

Making Performance-Based Contracting Perform: What the Federal Government Can Learn from State and Local Governments

New Ways to Manage Series



Lawrence L. Martin
Associate Professor
School of Social Work
Columbia University

IBM Endowment for
**The Business
of Government**

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F O R E W O R D

November 2002

On behalf of the IBM Endowment for The Business of Government, we are pleased to present this report by Lawrence L. Martin, "Making Performance-Based Contracting Perform: What the Federal Government Can Learn from State and Local Governments."

This report comes at a very opportune time. In April 2002, the Office of Federal Procurement Policy (OFPP) formed an interagency working group to examine performance-based contracting in the federal government. The working group will make recommendations to the administrator of OFPP regarding possible changes to existing federal guidance and regulations on performance-based contracting. We trust that this report will be helpful to the working group during their deliberations.

The Martin report should also be of high interest to those throughout the governmental community who are seeking examples of and ideas about innovative procurement practices. Over the last decade, we have seen much new thinking about how the procurement process can be dramatically improved. Two recent Endowment reports, "A Vision of the Government as a World-Class Buyer" by Jacques Gansler and "Contracting for the 21st Century" by Wendell C. Lawther, present and analyze recent trends in the procurement revolution. Professor Martin's report significantly adds to our body of knowledge about innovative procurement techniques. This report will also be of interest to those seeking to make government more performance based and outcome oriented.

Paul Lawrence
Co-Chair, IBM Endowment for
The Business of Government

Ian Littman
Co-Chair, IBM Endowment for
The Business of Government

EXECUTIVE SUMMARY

Performance-based contracting (PBC) is one of the hottest topics in federal procurement today. The federal Office of Management and Budget (OMB) has established a goal of making 20 percent of all eligible service contract dollars over \$25,000 performance based in fiscal year 2002, and the Procurement Executives Council has established a goal of making 50 percent of all service contract dollars performance based by fiscal year 2005 (OMB, 2001:1, GAO, 2001b:8-9). But what exactly is PBC? PBC is one of those interesting phenomena that arise in government from time to time where practice has outpaced theory. As a result, PBC means different things to different people.

This report begins by identifying the key characteristics that define the federal procurement environment today including: (1) the general acceptance of privatization and contracting out, (2) the increasing importance of service contracting, (3) the human capital crisis in federal procurement, (4) the Government Performance and Results Act, and (5) federal performance-based contracting initiatives. The report then transitions into a discussion of the federal perspective on PBC, identifying several problems:

- Definitional confusion
- Failure to link PBC more closely with the Government Performance and Results Act
- “One size fits all” approach
- Preference for design considerations over performance considerations

This section concludes with the observation that *the federal perspective on performance-based contracting is not performance based.*

The state and local government perspective on PBC is then presented and discussed. The report points out that the state and local government perspective differs considerably from the federal perspective. This difference is attributed to two factors: the Service Efforts and Accomplishments (SEA) reporting initiative of the Governmental Accounting Standards Board (GASB), with its greater clarity as to what constitutes performance accountability, and the greater freedom that state and local governments have to experiment with PBC. Ten case examples are then introduced that deal with various approaches state and local governments, and in one instance a Canadian province, have taken to PBC. The 10 examples were selected because of their novel approaches to various aspects of PBC and their potential to serve as exemplars for federal departments and agencies.

The report identifies several major conclusions and lessons learned from the review of the 10 examples. Finally, a set of recommendations are addressed to the Office of Federal Procurement Policy (OFPP) on how the federal perspective on PBC might be changed in light of the practices and experiences of state and local governments.

The lessons learned are:

Lesson 1. PBC at the state and local government levels differs considerably from what is generally recognized as PBC under federal guidelines.

Lesson 2. PBC at the state and local government levels defines “performance” as consisting of outputs, quality, outcomes, or any combinations thereof.

Lesson 3. PBC at the state and local government levels involves varying degrees of being performance based.

Lesson 4. PBC at the state and local government levels challenges the notion that there is one best way to do performance-based contracting.

Lesson 5. PBC at the state and local government levels includes share-in-savings contracting, revenue enhancement contracting, and milestone contracting.

Lesson 6. PBC at the state and local government levels makes frequent use of incentives and penalties regardless of mission criticality or the dollar value of the contract.

Lesson 7. The manipulation of workload can change the behavior of contractors to focus more on performance, exclusive of other PBC considerations.

Lesson 8. The adoption of “floating” incentives and penalties is a useful approach when a performance-based contract contains numerous important performance requirements.

Lesson 9. Third party certification is a low-cost and highly reliable approach to quality assurance and monitoring.

Lesson 10. The step-up/step-down method is a useful approach to structuring incentives and penalties.

Lesson 11. Contracting for non-specific performance is a creative approach to structuring PBC that may be useful in at least some situations.

The following recommendations are addressed to the Office of Federal Procurement Policy (OFPP). The OFPP should consider revising the guidance it provides federal departments and agencies on performance-based contracting (PBC) to:

Recommendation 1. Make federal PBC more compatible with the performance accountability framework and language of the Government Performance and Results Act and the Service Efforts and Accomplishments (SEA) reporting initiative of the Governmental Accounting Standards Board (GASB).

Recommendation 2. Operationally define “performance” as including outputs, quality, outcomes, or any combination thereof.

Recommendation 3. Recognize that varying degrees of being performance based can exist.

Recommendation 4. Include share-in-savings, revenue enhancement, and milestone contracting as recognized optional forms of PBC.

Recommendation 5. Adopt third party certification as an acceptable optional approach to quality assurance and monitoring.

Recommendation 6. Promote the use of the step-up/step-down method for structuring incentives and penalties in PBC.

Key Characteristics of the Federal Procurement Environment

Federal procurement is undergoing a major transformation. It has ceased to function simply as a support activity. Instead, federal procurement has evolved into a primary management and administrative function that is playing an increasingly critical role in enabling federal departments and agencies to discharge their primary missions.

In assessing the changing environment of federal procurement today, five key characteristics stand out: (1) the general acceptance of privatization and contracting out, (2) the increasing importance of service contracting, (3) the human capital crisis in federal procurement, (4) the Government Performance and Results Act, and (5) federal performance-based contracting initiatives.

General Acceptance of Privatization and Contracting Out

The 1980s and 1990s involved considerable ideological warfare over the appropriate role of privatization and contracting out within the federal government. A 1989 report issued by the National Academy of Public Administration entitled *Privatization: The Challenge to Public Management* captures the tension of the times (Salamon et. al, 1989). Today, one can argue that the war is over, although many battles may yet be fought. Rather than being viewed as a challenge to public administration, privatization and contracting out today are seen more as challenges for public administration. Having decided as a society that privatization and contracting out are legitimate forms of government service delivery, the issue for federal departments and agencies has become one of determining how

best to utilize these alternative service delivery tools (Salamon, 2002).

The general acceptance of privatization and contracting out creates a major challenge for federal procurement. The ability of federal departments and agencies to deliver services and discharge their primary missions is directly related to the quality of federal procurement.

