Making Government Work

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Lessons from America's Governors and Mayors

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CHAPTER FIFTEEN

City Services in the Competitive Marketplace

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Observing the Private Marketplace

Every day, the private sector introduces new products, improves old ones, expands services, and, in general, reduces costs. The desktop computer on which this chapter is being written, for example, was nonexistent 25 years ago and essentially unaffordable until very recently.

Government, on the other hand, becomes less responsive and more expensive over time. Spending by the federal government increased from $92 billion in 1960 to $1.5 trillion today. Yet almost no one would say that government services are better today than they were 40 years ago.

Why are private-sector companies more efficient, more customer-oriented, and more innovative than government? The answer is that these companies must compete in the marketplace, and they will go out of business if customers do not like the goods and services they offer. No matter how successful a company is today, if it loses touch with its customers' needs or charges too much, someone will steal its customers away tomorrow.

Government, which has a lock on the delivery of a wide range of services and the management of many assets, is not only a monopoly, but a particularly effective form of monopoly:

- Government cannot go out of business. Every citizen of the United States, like it or not, is a customer for government services—and a new customer is born every eight seconds. Poorer Americans in particular are customers for government services because they cannot afford to go elsewhere.
- Government controls revenue. If more money is needed to provide a service, government can and will raise taxes to pay for it. Whereas the private sector must persuade people to make purchases, government simply takes dollars. If a citizen decides not to buy what government is selling by refusing to pay taxes, that citizen will wind up in jail. General Motors would never close a plant if it could seize the assets of people who do not buy their cars.
- Government is allowed to spend more than it takes in. While many states and cities are required by law to enact balanced budgets, many government entities are not—including the federal government. And even governments that by law must balance their budgets nevertheless avoid doing so by borrowing, deferring capital spending, and employing bookkeeping devices. Private companies and families can only deficit spend in the short term before going out of business; government can go into debt indefinitely.
- Government delivers "essential services." Whenever reform-minded managers or elected officials exert pressure to reduce costs, status-quo managers can mount an effective defense by pointing to the essential nature of their task. A call for budget cuts in a municipal Department of Public Safety, for example, might be met with a cry that the streets will be less safe. Attempting to slow the growth of education spending might be met with a challenge such as, "Aren't our kids worth a few extra dollars a month?" This is a strategy that resonates powerfully with constituents, who have neither the time nor the inclination to scour budgets to see if savings are possible without cuts in service quality.

What limits government's incentive to be efficient is not public ownership per se, but the monopoly that government enjoys over the services it provides. The key issue is not public versus private—it is monopolistic versus competitive delivery. This is why in Indianapolis we prefer the term "marketization" to the more commonly used "privatization." As a rule, one can predict the responsiveness and efficiency of a company by the amount of competition its products face. The more rigorous the competition, the better the product. Utilities and large monopolies, for example, tend to be less efficient and customer-oriented. To the extent that we move services into the marketplace, or create markets for their delivery, we can increase efficiency, improve service quality, and reduce costs.

Moving Services into the Marketplace

One of the challenges in moving services into the marketplace is that governments at all levels diversified over time in order to support the services we think of as fundamental. For decades, governments vertically integrated themselves into performing services that would be best performed by the private sector. And it will probably take decades for governments to peel back the layers and return to providing only the services that are their proper province. Still, some services are more obvious candidates for competition than others, and identifying these "low-hanging fruit" can provide governments with lucrative and relatively straightforward competitive initiatives.

