The Price of Government:
Getting the Results We Need in An Age of Permanent Fiscal Crisis

by David Osborne and Peter Hutchinson

American government is waist deep in its worst fiscal crisis since World War II. And this one is permanent, because many of the forces that created it are hardwired into our fiscal environment. Most prominent among them are a colossally irresponsible president and Congress, an obsolete tax structure, an aging population, an ineluctable rise in the cost of health care, and continuing resistance to major tax increases. Economic recovery will ease the pain, but it will not eliminate it.

The president's tax cuts and spending increases, passed enthusiastically by Republicans in Congress, have blown a hole in fiscal policy that will be difficult to close. The 2004 deficit is expected to weigh in at *$521 billion*. Federal revenues in 2003 were the lowest, as a percentage of Gross Domestic Product (GDP), since 1950. In January 2004, the Congressional Budget Office forecast that at current spending and tax levels, President Bush's plan to make most of his tax cuts permanent would increase the national debt by *$4.1 trillion* over the next decade—a *60 percent* increase in just 10 years.

Meanwhile, many states, cities and counties have faced record shortfalls and made deep spending cuts for three years running. State revenue systems are deteriorating, as more corporations move their operations offshore, Congress and the Supreme Court forbid most taxation of Internet commerce, and most states still exempt services – which now account for 60 percent of all consumer spending -- from their sales taxes.

All of this pales compared to the aging of the population. With average life spans pushing 80, we spend ever greater portions of our income on the elderly. The Congressional Budget Office projects that under current law, even if the historical growth of Medicare slows a bit, the price of Social Security and Medicare will rise from about 6.6 percent of GDP to almost 15 percent by 2030 and almost 22 percent by 2050. To put this in perspective, *total* federal expenditures for all programs have averaged only 20 percent of GDP for the past 50 years. Without significant reform, Social Security, Medicare, Medicaid, and interest on the debt will consume the entire 20 percent within 25 years.

The real time bomb hidden in our ever-longer life spans is the cost of health care, which has been rising by 10 percent a year since 1960. It now eats up 15 percent of GDP, and governments pay 45 percent of that total. The rise appears both inevitable, because of our aging population, and unstoppable, because the American people wouldn't have it any other way. When technology can give us longer life spans—with new hearts and hips and knees, new drugs for cancer and heart disease and AIDS, new machines to scan our insides for problems—we will continue to shell out for the best medicine has to offer. And because we refuse to junk our aging loved ones as if they were worn-out machines, we will spend an ever-rising portion of our health care dollars on the elderly.

Skyrocketing health-insurance premiums are bad enough. Because they consume an ever-increasing share of our profits and paychecks, however, they also erode our ability to pay taxes to support public spending on health care. Yet that very spending is exploding. In 1985, Medicaid cost $40 billion and consumed 11 percent of state budgets; today it costs $230 billion and consumes 20 percent. (Health insurance for state employees and the non-Medicaid poor takes another 10 percent.)

It's not hard to see why. The elderly made up less than 10 percent of Medicaid recipients in 2000, but they consumed 28.3 percent of spending. Medicare, which is exclusively for the elderly, cost $278 billion in 2003, nearly 10 times what it cost in 1970, even after adjusting for inflation. The cost of services associated with the graying of our population is simply eating government alive.

Since the fiscal storm broke, state and local governments have flailed about, grabbing any solution that could keep them afloat for another year. The tidal wave of red ink has triggered accounting gimmicks and deceptions worthy of Enron: shifting next year's revenue into this fiscal year; pushing this year's spending onto next year's books; borrowing from future revenue to pay this year's costs; or just making things up. When sleight of hand is no longer enough, our leaders have sometimes turned to across-the-board cuts, which weaken every program equally, regardless of the impact on citizens.

But as shortsighted or thoughtless as these tactics may be, they all obscure the fundamental flaw in the conventional approach to fiscal crisis. The true outrage is that traditional budget cutting focuses entirely on what we cut, while ignoring what we keep. It does little to improve the effectiveness of the 85 or 90 percent of public dollars that continue to be spent. It never broaches the question of how to maximize the value of the tax dollars we do collect.

This is primarily because traditional budgets are organized around departments, agencies and programs, not results. Most public budgets are little more than itemized bills from agency or department heads and politicians for the costs they want citizens to pay. These public leaders can tell citizens how much a program will cost, but not whether it will make a difference.