Increasing Importance of Service Contracting

Just as the economy of the United States is transitioning from being goods based to being services based, so is federal procurement. Federal procurement increasingly involves contracting for services. Between 1990 and 2000, federal procurement of equipment and supplies declined by \$25 billion, while procurement of services increased by \$17 billion. Today, contracting for services represents the single largest category of federal procurement, representing some \$88 billion, or about 43 percent of total federal contract dollars (GAO, 2001a:4; 2001b:203). The growth in contracting for services is attributed to two primary areas: information technology services and professional, administrative, and management support services (GAO, 2001a, 2001b). Service contracting presents different problems for federal procurement. Services are not generally procured in the same manner and with the same techniques commonly employed in the acquisition of equipment, supplies, and material.

The transition to service contracting constitutes a fundamental paradigm shift for federal procurement.

Federal procurement must find new ways of conducting the federal government's business including the development of new policies, procedures, concepts, and tools to deal with a new service reality.

Human Capital Crisis in Federal Procurement

During the 1990s, the federal workforce was significantly downsized. In many instances, this downsizing was driven not by an orderly plan that assessed future federal workforce needs, but rather by retirements, voluntary separations, "buy-outs," and other quick-fix approaches. The knowledge, skills, and expertise of the current federal workforce do not necessarily match the knowledge, skills, and expertise that will be needed by the federal workforce of the future. The result is a "skill imbalance" in the federal workforce.

This skill imbalance is further exacerbated by the approaching retirement of the baby-boom generation. Those employees born in the years immediately following World War II and who entered federal service during the 1970s are now approaching retirement age. As these federal employees walk out the door, the institutional skills, knowledge, and expertise of many federal departments and agencies will be accompanying them. This situation is particularly critical for the federal procurement workforce. One estimate puts the proportion of the federal procurement workforce eligible to retire between 2000 and 2005 at 22 percent, with the figure steadily increasing after 2005 (Commercial Activities Panel, 2001:7). Another estimate suggests the proportion will be closer to 50 percent by 2005 (Gansler, 2002:7).

The federal procurement workforce of the future will be smaller and less experienced. New and creative ways must be found for the federal procurement function and the federal procurement workforce to operate more efficiently and more effectively.

Government Performance and Results Act

The Government Performance and Results Act (GPRA) (Public Law 103-62) requires federal departments and agencies to report annually to

the U.S. Congress on the performance of all programs and activities. In section 1115(a), GPRA states that each agency "shall be required to prepare an annual performance plan covering each program activity set forth in the budget of the agency." Further on in Section 1115(a)(4), GPRA comments that the annual plan shall "establish performance indicators to be used in measuring or assessing the relevant *outputs*, service levels, and *outcomes* of each program activity." Still further on in Section 1115(f) (2) and (3), GPRA provides the following clarification: an "*outcome* measure means an assessment of the results of a program activity compared to its intended purposes," while "*an output* measure means the tabulation, calculation, or recording of activity or effort." Finally, in Section 1115(f)(5), GPRA states that a "'performance indicator' means a particular value or characteristic used to measure *output* or *outcome*." (emphasis added).

GPRA explicitly acknowledges that performance has at least two dimensions (output and outcome). A third dimension (quality) is acknowledged implicitly in that GPRA consistently refers to "qualitative" measures. The fundamental theoretical underpinning of GPRA (performance accountability) as well as its language (output, quality, and outcome) have yet to permeate all aspects of federal management and administration. Federal procurement is a case in point. Guidance provided by the Office of Federal Procurement Policy (OFPP, 1997, 1998a) on performance-based contracting (PBC) does not make full or consistent use of the GPRA performance accountability framework and language.

If PBC is going to become a primary tool of federal procurement, then it must become more compliant with GPRA. As David Walker, the comptroller general of the United States, has observed, GPRA "must provide the foundation and framework for how the federal government does business every day" (Walker, 2001:20).

Federal Performance-Based Contracting Initiatives

Performance-based contracting is one of the hottest topics in government procurement today (Gordon, 2002). The interest and attention is understandable considering the success the Office of Federal

Office of Federal Procurement Policy Experiment with Performance-Based Contracting

Results of the evaluation of 26 performance-based contracts issued involving 15 federal departments and agencies with a value of \$585 million:

- Costs Decreased 15%
- Customer Satisfaction Increased 18%
- Financial Audits Decreased 93%

Source: OFPP (1998b:3-4)

Procurement Policy (OFPP, 1998b) had with its initial experiment with PBC. The OFPP experiment produced some remarkable results including significant decreases in costs, significant increases in customer satisfaction, and the reduction of financial audits to nearly zero. The OFPP experiment validated two basic assumptions of PBC: first, that the structure of contracts can influence the behavior of contractors to focus more on performance; and second, that monitoring costs (in this instance auditing costs) can be reduced through the use of PBC.

In light of the success of the OFPP experiment with PBC, the Office of Management and Budget (OMB) has established a goal of making 20 percent of all eligible federal service contract dollars over \$25,000 performance based during fiscal year 2002, and the Procurement Executives Council has established a goal of making 50 percent of all service contract dollars performance based by fiscal year 2005 (GAO, 2001a; OMB, 2001).

Federal PBC initiatives can be viewed as both a challenge for federal procurement as well as a potential response to the general acceptance of privatization and contracting out, the increase in service contracting, the human capital crisis in federal procurement, and GPRA. PBC involves new policies, procedures, concepts, and tools designed specifically to meet the needs of service contracting. Thus, PBC holds at least the promise of providing federal procurement and the federal procurement workforce with the wherewithal to function more efficiently and more effectively in a new service environment.

Performance-Based Contracting: The Federal Perspective

Performance-based contracting is one of those phenomena that arise in government from time to time where practice has outpaced theory. Consequently, PBC has come to mean different things to different people. Variations in approaches to PBC exist at the federal, state, and local government levels. However, the basic objective of PBC is quite simple: *to change the behavior of contractors to focus more on performance*. Beyond this basic objective, considerable ambiguity exists as to exactly what constitutes PBC.

Definitions of Performance-Based Contracting

In an attempt to bring some clarity to the concept, the Office of Federal Procurement Policy (OFPP), the Department of Defense (DoD), and the Federal Acquisition Regulation have all developed operational definitions of PBC. The results, however, have created as much confusion as clarification.

The Office of Federal Procurement Policy provides the following definition of performance-based con-

tracting: an approach where the statement of work is based on “objective, measurable performance standards *outputs*” (OFPP, 1998:5). In a related policy memorandum, the OFPP further states that a performance-based contract contains “performance standards (i.e., *quality, quantity, timeliness*)” (OFPP, 1997:2). The Department of Defense, which contracts for more services than any other federal department or agency, defines a performance-based contract as one that “describes the requirements in terms of measurable *outcomes* rather than by means of prescriptive methods” (DoD, 2000:1). The Federal Acquisition Regulation (FAR) Part 2.101 states that “performance-based contracting means structuring all aspects of an acquisition around the purpose of the work to be performed with contract requirements set forth, in clear, specific, and measurable *outcomes* as opposed to either the manner by which the work is to be performed or broad and imprecise statements of work.” In a different section, the Federal Acquisition Regulation Part 37.601 further states: “Performance-based contracting methods are intended to ensure that required performance *quality* levels are achieved and that total

Elements of Performance-Based Contracting

	Output	Quality	Outcomes
Office of Federal Procurement Policy	YES	YES	NO
Department of Defense	NO	NO	YES
Federal Acquisition Regulation (FAR)	NO	YES	YES

payment is related to the degree that services performed meet contract standards” (emphasis added).