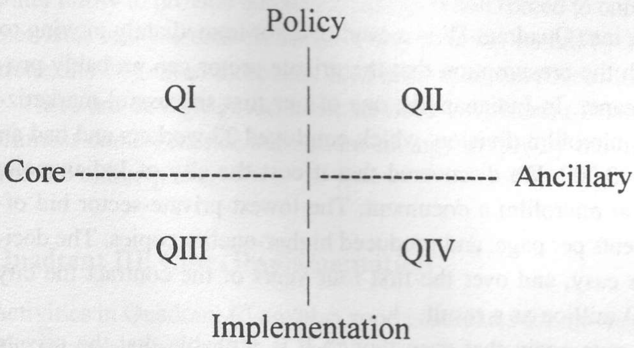
This can be a confusing and controversial task, because managers always insist that their jobs are fundamental to government operation. There are a few basic questions that managers can ask themselves to determine a given service's "ripeness" for competition, however. Based on what we in Indianapolis observed during our on-the-job training, figure 15.1 is a useful tool for thinking about services to be competitively bid.

Core vs. Ancillary

The horizontal axis of the graph below (figure 15.1) describes whether an activity is a "core service" that government must provide for citizens—a necessary, nondivisible public good—or whether it is an "ancillary service" performed, presumably, to support the provision of core services.

The core service behind any given activity can often be determined simply by repeatedly posing the question, "Why is this service necessary?" Each iteration

Figure 15.1 Thinking About Services to be Competitively Bid: Core vs. Ancillary.



will move the answer closer to a core service. For example, Indianapolis operates a Central Equipment Maintenance Division that, among its other duties, changes the oil in police cars. Why does it do so? Because the city's Police Department needs a well-maintained fleet. Why? So that police officers can patrol, make emergency runs quickly, and pursue suspects if necessary. Why? So that the Police Department can protect the public. Why? At this point, the answer is: protecting the public is a core service.

Therefore, the position of a given activity along the horizontal axis of this graph is determined by how closely it relates to the performance of a core government service.

Policy vs. Implementation

This is similar to the distinction David Osborne described in *Reinventing Government* as the difference between "steering" and "rowing." Does the activity by its nature require the making of policy, or is it an activity that involves the implementation of policy that has already been established?

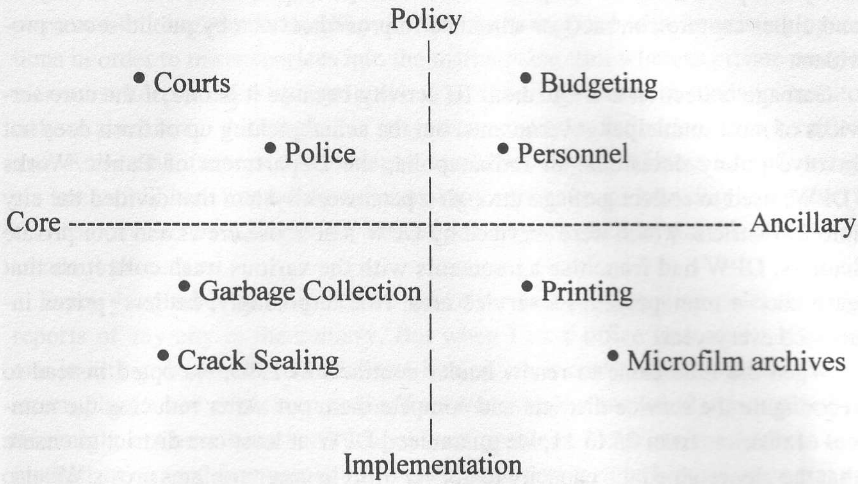
The distinction between policy and implementation is often difficult. Reasonable people could differ about whether a police officer recognizing a certain behavior as domestic violence and making an arrest is making a policy decision or implementing policy. However, some activities are easily identifiable as more policymaking than others: deciding to equip city buses with lifts for the handicapped is a policy decision; installing the lifts is implementation. The position of an activity along the vertical axis is determined by how much policymaking it requires. Plugging various services into figure 15.1 results in the figure 15.2.

Quadrant IV: Ancillary, Implementation

Any service that falls into Quadrant IV is a candidate for immediately moving to the marketplace, with the presumption that the private sector can probably provide it better and cheaper. In Indianapolis, one of our first successful marketizations was the city's microfilm division, which employed 22 workers and had an annual budget of $700,000. We discovered that it cost the city of Indianapolis 10.5 cents per page to microfilm a document. The lowest private-sector bid offered a price of 3.3 cents per page, and produced higher-quality copies. The decision to privatize was easy, and over the first four years of the contract the city saved more than $1.3 million as a result.

