you cannot win the argument with sweet reason, try a pilot project. Get your budget office or appropriations committees to allow one or two agencies to keep part of what they don't spend. Let them see the savings that result—and let them learn firsthand how gratifying it is to get 50 percent of something rather than all of nothing. Once they have experienced the benefits, it will be easier for them to let go of the sweets.

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RESOURCE ON SHARED SAVINGS

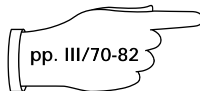
David Osborne and Ted Gaebler. *Reinventing Government.* Reading, Mass.: Addison-Wesley, 1992. See pages 118–121 for a full picture of the Fairfield-Visalia version of this tool.

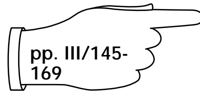
PERFORMANCE CONTRACTS AND AGREEMENTS

***Performance Contracts and Agreements* put managers and their organizations on the hook for performance. They build in rewards and penalties, and they give public leaders the freedom to get rid of top managers—or entire organizations—that do not deliver the desired results.**

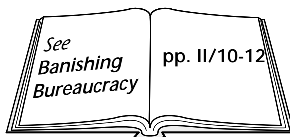
Public school principals in Chicago have something in common with public executives in New Zealand and the U.K. Reinventors have stripped them of traditional job tenure—guaranteed employment—and forced them to work on performance contracts of no more than a few years duration. If the organization's performance lags, they can be shown the door.

In Chicago, changes in state law ended tenure in 1989 and forced principals to apply for their jobs. The shift contributed to a mass exodus of principals. Some retired early or left the system; others were not rehired. Within several years, about half of the approximately 540 principals were newcomers. By 1996, turnover had increased to roughly *80 percent,* according to John Easton, district director of standards, assessment, and research.





The most common form of organizational performance contract is a contract with a service provider, whether a public agency, a private firm, or a nonprofit organization. The flexible performance framework metatool we described in Chapter Seven is an organizational performance agreement, often accompanied by a performance contract with the chief executive. In the U.K., for example, departments negotiate five-year "framework documents" with executive agencies. Agency chief executives then sign individual performance contracts that typically include a bonus for delivering on their targets. The contracts are good for five years—at which point the executives must compete for their jobs. "That concentrates the mind a bit," says Michael Fogden, former head of the Employment Service. The U.S. General Accounting Office agrees. It found that Britain's "chief executives were acutely aware of their visible personal responsibility and accountability for the success of their agencies."



New Zealand also put its chief executives on performance contracts. By 1995, only 6 of the 33 in place when it began the practice in 1988 were still employed as chief executives. Even Costa Rica has negotiated performance contracts between its president and his department heads.

U.S. school boards have traditionally contracted with superintendents—

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but usually without specifying the results they wanted. This is changing in some districts, because superintendents are asking for performance contracts. In others, school boards are turning to performance contracts to hold superintendents' feet to the fire.

In Swanton, Ohio, Superintendent Roger Barnes announced in 1994 that he would resign if the district did not achieve a 10 percent increase in the number of ninth graders passing all four sections of the Ohio proficiency exam. Barnes had just signed a five-year contract. He says his unusual move led "my colleagues in the superintendency [to] wonder what would inspire me to make such a commitment. They feel I am either crazy or bored with my current position."

In reality, Barnes was neither crazy nor bored. He was concerned. His school district's scores on state tests were the lowest in the county, he says.

> *I realized I had to make a statement to indicate to the community that we were maintaining our strong commitment to academic improvement. By holding myself ultimately accountable for the continued progress of student performance, I sent a crucial message.*

Some of Barnes's staff told him his announcement put "undue pressure" on them, he reports. For others, his goal became a focal point for renewed efforts to improve student performance. And that is precisely the point of performance contracting. When top managers are accountable for producing specific results, they are more likely to lead their organization to produce them.

Performance Contracting: Pitfalls to Avoid

Chapters Seven and Ten offer numerous lessons about performance contracts with both public and private organizations. Performance contracting with individual managers is not quite as challenging, but it has its share of potential pitfalls. The general lessons on performance management offered earlier cover many of these. We discuss a few more pitfalls—and how to avoid them—in the paragraphs that follow.

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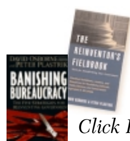
pp. III/106-120

Elected officials may not follow up on their commitment to performance contracts. In the U.S., for example, Vice President Al Gore's National Performance Review drew on overseas experiences to recommend in 1993 that the president develop written performance agreements with department and agency heads. Two and a half years later, only a handful had been completed. Similarly, the Labor Government in New Zealand was slow to follow up after it required performance contracts with department executives.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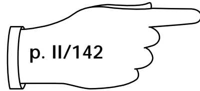
Part of the problem is that politicians get distracted by more pressing issues. Some, however, don't really believe in the tool, because they don't want the public to have information about the performance of their government. Clinton's Office of Management and Budget fought to wipe out all quantifiable elements of performance agreements with cabinet secretaries, to prevent failures that might embarrass the president. The only solution to this obstacle is to send a clear message from the top—something that requires courage.

Another barrier is that elected officials often don't know how to use performance contracts. They have trouble specifying what they want agencies to accomplish, in measurable terms. In other words, they have trouble steering. In New Zealand, for example, elected ministers had great difficulty figuring out what to put into their contracts with agency chief executives.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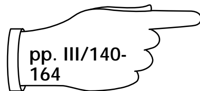
To ensure effective implementation of performance contracts, managers must help elected officials with performance measurement. To create pressure to secure agreements, we suggest that you tie agency budgets to the presence of a performance agreement: no agreement, no budget.


pp. III/140-164

Performance contracts may only contain vague measures. If you do not nail down specific performance measures, you may not be able to tell at the end of the contract how well the manager performed. For any measure under consideration, ask yourself if the data will really help you judge the quality of performance.

The pool of talent from which top managers is selected may be too small. Performance contracts are only as good as the people who sign them. A number of governments—including New Zealand and the U.K.—have used the shift to performance contracting as an opportunity to break the civil servant monopoly on top public management positions. They have changed the rules to allow private sector managers to compete for the jobs.

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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 Eleven

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