Essential Elements of Performance-Based Contracting

The Office of Federal Procurement Policy (OFPP, 1997:2-5) has also enumerated what it considers to be the minimum essential elements that a performance-based contract must contain: (1) performance requirements, (2) performance standards or acceptable quality levels (AQLs), (3) a quality assurance or monitoring plan, and (4) positive and negative incentives if the contract is mission critical or involves a relatively large expenditure of federal funds.

Office of Federal Procurement Policy Minimum Requirements for Performance-Based Contracting

1. **Performance Requirements** that define in measurable terms the work to be accomplished or the service to be provided. Also called “performance measures” and “performance indicators.”
2. **Performance Standards** that define the allowable deviation, if any, from the performance requirements. Also called the “acceptable quality level” or AQL.
3. **Quality Assurance Plan** that specifies the means by which contractor performance will be determined and documented. Also called a “QA plan,” a “surveillance plan” and a “monitoring plan.” Acceptable approaches to quality assurance plans include:
 - A. 100% Inspection
 - B. Random Sampling
 - C. Periodic Inspection
 - D. Customer Input
4. **Positive and Negative Incentives** tied to the quality assurance plan. Also called “incentives” and “penalties.”

Source: OFPP (1997:2-5; 1998a:16).

Problems with the Federal Perspective on Performance-Based Contracting

The federal perspective on performance-based contracting suffers from several problems: (1) definitional confusion, (2) the failure to link performance-based contracting more closely with GPRA, (3) a “one size fits all” approach, and (4) a preference for design considerations over performance considerations.

Definitional Confusion

How should one interpret the various federal definitions of performance-based contracting? The Office of Federal Procurement Policy views PBC as contracting for *outputs* and *quality*. The Department of Defense views PBC as contracting for *outcomes*. And the Federal Acquisition Regulation views PBC as contracting for *outcomes* and *quality*. Two alternative interpretations can be taken from this definitional confusion. Either the definitions are saying different things or they are saying the same thing differently. Under the first interpretation, the argument can be made that the definitions are saying different things and thus real confusion exists on the part of federal departments and agencies as to what exactly constitutes PBC. Under the second interpretation, the argument can be made that the various definitions are simply saying the same thing differently in that they recognize the multidimensional nature of performance, but choose to focus on different dimensions (outputs, quality, and outcomes).

Regardless of which of the two interpretations is correct, the Office of Federal Procurement Policy needs to promulgate clarifying guidance. If the first interpretation is correct and considerable confusion does in fact exist over what is meant by PBC, then OFPP needs to provide a clarifying definition. If the second interpretation is correct, then OFPP needs to issue clarifying guidance, recognizing that performance in PBC has three dimensions (outputs, quality, and outcomes).

Failure to Link Performance-Based Contracting More Closely with GPRA

At least part of the explanation for the federal definitional confusion over PBC can be attributed to its failure to be linked more closely to GPRA. The

question needs to be asked and answered as to why PBC is not fully compliant with GPRA's performance accountability framework and language. If federal departments and agencies are going to be held accountable for performance as defined by GPRA, why shouldn't contractors? Additionally, in a federal service environment characterized by increased privatization and contracting out, the only way many federal departments and agencies will be able to meet the reporting requirements of GPRA is to pass along those requirements to their contractors. Thus, there must be at least some consistency in the performance accountability framework and language used internally by federal departments and agencies and their approaches to PBC.

"One Size Fits All" Approach

By identifying what it considers to be the essential elements of a performance-based contract, the Office of Federal Procurement Policy has *de facto* decreed a "one size fits all" PBC policy. In fairness to OFPP, it is attempting to get federal departments and agencies and the federal procurement workforce to break out of the traditional ways of doing business and to think "outside the box." Unfortunately, the end result may be the replacement of an old box with a new box. By adopting a "one size fits all" approach, OFPP is retarding experimentation with PBC. At the present time, no reason exists to assume that OFPP has discovered the one best way to implement PBC. Other ways may exist that can produce equal or better results in terms of changing the behavior of contractors to focus more on performance.

Preference for Design Considerations over Performance Considerations

By choosing to emphasize the essential elements of PBC, while simultaneously failing to provide definitional clarity, the federal perspective represents a triumph of design considerations over performance considerations. Public procurement theory makes a distinction between the use of design specifications and performance specifications in government contracts. The National Association of State Purchasing Officials (NASPO, 1997:147 and 153) defines a design specification as "a type or manner of writing a purchase description characterized by detail as to how the product is to be manufactured or the work performed" and a performance specification

Author's Discussion with a High-Ranking Procurement Official of the Department of Defense

Question: "Will your agency have any difficulty meeting the goal of having 50 percent of its service contracts performance based by 2005?"

Response: "Not at all! All we have to do is slap a QA [quality assurance] plan on our existing contracts and we're done."

as "a purchase description accenting performance over design." When design specifications are used, the government tells the contractor *how* to provide the service. When performance specifications are used, the government tells the contractor *what* is expected and leaves it free to determine how best to accomplish the desired end result.

PBC requires the use of performance specifications. The essence of PBC is telling the contractor *what* is expected and letting it decide on the *how*. But the OFPP (OFPP, 1998a) guidance on PBC represents a design specifications approach. If a contract is designed so as to meet the OFPP essential elements, it constitutes PBC regardless of the extent to which it ultimately succeeds in changing the behavior of the contractor to focus more on performance. In other words: *The federal perspective on PBC is not performance based*. If the federal perspective is to simply view PBC as a set of design specifications that must be included in a contract, rather than as an attempt to change the behavior of contractors to focus more on performance, then the potential usefulness of PBC will be greatly diminished.

Performance-Based Contracting: The State and Local Government Perspective

The state and local government perspective on performance-based contracting differs considerably from the federal perspective. Two reasons account for this difference. The first is the performance accountability framework provided by the Service Efforts and Accomplishments (SEA) reporting initiative of the Governmental Accounting Standards Board (GASB). The second is the greater freedom that state and local governments have to experiment and innovate with PBC.

Influence of the Service Efforts and Accomplishments Reporting Initiative of the Governmental Accounting Standards Board

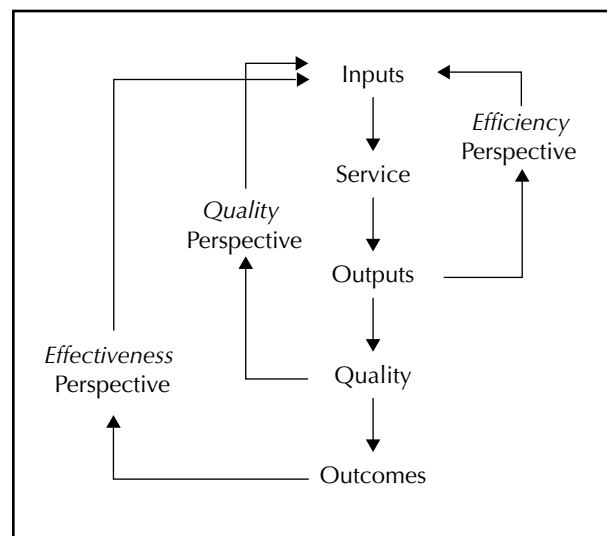
The Governmental Accounting Standards Board is the organization that establishes “generally accepted accounting principles” for state and local governments. The Service Efforts and Accomplishments (SEA) reporting initiative of GASB (1994) represents an attempt to do for state and local governments what GPRA has done for the federal government: create a system of performance accountability.