It is important to note again that even though it is probable that the private sector can provide any Quadrant IV service better and at lower cost than govern-

Figure 15.2 Thinking About Services to be Competitively Bid: Policy vs. Implementation.



ment, it is the process of competition, and not merely provision by the private sector, that produces cost savings.

Indianapolis provides an example that illustrates this point as well. Each month, the Department of Public Works sent out bills to its customers for sewer service; this service cost the city $3 million each year. Since this activity almost exactly parallels the billing procedure of our local water utility, we approached the utility about taking over the city's sewer-user billing. The water utility made a proposal that would have saved us 5 percent annually on our sewer billing. Not satisfied, we approached other utilities in the area and asked them to bid with the water utility to provide our sewer billing. When forced to compete for the service, the water utility creatively found a way to lower its bid by 70 percent. Last year alone, the city saved more than $3.5 million on the cost of billing its sewer users.

There are enough government services in Quadrant IV that any level of government could generate substantial savings simply by moving all these services into the marketplace.

Quadrant III: Core, Implementation

Activities in Quadrant III are also good candidates for moving to the marketplace. But because these activities are closer to core services of government, government may actually be able to provide them cheaper than the private sector. Therefore, Quadrant III services provide the best opportunities for public employees to win contracts. It is also probable that if Quadrant III activities are competitively bid, private-sector companies will develop competencies in these activities and either capture contracts or stimulate improved service by public-sector providers.

Garbage collection is a Quadrant III activity because it is one of the core services of most municipal governments, but the actual picking up of trash does not involve policy decisions. In Indianapolis, the Department of Public Works (DPW) used to collect garbage through a patchwork system that divided the city into 25 districts, which were serviced by DPW's in-house crews and four private haulers. DPW had franchise agreements with the various trash collectors that gave each a monopoly in its service area. Not surprisingly, haulers' prices increased every year.

When the time came to renew hauler contracts in 1993, we opted instead to reconfigure the service districts and compete them out. After reducing the number of districts from 25 to 11, we guaranteed DPW at least one district to ensure that the city retained the capacity to collect trash in case problems arose. We also limited private collectors to a maximum of three districts to prevent monopolistic situations and predatory pricing.

Empowered and cost-conscious DPW employees found ways to provide more service for less money and won the maximum three districts in the process. Competing out garbage collection resulted in more than $15 million in savings over the following three years, and more than $9.5 million in additional savings was projected for 1997 alone.

Quadrant II: Ancillary, Policy

Our experience is that most of the activities in Quadrant II are carried out by the Department of Administration. Decisions about personnel policies and budgeting are several steps removed from the provision of core government services but involve reasonably important policy choices.

Quadrant I: Core, Policy

Quadrant I includes services and activities that could be considered both "core" and "policy"—such as zoning, police and fire protection, and the courts. These activities will probably be the last that an entrepreneurial government examines in its efforts to move services into the marketplace.

Activity-Based Costing

Regardless of the service being considered for competition, governments must possess a thorough understanding of the costs associated with its existing operations in order to move services into the marketplace. But whereas private companies must keep a close eye on costs at all times, government tends to monitor only expenditures. Although this may seem a subtle distinction, it is a critical one. A car manufacturer, for example, would not stay in business long if managers knew only how much they spent making cars, without knowing how much it cost to manufacture a single car. Yet for government at all levels, this tends to be standard procedure.

Every year Indianapolis produces one of the best-looking, four-color financial reports of any city in the country. But when I took office in January 1992, no one in city government could tell me how much it cost to fill a pothole, pave a street, plant a tree or pick up trash. If we were simply interested in privatization, this might not have been such a significant problem. However, our interest is in marketization, and any reasonable evaluation of competitive bids requires that we know how much a given activity costs us to perform in-house.