Some conservatives are happy with this situation; they don't mind beggaring government to "starve the beast." Many liberals, on the other hand, plead for higher taxes to protect spending for the poor and other core constituencies. Few from left or right ask the most fundamental question: How can citizens get the most value for the taxes they pay? Addressing this issue is neither liberal nor conservative—it is just plain common sense.

Smarter Government

Success in today's era of permanent fiscal crisis requires smarter ways of doing the public's business. Our new book, *The Price of Government,* describes a series of proven innovations that elected officials at every level of government can emulate. We show not only how vital services can survive the fiscal crisis, but how leaders can turn that crisis into an opportunity to reinvent the way their bureaucracies work. We begin with smarter budgeting—specifically, what we call Budgeting for Outcomes.

In government, as in most realms of life, we find it safer and easier to do what we've always done, simply because we've always done it. Only on rare occasions — usually at times of crisis — do we step back to gain a broader perspective, erase all our preconceived ideas and routine behaviors, and take a fresh look at how to make the most of our limited time and resources. Budgeting for Outcomes allows public leaders to do some of this big-picture, creative thinking *each time* they prepare a budget. In fact, the process demands it.

Budgeting for Outcomes was pioneered by Governor Gary Locke of Washington, at a time when his state faced a $2.5 billion shortfall. (Locke's approach was chronicled in the April 2003 issue of *Blueprint*.) The Seattle Times described the rationale for Locke's approach this way:

> *The usual, political way to handle a projected deficit is to take last year's budget and cut. It is like taking last year's family car and reducing its weight with a blowtorch and shears. But cutting $2 billion from this vehicle does not make it a compact; it makes it a wreck. What is wanted is a budget designed from the ground up.*

In traditional budgeting, leaders start with last year's costs, then add or subtract. In Budgeting for Outcomes, they start with the results citizens value. This approach clears away all the games department's play – padding costs and hiding excess, to protect themselves against the inevitable cuts. It focuses squarely on the real issue: producing results citizens value at a price they are willing to pay.

Governor Locke's effort produced impressive results, even though Washington State's budgeters did not have time to go the "full Monty." The key steps in a complete process of Budgeting for Outcomes include:

Getting a grip on the problem: Getting beyond denial and deception begins with getting a grip on the reality of the fiscal crisis. How much is short-term and how much is long-term? Is it driven by revenue or expenses, or both?

Set the price of government: Establish up front how much citizens are willing to pay for government's services. Get agreement on a revenue forecast and any tax or fee changes. Recognize that citizens have figured out what price (the sum of all taxes, fees and charges as a percentage of personal income) they are willing to pay, and that price has probably remained relatively steady for decades.

Set the priorities of government: Define the five or ten outcomes that matter most to citizens, along with indicators to measure progress.

Set the price of each priority: Divide the price or revenue among the priority outcomes on the basis of their relative value to citizens.

Develop a purchasing plan for each priority: Create "results teams" to act as purchasing agents for the citizens. Ask each one to decide which strategies have the most impact on their desired outcome. Ask them to start by developing a strategy map—using available evidence about "what really matters" to create an explicit cause-and-effect diagram showing the best ways to achieve their desired outcome. With a cause-and-effect theory in hand, they can draw up a general purchasing plan, laying out the key strategies they would use to produce that outcome.

In contrast to traditional budget development, this process stimulates enormous creativity, because it requires those involved to be clear about how they think activities add up to results. Doing so subjects each "theory of what matters most" to a challenge from every competing theory—exactly the kind of debate the budgetary process should stimulate.

Solicit offers to deliver the desired results: Have the results teams issue "requests for results" to all comers, including their own government's agencies or departments, other governmental jurisdictions, unions, non-profits and businesses. Invite these "sellers" to propose how they would deliver the strategies and outcomes—and at what price. Then buy those proposals that experience suggests will provide the best results for the money.

Negotiate performance agreements with the chosen providers. These should spell out the expected outputs and outcomes, how they will be measured, the consequences for performance, and the flexibilities granted to help the provider maximize performance.

Budgeting for Outcomes focuses attention squarely on the need to buy better results—and deliver higher-value government—with the revenue that's available. The next question is "how?" The answer is smarter sizing, spending, management, and work processes. Here are ten proven methods:

1. Strategic Reviews: Divesting to Invest. Because time is short during budget season, smart leaders create ongoing review processes—outside the budget process— to develop new strategies and eliminate programs that are not central to their core purposes or are no longer valuable to citizens. There are many tools they can use to comb through every organization, from top to bottom, including program reviews, sunset reviews, special commissions, and subsidy reviews.