From the outset, SEA reporting has viewed “performance” as a multidimensional concept consisting of outputs, quality, and outcomes. SEA reporting defines an output as the “quantity of service provided”; quality as the “quantity of service provided that meets a quality requirement”; and outcome as the “accomplishments or results that occur (at least partially) because of services provided” (GASB, 1994:22). SEA reporting does not take the position that any one dimension of performance is more

important than another, but rather suggests that all three dimensions are important. This tripartite conceptualization of performance creates what can be called an “expanded systems model” (see Figure 1).

As Figure 1 demonstrates, performance feedback on the production of outputs compared to the consumption of inputs provides a measure of program *efficiency*. Performance feedback on quality in relationship to the consumption of inputs provides a measure of program *quality*. And feedback on the production of outcomes in relationship to the consumption of inputs provides a measure of program *effectiveness*. All three perspectives are considered important in the evaluation of government programs (Martin & Kettner, 1996).

Figure 1: Performance Accountability and the Expanded Systems Model



SEA reporting has also had a major impact on the design of state and local government performance measurement and performance budgeting systems (Melkers & Willoughby, 1998; Martin, 1997). These performance measurement and budgeting systems have, in turn, influenced the perspectives state and local governments have taken with respect to PBC (Martin 2002a, 2002b).

Greater Freedom to Experiment and Innovate with Performance-Based Contracting

Unlike federal departments and agencies, state and local governments have fewer policies, procedures, and guidelines on how to construct performance-based contracts. Consequently, state and local governments have greater freedom to experiment with approaches to PBC that differ from the federal perspective.

The next section reviews some of the more interesting case examples of state and local government use of performance-based contracting.

Case Examples

This section reviews the use of performance-based contracting by nine state and local governments and the Province of Ontario, Canada. These cases were selected because of their novel approaches to various aspects of PBC as well as their potential to serve as exemplars for federal departments and agencies. All of the case examples involve ongoing contracts. Figure 2 describes each of the 10 case examples.

The case examples were identified and selected through a combination of approaches. The author contacted state and local governments known to be actively experimenting with PBC. The National Institute of Governmental Purchasing also solicited its U.S. and Canadian members and encouraged them to provide the author with information about their PBC practices. Finally, the author participated in a series of best practices conferences on PBC conducted in the United States by The Performance Institute and in Canada by The Canadian Institute.

Case Example 1—Metropolitan Government of Nashville & Davidson County: PBC for Share-in-Savings with Partnering

Background

Federal departments and agencies contract for a variety of consulting type services (e.g., evaluation, management consulting, policy analysis, auditing, etc.) in which the *output* is a report, but the hoped for *outcome* is sound recommendations that will lead to service improvements, greater customer satisfaction, and reduced costs. The Metropolitan

Government of Nashville and Davidson County, Tennessee (Metro) is using performance-based contracting for “change management” services (a form of management consulting) designed to improve the operating efficiency of Metro Water Services (MWS). In considering its contracting options, Metro wanted to ensure to the greatest extent possible that the contractor’s recommendations would be implemented by MWS staff and that the recommendations would result in actual cost savings. Metro decided to use a share-in-savings approach to PBC with a partnering provision that included MWS employees.

Share-in-savings approaches to PBC have been used by some federal departments and agencies. The most common applications, however, are in the areas of recovery auditing, building energy savings, and the leasing and utilization of government buildings and properties (Beaulieu, 2000). Under a typical share-in-savings arrangement, incentives (increased contractor compensation) are used to encourage contractors to reduce service delivery costs. Metro’s approach to share-in-savings PBC is unusual in that it involves management consulting services.

Implementation

Metro’s performance-based contract requires the contractor (Brown & Caldwell, an environmental engineering and consulting firm) to reduce the MWS’s operating and maintenance budget from a base of \$74 million in fiscal year 1999 to a level of \$64 million in fiscal year 2002 and to a level of \$60 million in fiscal year 2004. This \$10-million-dollar reduction is a contractual obligation. As an

Figure 2: Description of Case Examples

Case Example	Description
1. Metropolitan Government of Nashville & Davidson County, Tennessee: PBC for Share-in Savings with Partnering	PBC for change management services using share-in-savings and partnering whereby the contractor and public employees share in the cost savings
2. Washington State Lottery: PBC for Revenue Enhancement	PBC for advertising services with the contractor's fee tied to lottery sales
3. Arizona Department of Economic Security: PBC with Indefinite Performance	PBC for job training and placement services with indefinite performance where the contractor's compensation and performance standards are tied to the performance benchmarks of another provider
4. DeKalb County, Georgia: PBC with Independent Third Party Performance Requirements and Monitoring	PBC for correctional health services using one quality/outcome performance requirement: The contractor must seek and secure accreditation
5. City Of Charlotte, North Carolina: PBC with Step-Up/Step-Down Incentives and Penalties	PBC for help desk and desk side support services with incentives and penalties that step-up/step-down from the performance standards or acceptable quality levels (AQLs)
6. Oklahoma Department of Rehabilitative Services: PBC for Individual Client Milestones	PBC for employment services using a milestone approach where each person served is treated as an individual project with a start point, end point, and major milestones
7. Pinellas County, Florida: PBC with Penalties for Incomplete Service Data	PBC for ambulance services with penalties for data integrity problems
8. Metro (Portland, Oregon) Exposition-Recreation Commission: PBC for Goals	PBC for convention marketing services using goals and an incremental/developmental approach
9. Illinois Department of Children & Families: PBC by Manipulating Contractor Workload	PBC for child permanency placements (family reunification, adoptions, and subsidized guardianship) using workload manipulation to increase contractor performance
10. Ontario (Canada) Realty Corporation: PBC with "Floating" Incentives and Penalties	PBC for multi-year property management services using "floating" incentives and penalties tied to 112 performance requirements

incentive, 10 percent of the contractor's monthly compensation is being held in escrow by Metro until MWS's operating and maintenance budget is reduced to the \$60 million level. As an additional incentive to both the contractor and the MWS staff, the contract also includes a share-in savings provision as well as a partnering provision:

- For the first \$4 million in additional savings (when the MWS's operating and maintenance budget is between \$64 and \$60 million per year), the contractor and the MWS staff are to share in 15 percent of the annual cost savings over the term of the contract.
- For savings in excess of the \$4 million (when the MWS's operating and maintenance budget is less than \$60 million per year), the contractor and the MWS staff are to share in 20 percent of the annual cost savings over the term of the contract. (Metropolitan Nashville & Davidson County, 1999:1-4).

Under the terms of the contract's partnering provision, any share-in-savings is to be divided among the contractor, the MWS, and the employees of the MWS as follows: 15 percent to the contractor, 15 percent to the MWS employees on payroll at the time the partnering provisions become activated, and 70 percent to be carried over and available for use by the MWS. Current trended projections indicate that the MWS's operating and maintenance budget for fiscal year 2002 will be \$66.2 million (Metro Water Services, 2002). This \$66.2 million figure represents an overall reduction of \$7.8 million, but is still \$2.2 million above the level at which the share-in-savings and partnering provisions become activated. The share-in-savings and partnering provisions can still be activated during fiscal years 2003 and 2004 (Metro Water Services, 2002).