In the spring of 1992, we hired KPMG Peat Marwick to lead a process called activity-based costing (ABC). For every identifiable activity of government, ABC would determine the cost of everything that went into producing that activity. The process used private-sector definitions of depreciation and loaded in all the costs of idle equipment, building space, and other fixed costs.

Our Department of Transportation's snow-plowing operation was one of the first services we subjected to the activity-based costing process. The results provided a good example of how the simple act of measuring costs can by itself improve the quality of service. We divided the snow-plowing groups into regions and then analyzed the costs of each activity associated with plowing snow. First, the consultants examined all of the equipment used, then all of the materials, then all of the labor for every mile of snow plowed. Managers discovered that the cost of plowing snow varied wildly from region to region. The labor cost of plowing a mile of snow was $39.90 per mile in the central region, but only $13.20 in the southeast region. The cost of materials varied from $48.97 in the southwest region to $9.25 in the northeast region. Total cost for plowing one mile of snow ranged from $117.59 in the southwest region to $39.96 in the southeast.

Now, it may be that differences in topography, road layout, or miscellaneous other factors contributed to some of the difference in cost between regions, but it was clear to us that they could not account for such a huge discrepancy. By examining the numbers and applying the best management practice in each region to all the regions, we were able to improve the mix of equipment, resources, and training in each location.

As this example shows, there are benefits to the costing process wholly independent of competition. Because every dime of government spending is allocated to some outcome, managers scramble to reduce waste and overhead.

Although we did not compete out Indianapolis's snow-plowing operations, we did compete out more than 70 other city services, none of which would have been possible without activity-based costing. Using private-sector rules for our accounting allowed city workers and managers to prepare legitimate internal bids and provided us with a meaningful standard against which to compare private proposals.

Maximizing Value

Simply saving money is not enough. Government must respond to customer preferences and maximize value from every tax dollar it spends. Toward this end, measuring and rewarding performance become indispensable, requiring officials to pay close attention to what government actually produces and not simply the amount of money it spends on a given service. This task is complicated by the previously mentioned vertical integration of government, which makes it difficult for managers to distinguish between outcomes and outputs.

For example, everyone expects the Police Department to make the city safer—an outcome. Yet somehow this led the Indianapolis Police Department to operate a full-service print shop that prints the department's own tickets and arrest warrants—an output. Everyone expects the Public Works Department to dispose of sewage in a way that enhances water quality—an outcome. Yet somehow this led Indianapolis to spend tens of thousands of dollars assembling a television studio just to make training tapes—an output.

Distinguishing outcomes from outputs can be extremely difficult. Early in my administration, at a meeting of the city's department directors I expressed my frustration at our progress in being able to measure our performance. I told the director of the Department of Transportation that I wanted to know exactly how many potholes his crews filled in a week. "I thought you wanted to measure performance," he replied. "You shouldn't care how many potholes my department fills. You should care how smooth the roads are. How do you know we're not doing such a poor job filling potholes that we have to go back out and redo them later?" He was right—smooth roads are the outcome; filling potholes is the output.

Because government simply confiscates dollars rather than competing for them, government managers do not get good information about their customers' needs and wants. Therefore, government must invent processes to determine preferences, including neighborhood forums, focus groups, and public-opinion surveys. In contrast, in the private marketplace it is a relatively straightforward task to determine what outcomes people desire: follow their dollars. Do they spend their earnings on vacations? A mortgage? Their children? Marketplace activity demonstrates what outcomes people value and how much they are willing to pay to produce them.

In Indianapolis, our goal is to produce added value for our citizens. It is therefore our responsibility to shift resources toward activities that produce desired outcomes for citizens. Whenever we produce more of a desired outcome without increasing cost, or produce the same outcome at a lower cost, we add value for our customers. If we cannot produce a dollar's worth of outcome for every dollar's worth of government spending, then we must not spend the dollar. For our managers, this equation is the bottom line.