2. Consolidation. Politicians love to merge organizations, because it looks like they're taking action to save money. But simply moving boxes on an organization chart can actually make matters worse, increasing costs while sowing confusion that hampers performance. A much more powerful alternative is to consolidate funding streams and policy authority into "steering" organizations that can purchase results from any "rowing" organizations—public or private—that can best produce them.

Consider the Pinellas County Juvenile Welfare Board, in the Tampa, St. Petersburg area. The board uses $46 million a year from a dedicated property tax to contract with some 60 different not-for-profit organizations to improve outcomes for poor children. It does no rowing itself, but these 60 providers offer a wide array of services, from child-care centers to parenting skills to teen centers to residential treatment services. The Juvenile Welfare Board measures their performance, weeds out the least effective, and moves money to strategies and organizations that demonstrate the greatest impact.

3. Rightsizing. Some organizations work better when reduced in size, but others are crippled. Finding the right size does not start with layoffs. Rather it starts by asking whether organizations are doing the right work, aimed at producing the right results, in the most effective way. Then it is essential to make sure the organization has the right staff with the right mix of skills to maximize the value delivered. Eliminating bureaucratic layers and closing regional offices can help an organization find the right size, while human-capital planning can help it develop the right skills.

Consider the Iowa Department of Transportation, which eliminated seven construction offices, 5 maintenance offices, and 27 maintenance garages during the recent fiscal crisis. It cut 403 positions (11 percent of its workforce), increasing the average span of control from one manager for every 9 employees to one for every 14. To protect services like snow plowing and highway maintenance, the department bought new technology and cross-trained employees, so the same workers now handle both construction and maintenance. The bottom line: $35 million in annual savings with only no significant impact on core services.

4. Buying Services Competitively. The fastest way to save money and increase value is to force public institutions to compete. Nobody who doesn't own one thinks monopoly is good for business. Why should it be any different in the public sector? When Steve Goldsmith was elected mayor of Indianapolis during the last fiscal crisis, he decided to make public agencies bid against private firms for the right to continue delivering public services. Over the next four years he bid out more than 30 services, from garbage pickup to operation of the city's wastewater treatment system. Close to half were won or shared by public agencies; the rest were won by private organizations. The average amount saved the first time a service was bid competitively was *25 percent.* Over seven years, competition saved Indianapolis more than $120 million.

5. Rewarding Performance, Not Good Intentions. If public-sector managers don't know what they're getting for their money, chances are they aren't getting it. The solution is to set performance targets at all levels, measure performance against them, and reward those who improve. In a time of fiscal crisis, however, positive outcomes aren't enough. The new imperative improved outcomes for less money: value for dollars.

Baltimore provides a perfect example: With his Citistat initiative, Mayor Martin O'Malley requires every department head to personally stand up and report on performance every two weeks. By giving direct, immediate, personal feedback, the Mayor and his staff hold their department heads accountable for solving problems, improving performance, and saving money. In its first year alone, the initiative saved the city $13.6 million, helped cut violent crime by 24 percent and emergency hospital visits due to drug overdoses by 25 percent, and eliminated all but 200 of 2,700 illegal dumping grounds. Since O'Malley formed a "Leadstat" team, more than 1,000 sites have been cleaned up and lead poisoning among children is down 36 percent.

6. Smarter Customer Service: Putting Customers in the Driver's Seat. When public organizations let their customers choose between providers, rather than imposing services on them, they can achieve much greater customer satisfaction at less cost. With some services, the Internet even makes self-service possible, at enormous savings. But consider a low-tech service like care for developmentally disabled children.

During the 1990s, Minnesota's Dakota County stopped using grant funds to pay agencies for services and instead provided grants directly to families. The families chose the services they wanted, subject to certain controls, to make sure they used the money responsibly. This dramatically improved customer satisfaction, because families could now decide what made sense for them—for example, having one parent quit work to care for a child, rather than using a caregiver paid by the county. Everyone was better off, and the county saved money. The innovation was so successful that it was adopted statewide.

7. Don't Buy Mistrust—Eliminate It. The sad truth of bureaucracy is that 20 percent of government spending is designed merely to control the other 80 percent. The ruling assumption is that most of us, given the opportunity, will lie, cheat, and steal. Not only does this approach undermine performance, it is incredibly expensive. The smarter move is to first win voluntary compliance by simplifying the rules, working in partnership with and educating compliers, making the process of compliance easier (without lowering the performance standards), creating incentives that reward compliance, and reserving punishment for those who willfully violate the rules.