Assessment

This case example makes two major points that should be of interest to federal departments and agencies. First, PBC using a share-in-savings approach can be applied to consultative type services. Second, allowing federal employees to share in cost savings through a partnering provision may increase the likelihood of a consultant's recommendations being implemented.

Case Example 2—Washington State Lottery: PBC for Revenue Enhancement

Background

Performance-based contracting for revenue enhancement is the flip side of share-in-savings. Under PBC for revenue enhancement, incentives (increased contractor compensation) are tied to the amount of additional revenue generated as a result of the contractor's work. Increased revenue becomes the performance *outcome* of the contract.

The Washington State Lottery was spending some \$6.5 million annually for advertising services. The previous contract type had been "level of effort," where the contractor was paid for performing certain tasks including advertising services, production activities, printing, and television and radio media buys. The contractor's compensation was set as a percentage (15 percent) of the contract price. From a performance perspective, the contract suffered from a major structural fault: The contractor was not accountable for any results, either in terms of the success of the advertising campaign(s) or in terms of increased lottery sales. In the view of the Washington Office of State Procurement, the purpose of the advertising contract was to generate lottery sales through effective advertising, yet there was no financial risk to the contractor, only the state, if the efforts were unsuccessful (Joplin & Bunker, 1998).

Implementation

The Washington Office of State Procurement (OSP) provided consulting and technical assistance services to the Washington State Lottery (Lottery) to make the advertising services contract more performance based. Because advertising services is a complex activity, the OSP and the Lottery met several times with industry representatives to brainstorm issues before the release of a request for proposals (RFP). The RFP led to a totally new approach to contracting for advertising services. Under the terms of the performance-based contract, the contractor (Publicis in the West, a division of Publicis SA, a French multinational advertising company) is being compensated on the basis of a fixed-fee tied to Lottery sales with a range between 90 percent and 115 percent (Joplin & Bunker, 1998). Thus,

the contractor's compensation can be as low as 90 percent of its fee if lottery sales are below the specified benchmark amount or as high as 115 percent of its fee if lottery sales are greater than the specified benchmark. The actual fee to be paid the contractor is computed using the formula in Figure 3.

Figure 3: Washington State Lottery Computation of Contract Fee for Advertising Services

- | |
|--|
| <p>Step 1: $\text{Actual Sales/Projected Sales} = S\%$
(rounded down to 3 decimal places).</p> <p>Step 2: $S\% \times \text{Annual Fee Bid} = \text{Actual Annual Fee Payment}$ (The actual annual fee to have a floor of 90% and a ceiling of 115%)</p> |
|--|

Source: Adapted from Joplin & Bunker (1998).

Assessment

Federal departments and agencies spend over \$500 million annually on media and advertising (GAO, 2000:3). To what end? While federal departments and agencies may not be concerned with revenue enhancement, they are concerned with increasing the effectiveness of their media and advertising expenditures. Tying contractor compensation to the effectiveness of media advertising through PBC is a creative and attractive approach to accomplishing this objective.

Case Example 3—Arizona Department of Economic Security: PBC with Indefinite Performance

Background

A major challenge in implementing performance-based contracting is the need to specify up front in the contract the performance standards, or acceptable quality levels, by which contractor performance will be assessed. An associated problem is that historical performance data may not be readily available. Also, changes in economic conditions during the term of a contract can affect contractor performance. The performance of a contractor may be higher when the economy is expanding and may be lower when the economy is constricting.

How can federal departments and agencies account for the lack of historical performance data and changes in economic conditions when developing performance standards? The Arizona Department of Economic Security (Arizona DES) is experimenting with an interesting potential solution to these problems.

The Arizona DES is using PBC to implement a new welfare-to-work program called "Arizona Works" (State of Arizona, 2001). Like other welfare-to-work programs across the country, the purpose of Arizona Works is to transition people from various kinds of public assistance and support to jobs and independent living status—the performance *outcome*. The Arizona DES approach to PBC does not include specific performance standards or AQLs. Instead, the contract calls for indefinite performance using the Arizona DES's own performance as a benchmark.

Implementation

The Arizona DES approach to PBC calls for the contractor to operate the Arizona Works program in one portion of Maricopa County (Phoenix), Arizona. The contractor, MAXIMUS, Inc., is a large multistate provider of welfare-to-work services to state and local governments. In the remaining portions of Maricopa County, the Arizona DES continues to provide the same services as the contractor. The situation is analogous to the classic control group/experimental group research design. The Arizona DES functions as the control group; the contractor represents the experimental group. The contract contains five performance requirements, but without any specific performance standards or AQLs. Instead, the contract simply states that the contractor *must* exceed the performance of the Arizona DES by a minimum of 30 percent on each of the five performance requirements. Incentives and penalties are included in the contract for performance that exceeds or falls short of the performance benchmarks achieved by the Arizona DES.

The Arizona DES has been the subject of criticism for using the 30 percent figure, which is considered by some to be too high (Phillips & Franciosi, 2001). Why not 25 percent or even some lesser figure? Nevertheless, the contractor agreed to the 30 percent figure. During the initial contract term, the contractor did succeed in outperforming the Arizona

Performance Requirements for Arizona Works Performance-Based Contract

1. Number of individuals placed in jobs
2. Number of individuals placed in the highest and most appropriate jobs
3. Reduction in welfare caseload
4. Reduction in the length of stay on public assistance
5. Number of individuals placed in jobs who continue in those jobs for at least 90 days

Source: Adapted from Arizona DES (2001, 45-48).

DES by 30 percent on four of the five performance measures. Efforts are currently under way to expand the Arizona Works program and the Arizona DES approach to PBC to a second county (Greenlee).

Assessment

Using PBC for indefinite performance by tying performance standards or acceptable quality levels to the performance benchmarks of another service provider (either a contractor or an in-house department) is a creative approach that federal departments and agencies may find useful. Specific performance standards need to be established at the outset of the contract. Contractor performance expectations are automatically adjusted for changes in economic conditions. And federal departments and agencies, as well as other stakeholders, are provided with a research-based approach (control group/experimental group) to assess the success and relative merits of various alternative service delivery approaches.

Case Example 4—DeKalb County, Georgia: PBC with Independent Third Party Performance Requirements and Monitoring

Background

One of many insights into service contracting provided by principal/agent theory (OECD, 1999) is

the realization that governments (principals) have little economic incentive to monitor their contractors (agents). A major reason that governments use service contracting is to reduce service delivery costs; contract monitoring represents an additional cost. Consequently, principal/agent theory suggests that governments should design low-cost but reliable approaches to contract monitoring. The Office of Federal Procurement Policy (OFPP, 1998, 16) guide to best practices for performance-based contracting identifies four acceptable methods for structuring the quality assurance or monitoring plan: (1) 100 percent inspection, (2) random sampling, (3) periodic inspection, and (4) customer input. One hundred percent inspection is highly reliable, but is also quite costly. Conversely, customer input is low cost, but can be highly unreliable. Random sampling and periodic inspection are mid-range approaches in terms of reliability and cost. DeKalb County, Georgia, is experimenting with another method, third party certification, that is both low cost and highly reliable.

DeKalb County, Georgia, was sued, *Adams v. DeKalb*, over allegations of inadequate medical services provided to prisoners of the DeKalb County Jail. As part of the settlement agreement reached in the case, the county agreed to ensure that in the future correctional health services would be provided in accordance with the Standards for Health Care in Jails established by the National Commission on Correctional Health Care.