An example from my days as a prosecuting attorney illustrates the point of the value equation. Having determined that making an arrest for domestic violence made the recurrence of violent activity less likely, we set up an enhanced prosecution effort and devoted substantial resources to it. Eventually, a researcher asked what should have been an obvious question: Does the additional sanction of prosecution over and above the initial arrest further reduce the recurrence of violence?

As we soon discovered, the answer in most cases was *no*. We were devoting substantial resources to do something very effectively that did not produce the outcome most desired by citizens—a reduction in domestic violence. Clearly that does not mean we should not fully prosecute and seek convictions for those who commit domestic violence. But if our desired outcome is to decrease domestic violence, and if we have limited financial resources, then we should know how to focus our resources to achieve the desired outcome most frequently.

Only by identifying a clear and specific set of outcomes can managers truly begin to maximize value. Of course, measuring and pricing these outcomes are useful only insofar as managers are willing to act on that knowledge to improve service delivery. Government bureaucracies are notoriously rigid, and it takes powerful incentives to motivate government employees to break with traditional practices and implement creative solutions.

Competition Is Key

It is competition that causes managers to take the activity-based costing process seriously and use the new information at their disposal to make prudent choices about service delivery.

When we announced that we were going to open up a part of our Department of Transportation's (DOT's) crack-sealing operation for competitive bid, the drivers' union made the legitimate point that if we wanted it to compete for the bid, we had to free it from all the unnecessary overhead that was loaded into its budget. It turned out that in this particular division, there were 32 managers supervising 94 workers. This was not a good ratio by anybody's standards, so we complied with the union's request and eliminated 14 of the 32 managers. Armed with greater decision-making authority, front-line workers found creative ways to improve efficiency dramatically. For example, union workers determined that they did not really require eight men working with two trucks to seal cracks. By removing a certain piece of equipment from the second truck and adding it to the first, DOT could seal cracks with one truck and five workers. The union bid for the job and won. When asked about the competitive process afterwards, one of the DOT workers said, "It was like going from darkness into daylight."

The DOT example taught us that if we are serious about allowing public employees to compete for contracts, it is our duty to free them from as much unnecessary bureaucracy and cost as possible. To encourage city workers to seek out unnecessary costs, I established a Golden Garbage Award to be given on a regular basis to city employees who find egregious examples of government waste.

The December 1992 winner of the Golden Garbage Award was a manager at the city's Advanced Wastewater Treatment (AWT) plant. Several years ago, the Department of Public Works set up a full-service television studio to make training tapes for new AWT employees. At the press conference announcing that we would get rid of this equipment, the manager was asked why he had identified the studio as government waste. The manager answered: "We aren't in the business of video production. We're in the business of training employees. Eventually, we will be asked to compete against private-sector providers of training services, and all of this equipment—and the cost of this wasted square footage—will be loaded into my overhead. If I'm going to compete, I need to get rid of all this." He answered exactly the way an efficient government manager should.

Conclusion

In addition to getting more value for tax dollars, properly structured marketization can also provide business opportunities for citizens, especially minority and women business owners and enterprising residents of poorer urban neighborhoods. For example, contracts with private companies can require vendors to use their best efforts to do business with minority- and women-owned enterprises. In Indianapolis, many vendors exceed the targeted participation levels specified in their contracts and surpass the city's previous commitment to these businesses—not as set-asides, but through market-driven, value-added decision making.

Likewise, competing out city services can offer real business opportunities for residents of poor neighborhoods. In the current system, we tax people in poor neighborhoods, accumulate their limited wealth, and then use that wealth to hire a worker from outside their neighborhood—a Parks Department worker from a middle-class neighborhood, for example—to come in and provide a service that the neighborhood may not want in the first place. By competing out the delivery of services, municipal governments can provide opportunities for neighborhood-level business development, as neighborhood groups can bid to perform their own services and use the revenue stream to leverage other possible business opportunities.

Perhaps most important, to the extent that marketization reduces the size and cost of government, it leaves more money for families to spend themselves. Moving services into the marketplace can be the fairest, most populist way to approach city services.

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