Ten years ago, for example, U.S. Occupational Safety and Health Administration (OSHA) officials in Maine were intensely frustrated by the failure of their traditional inspect-and-fine approach. While they won gold medals from Washington for issuing the most citations and fines, Maine's workplace safety records were the worst in the nation. So they decided to try something different: They asked the 200 employers with the highest volume of injury claims—45 percent of the state's total—to create employee teams that would survey hazards in their plants and correct most of them within 12 months. As long as the company was making a good-faith effort, OSHA would forgo its traditional inspections and fines.

It worked. Over the previous eight years, OSHA inspectors had identified 37,000 hazards at 1,316 work sites. In the new program's first two years, employee teams identified 174,331 workplace hazards and corrected 118,671 of them. Two of every three companies decreased their injury and illness rates, and payable worker's compensation claims by the 200 dropped by 47.3 percent—far outpacing declines in other companies.

8. Using Flexibility to Get Accountability. From the governments of New Zealand and the United Kingdom to the U.S. Education Department's Office of Federal Student Aid (FSA), examples abound of "performance-based organizations" that have willingly accepted greater accountability in return for freedom from rules and regulations that impede performance. Charter schools use the same formula, with even more independence and accountability: They are free from many state and district rules, and most operate independently of any district, but they can be closed down if they don't perform. Governor Tom Vilsack of Iowa is even working on a "freedom communities" initiative, in which the state would give groups of local cities and/or counties new flexibilities if they modernized their structures, combined services and created mechanisms to measure performance and report it to the public.

9. Making Administrative Systems Allies, Not Enemies. All organizations are creatures—or prisoners—of their internal systems. Traditional budget, accounting, personnel, procurement, and audit systems are nests of red tape that tie employees up in knots. The messages these systems send about following bureaucratic rules are much more powerful than any leadership exhortations to perform better.

To get lasting improvements in performance, public leaders have to modernize and streamline these systems. The payoff is dramatic savings: Two major procurement reform bills passed by Congress, in 1994 and 1996, had already saved $12 billion by the end of 1997. Milwaukee's Purchasing Department was able to cut its staff by nearly two-thirds and its budget by more than 55 percent by simplifying processes, investing in technology, and giving more authority to departments. Montgomery County, Maryland, managed to shrink its accounts payable staff by more than half simply by giving departments authority to pay invoices in amounts up to $5,000 rather than sending them to central accounts payable.

10. Smarter Work Processes: Tools from Industry. To do more with less, organizations must ultimately change the way they work. Some of this involves wholesale substitution of new methods and strategies. But much of it requires that existing work processes of all kinds—from street repair to eligibility determination to tax collection—be streamlined.

Industry has developed several powerful tools to do this. Total Quality Management trains and empowers small teams of employees to make continual small improvements in their work processes. WorkOuts, invented at General Electric, bring people together for three to five days to solve problems; leaders set a time limit for finding answers, approve or reject recommendations on the spot, and keep everyone on the job until it is done. And Business Process Reengineering is radical, "clean sheet" redesign of complex, large-scale business processes, to increase their efficiency and quality in dramatic ways.

That citizens want value for their money is no mystery. We all want as much value as we can get from each dollar we spend—including what we spend on government. The price and value of government are up against the price and value of housing, food, clothing, health care, and countless other goods and services that meet people's needs. The price of government is limited, therefore, by the value that citizens want—and get—from government, compared with the value they want and get elsewhere. Government can compete—and stay relevant—only by delivering more value per dollar.

The rising costs of health care, social security, public pensions, prisons, and interest on the public debt have put the price of government under immense upward pressure. Yet that pressure has met enormous resistance to broad-based tax increases. President Bush and the Republican Congress have pushed the federal price of government down to its lowest level in 50 years, by cutting taxes and borrowing the difference. Spending borrowed money may create the illusion that we're getting more for our money, but it is virtually impossible at the state and local levels, because such massive borrowing is nominally illegal. Yet resistance to tax increases remains strong, because too many voters feel they aren't getting value for their tax dollars.

This fiscal collision is undermining vital state and local services, while generating massive federal deficits. But given the political realities, we believe that our governments and school districts must dramatically improve the services they offer, if citizens are to willingly pay a higher price. *Any significant change in the price of government is impossible until the majority of Americans feel they are getting real value for their tax dollars.* And the only way to accomplish that is to reinvent the way we do the public's business. Our public institutions must learn to work harder, but more important, they must learn to work smarter.

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