Implementation

As part of a plan to upgrade correctional health services at the county jail, DeKalb County decided to contract for services. The county chose to use performance-based contracting. The contract was awarded in April 2001 to Correctional Medical Services, Inc. The contract contains a large number of design specifications dealing with such input and process issues as staffing levels, staff qualifications, hours of operation, etc. Rather than attempting to develop output, quality, and outcome performance specifications for such a highly specialized service as correctional health, DeKalb County chose instead to include just one *quality/outcome* performance requirement and associated performance standard or acceptable quality level. The contractor must become accredited by the

National Commission on Correctional Health Care within 18 months from the effective date of the contract (DeKalb County, 2001).

Assessment

Attempting to monitor a contract for a professional service such as correctional medical requires a level of in-house expertise that many federal departments and agencies may not have. Even those federal departments and agencies that do possess the required in-house expertise may have other equally or even more pressing uses for that expertise. A solution in both situations is to use third party certification to perform the quality assurance or contract monitoring function. For services where licensure, certification, or accreditation organizations exist, their use represents a low-cost and highly reliable alternative, or augmentation, to direct quality assurance or monitoring. Licensure, certification, and accreditation usually involve meeting multiple performance requirements, including *quality* and *outcome*. Third party certification can also be made a requirement for doing business with a federal department or agency. For example, human service contractors must seek and secure accreditation as a condition of doing business with the states of Florida and North Carolina.

Case Study 5—City of Charlotte, North Carolina: PBC with Step-Up/Step-Down Incentives and Penalties

Background

The Office of Federal Procurement Policy (OFPP, 1997:2) suggests that performance-based contracting should include incentives and penalties when the service is either mission critical or involves relatively large expenditures of public funds. Many state and local government performance-based contracts include incentives and penalties regardless of mission criticality or dollar value. Incentives and penalties usually take the form of additional compensation contractors can earn for performance that exceeds the performance standards or acceptable quality levels, or compensation that is denied contractors for performance that is below the performance standards or AQLs. The appropri-

ate mix of incentives/penalties can, and does, vary from contract to contract depending upon the type of service, the preferences of individual governments, what contractors are willing to agree to, and other factors. State and local governments frequently structure their performance-based contracts so that incentives and penalties step up and step down from the performance standards or AQLs.

Implementation

The City of Charlotte, North Carolina, is using PBC for help desk and desk side support services. The contractor is the UNISYS Corporation. The contract contains three performance requirements and associated performance standards or AQLs, plus a quality assurance/monitoring plan. The contract also contains incentives and penalties that increase and decrease from the performance standards in a step-up/step-down fashion. One of the performance requirements calls for the contractor to “repair broken personal computers including hardware, operating system problems (desktop and laptop) and supported software...” (City of Charlotte, 2001:34). The associated performance standard is that 85 percent of personal computers will be restored to operations (the performance *outcome*) within two hours. The maximum total incentive payment that the contractor can earn for exceeding the contract’s three performance requirements and associated performance standards or AQLs is 2 percent of a monthly billing. Conversely, the maximum total penalties that the contractor can incur for failure to meet the three contract performance requirements and associated performance standards is 4 percent of a monthly billing.

Figure 4 illustrates how the incentives and penalties step up/step down from the performance standard or AQL. For superior performance above the performance standard or AQL of 85 percent, the contractor can earn an incentive payment of up to 2 percent of a monthly billing. Because of the importance the City of Charlotte places on this particular performance standard, the contractor can also have penalties imposed of up to 4 percent of a monthly billing. If the contractor’s performance is between 88 percent and 89 percent for a given month, it earns an incentive payment equal to 1 percent of the monthly billing, stepping up to 1.5 percent of the monthly billing for performance between 90

Figure 4: Incentives and Penalties for Help Desk & Desk Side Support Services

Contractor Premium	Baseline Performance Metric Percentage	
2.0% Max	92% and above	
1.5%	90%–91%	
1.0%	88%–89%	
0.0%	86%–87%	
85% Baseline		
	84%	1.0%
	83%	2.0%
	82%	3.0%
	81% and below	4.0%
City of Charlotte Credit		

Source: City of Charlotte, North Carolina (2001, 34).

percent and 91 percent and stepping up again to 2 percent of the monthly billing for performance at or above 92 percent.

Conversely, if the contractor’s performance falls below the performance standard of 85 percent, the contractor’s compensation is reduced in a step-wise fashion: 1 percent for a performance level of 84 percent, 2 percent for a performance level of 83 percent, 3 percent for a performance level of 82 percent, and a maximum of 4 percent for a performance level of 81 percent and below.

Assessment

The concept of using step-up/step-down incentives and penalties in PBC may be an attractive approach for federal departments and agencies to consider. Step-up/step-down incentives and penalties highlight, and tend to keep contractors focused on, the performance standards. Additionally, contractors also have both positive and negative motivations to achieve the performance standards. The implications of superior and inferior performance are made quite clear to contractors. When the incentives and penalties step up/step down in similar

fashion and in similar quantities, an appeal is also made to fairness. However, at least some research exists suggesting that the use of penalties can be quite effective (perhaps even more effective than incentives) in changing the behavior of contractors to focus more on performance (e.g., Shetterly, 2002, 2000; Martin, 2002).

Case Example 6—Oklahoma Department of Rehabilitative Services: PBC for Individual Client Milestones

Background

Federal departments and agencies have long used project management to administer contracts for construction and non-recurring services. The Oklahoma Department of Rehabilitation Services (Oklahoma DRS) has taken the concept of project management one step further by applying it to performance-based contracting for a recurring service: supportive employment. The Oklahoma DRS calls its approach “milestone” PBC (Frumkin, 2002).

Figure 5: Oklahoma Department of Rehabilitation Services Performance-Based Milestone Contracting for Supportive Employment

Milestone	Type of Milestone	% of Fee
1. Determination of Need	Process	10
2. Vocational Preparation	Process	10
3. Job Placement	Output	10
4. Job Training	Process	10
5. Job Retention	Process	15
6. Job Stabilization	Quality/Outcome	20
7. Case Closed	Outcome	25

Sources: Adapted from Oklahoma DRS (n.d.):1-2; Novak, Mank, Revell & O'Brien (n.d.):29.

Implementation

The Oklahoma DRS is using PBC for supportive employment (job training and placement services for persons with physical and mental disabilities). Under the Oklahoma DRS approach to milestone PBC, each person served under a contract is treated as an individual project. As Figure 5 demonstrates, each person served has a definable start point (entrance into service), end point (exit from service), and identifiable major milestones (e.g., job placement) to be accomplished in between. The payment mechanism used by the Oklahoma DRS equates to a fixed-fee contract with progress payments. A fixed fee per person is established, and contractors (nonprofit community rehabilitation agencies) earn a portion of that fee (the progress payment) every time a person achieves one of the milestones. Since contractors are only paid for accomplishing the milestones and receive no other compensation, incentives and penalties are automatically built into the contract.

Assessment

In addition to being a creative application of project management, three aspects of the Oklahoma

DRS approach are worthy of highlighting because they challenge the federal perspective on PBC (OFPP, 1998). First, all three dimensions of performance (output, quality, and outcome) are included in the Oklahoma DRS milestone approach. Second, the Oklahoma DRS’s milestone approach does not view PBC as an “all or nothing” proposition. While 55 percent of contractors’ fees are tied to output, quality, and outcome *performance specifications* (i.e., performance standards), the remaining 45 percent is tied to input and process *design specifications*. Third, different contractors can have different mixes of design and performance specifications (performance standards) and different associated payment schedules. Thus, milestone PBC can be used in a developmental approach whereby contractor focus is shifted over time away from design specifications to performance specifications (performance standards).

The Oklahoma DRS is not the only state human service agency experimenting with milestone PBC. Kansas, North Carolina, and Pennsylvania have also used milestone PBC. In all instances, the results in terms of changing the behavior of con-

tractors to focus more on performance have been impressive (Martin, 2002a; 2002b). The milestone approach to PBC should be of interest to those federal departments and agencies that contract for professional, health, or human services provided to federal employees or where the federal government is a third party payer.

Case Example 7—Pinellas County, Florida: PBC with Penalties for Incomplete Service Data

Background

A long-standing problem associated with attempts to implement performance-based contracting is data integrity. Both the Office of the Texas State Auditor (2000) and the Florida Office of Program Performance and Accountability to the People (1998) have documented problems with the validity and reliability of performance measurement data. In PBC the issue of data integrity is particularly important. When contractor compensation, either partially or in toto, is tied to performance, the performance itself becomes auditable. If the performance data cannot be documented, verified, and replicated, audit exceptions and questioned costs can arise. In the Office of Federal Procurement Policy's (OFPP, 1998) initial experiment with PBC (see p. 9), the number of financial audits was reduced by an astounding 93 percent. The implications of this finding have not been lost on auditors and the auditing profession; they are presently gearing up to conduct more performance audits.

When Pinellas County, Florida, decided to use PBC for ambulance services, one of the many issues it had to confront was data integrity (a *quality* performance standard). Third party payers (e.g., insurance companies, managed health care programs, Medicare, Medicaid, and others) generally will not pay for services rendered unless complete and accurate data are provided documenting the need for the service, the type of service provided, and the name and relevant personal information of the person receiving the service.

Implementation

In order to ensure that it would be able to properly invoice third party payers, Pinellas County built

stringent data integrity penalties into its ambulance services contract:

Pinellas County “shall automatically deduct from the Additional Service Amount equal to the Wholesale Rate for one transport for every Patient served by Contractor for whom all the information required to be supplied by Contractor (i.e., dispatch record, Billable Run Report, and any required forms) is incomplete, illegible, inaccurate, altered, or lacking evidence of medical necessity, where such medical necessity exists, as to result in (Pinellas County’s) claim for payment being denied by responsible payors, or to otherwise prevent (Pinellas County) from effectively utilizing its data processing, billing and collection procedures” (Pinellas County, 1999:58). (parentheses added)

This well-defined penalty clause has apparently had the desired effect. Pinellas County reports that data integrity problems are minimal.

Assessment

As federal departments and agencies adopt PBC for more and more services, the issue of data integrity will become increasingly important. Including stringent data integrity requirements in contracts, and disallowing payments for services when complete and accurate data are missing, may be an approach that federal departments and agencies can use to “audit proof” their performance-based contracts.

Case Example 8—Metro (Portland, Oregon) Exposition-Recreation Commission: PBC for Goals

Background

When is a contract “performance based” and when is it not? Must a contract contain all the essential elements as enumerated by the Office of Federal Procurement Policy (OFPP, 1997) to be considered a performance-based contract? These are questions that confront not only federal departments and agencies, but other governments as well. When it comes to state and local governments, performance-

based contracting is conceptualized less as a “yes or no issue” (the contract is or is not performance based) and more as an “issue of degrees,” ranging from non-PBC to full or complete PBC.

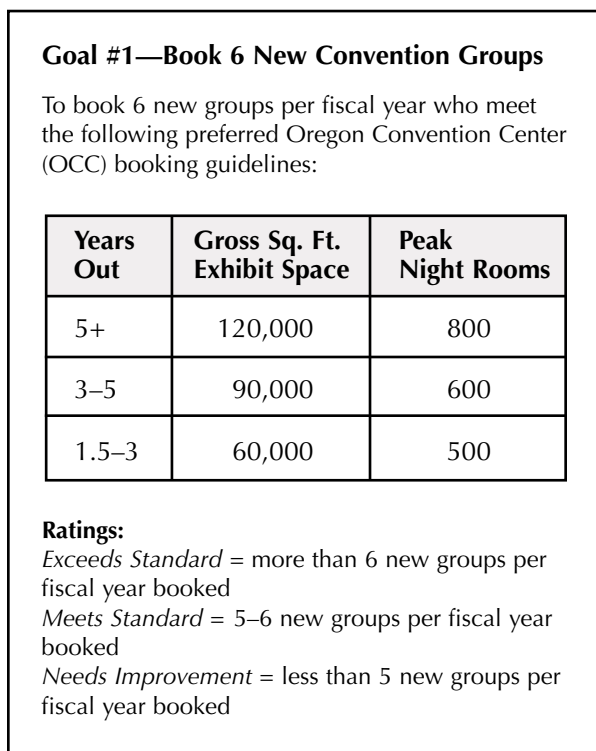
In September 2000, the Metro (Portland, Oregon) auditor conducted a review of the marketing services contract between the Metro Exposition-Recreation Commission (MERC Commission) and the Portland Oregon Visitors Association (POVA), a private nonprofit organization that promotes tourism and conventions in the metro Portland area. As part of the audit report, the Metro auditor recommended that the contract be made more performance based (Metro Auditor, 2000). The question to be resolved was: to what extent?

Implementation

POVA developed six goals (performance requirements) that were included in the contract by amendment dated October 2001. The goals include *output* and *outcome* performance requirements as well as process requirements. The goals, or performance requirements, also include ratings that are analogous to performance standards or acceptable quality levels. Goal 1 (a performance *outcome*) and its associated rating (AQL) is shown in Figure 6. As Figure 6 illustrates, the overall goal for the two-year contract is to book 12 new convention groups. Since conventions are frequently booked many years in advance, sub-goals are included that cover one and a half to three years out, three to five years out, and five-plus years out. The performance standard or AQL is to book a minimum of five new groups per year over the two-year period.

From a federal perspective (OFPP, 1998), two major criticisms can be leveled against the MERC Commission performance-based contract: (1) it does not contain a quality assurance or monitoring plan, and (2) incentives and penalties are not included even though the contract is mission critical and involves the expenditure of substantial government funds. Nevertheless, a contract that previously had no performance requirements and no performance standards or acceptable quality levels now contains them. And both a government and a contractor that had little previous experience with PBC are now gaining experience. The MERC

Figure 6: Marketing Services Goals



Source: Adapted from MERC Commission (2001):1

Commission and the contractor have jointly made a substantial move along the continuum from non-PBC to full-PBC. At the expiration of the current contract term, both the MERC Commission and the contractor will be poised and prepared to take the next steps in a developmental approach to PBC.

Assessment

Treating PBC as an incremental and developmental process would appear to have obvious benefits for federal departments and agencies. Not all services and not all contractors may be capable of transitioning from non-PBC to full or complete PBC at one time. Such a transition can create difficulties for contractors as well as disrupt service delivery and affect mission-critical activities. Federal departments and agencies might be better served by conceptualizing PBC as an incremental and developmental process for some services and for some contractors.

Case Example 9—Illinois Department of Children & Families: PBC by Manipulating Contractor Workload

Background

During the 1990s, the Illinois Department of Children & Families (Illinois DCF) had one of the highest child welfare caseloads in the nation. The Illinois DCF decided something had to be done to change the behavior of its contractors (private nonprofit organizations) to focus more on *outcome* performance: finding suitable permanent placements (reunification, adoption, or subsidized guardianship) for children in care. The Illinois DCF decided to adopt performance-based contracting.

What is most interesting about the Illinois DCF approach is that it violates nearly every aspect of the federal perspective on PBC. Based on the essential elements as enumerated by the Office of Federal Procurement Policy (OFPP, 1998), the Illinois DCF approach does not remotely qualify as PBC. While use is made of performance requirements, the Illinois DCF approach does not include: performance standards or acceptable quality levels (AQLs), incentives, or penalties, and no quality assurance or monitoring plan. Despite these “short-comings,” what the Illinois DCF approach has achieved is impressive contractor performance.

Implementation

The Illinois DCF suspected that its traditional cost reimbursement approach to contracting might be creating perverse incentives. Contractors might be keeping children in care longer than necessary

because no incentives or penalties existed in the contract tied to the length of time children were in care. In thinking about its contracting options, the Illinois DCF could have opted to tie contractor payment to performance as is done in the milestone approach used by the Oklahoma Department of Rehabilitative Services (see case example 6). Milestone contracting, however, would put their nonprofit contractors at financial risk for failure to perform. The Illinois DCF decided against adopting a milestone approach, choosing instead to develop its own unique approach to PBC.

The premise of the Illinois DCF approach to PBC is to increase contractor outcome performance (measured in terms of child permanency placements) while holding inputs (measured in terms of dollars) constant (Illinois DCF, 2000; n.d). The Illinois DCF approach accomplishes this objective through the manipulation of contractor workload. Contractors are still compensated using cost reimbursement contracts at a level of 25 cases per caseworker. However, caseworkers are now expected to find permanent placements for at least five children each fiscal quarter. At the beginning of every fiscal quarter, each contractor caseworker is assigned five new cases by the Illinois DCF (see Figure 7). No additional compensation is provided to the contractors or the caseworkers.

If a contractor caseworker places five children during the preceding fiscal quarter, his/her caseload remains constant at 25. If fewer children are placed, the caseworker’s caseload goes up; and if more than five children are placed, the caseworker’s caseload goes down. The Illinois DCF’s approach to PBC has demonstrated impressive results. Contractor performance in terms of the number of

Figure 7: Illinois Department of Children & Families Contractor Caseworker Caseloads

	Caseworker 1	Caseworker 2	Caseworker 3
Old Caseload	25	25	25
Cases Closed	(5)	(0)	(10)
New Cases	5	5	5
New Caseload	25	30	20

child permanency placements has increased over 200 percent since the transition to PBC (Illinois DCF, 2000:3).

Assessment

The Illinois DCF’s approach to PBC does not include the minimum OFPP essential elements. Consequently, the Illinois DCF approach is not considered to constitute PBC according to the federal perspective. What the Illinois DCF lacks in terms of federal purity, however, is more than made up for in terms of changing the behavior of contractors to focus more on performance. Again, the issue is raised as to when should a contract be considered performance based and when should it not. Should the decision depend upon the process that is used or the performance achieved? PBC is supposed to change the way federal departments and agencies contract for services—to get federal employees to think “outside the box.” It would be unfortunate if the OFPP essential elements for PBC simply result in an existing box being replaced by a new box.

Case Example 10—Ontario (Canada) Realty Corporation: PBC with ‘Floating’ Incentives and Penalties

Background

When and how to include incentives and penalties is yet another challenge facing federal departments and agencies in implementing performance-based contracting. Not every performance requirement and associated performance standard or acceptable quality level merits, or would necessarily benefit from, having an incentive or penalty attached. Conversely, situations can arise in which numerous performance requirements are included in a performance-based contract and any particular one might be more or less important depending upon what happens during the contract term. The second situation represents a particular challenge in using PBC. Contracts can always be amended to meet unforeseen circumstances, but formally amending a contract requires the agreement of the contractor.

This last case example comes not from a state or local government, but from the Provincial Government of Ontario, Canada. The Ontario

Realty Corporation has devised a novel solution to the challenge of dealing with multiple important performance requirements and associated performance standards, or AQLs, contained in a long-term performance-based contract.

Implementation

The Ontario Realty Corporation (ORC) is a public corporation of the Ontario, Canada, Provincial Government. The ORC is currently using PBC for land management services. The performance-based contract covers 65,000 acres; 3,500 properties; 1,500 leases; and 1.6 million square feet of commercial and industrial space. The contractor, Del Management Solutions, Inc., is one of Canada’s largest real estate and facility management companies. In addition to its massive scale, what is perhaps even more interesting about ORC’s approach to PBC is the complexity of the contract. The contract contains five output, quality, and outcome performance objectives weighted for relative importance. Associated with these five performance objectives are 13 broad measures, 30 performance measures and 112 performance requirements. The contract includes two types of incentives/penalties: (1) a 10 percent quarterly management fee hold back, and (2) an annual share-in-savings arrangement (Kessel, 2001).

An issue ORC had to resolve in developing its approach to PBC was: Which of the 112 performance requirements should have associated incentives and penalties? Given the size and complexity of the contract, ORC believed that all the 112 performance requirements were important. But ORC

Ontario Realty Corporation Performance Objectives	
Management	(15%)
Financial	(20%)
Asset Integrity	(20%)
Customer Service	(20%)
Rent Collection	(20%)

Source: Adapted from Kessel (2001).

also realized that it would be difficult to administer a contract with incentives and penalties tied to 112 performance requirements and associated performance standards or AQLs. The solution devised by ORC was to create a system of “floating” incentives and penalties. At any one time, the contract incentives and penalties are tied to only about a dozen performance requirements. But ORC reserves the right to change the mix with 30 days’ notice to the contractor (Kessel, 2001).

Because the contractor can’t be sure which set of performance requirements may have associated incentives and penalties at any one time, ORC believes that the contractor will necessarily have to pay attention to all 112. For example, if the contractor’s performance falls below the performance standard or AQL on any one of the 112 performance requirements, ORC can simply change the mix of incentives and penalties to include that specific performance requirement.

Assessment

Federal performance-based contracts can often be complex and contain numerous performance requirements. The use of “floating” incentives and penalties that can be changed during the term of a contract should have numerous potential PBC applications for federal departments and agencies.

Lessons Learned

In summarizing the experiences of state and local governments, drawing conclusions, and identifying lessons learned, the discussion returns to, and is guided by, the basic objective of PBC: *changing the behavior of contractors to focus more on performance.*

Lesson 1. PBC at the state and local government levels differs considerably from what is generally recognized as PBC under federal guidelines.

The federal approach to PBC represents a design specifications approach. To be considered performance based, a service contract must contain certain essential elements: performance requirements, performance standards or acceptable quality levels, a quality assurance or monitoring plan, and, in certain circumstances, positive and negative incentives.

Not being bound by federal guidelines as to what does and does not constitute PBC, state and local governments are free to think “outside the box” and to experiment with various performance-based policies, practices, techniques, approaches, and tools. Instead of being overly concerned with the elements of PBC, state and local governments have adopted more of a performance-specifications approach. State and local governments classify as PBC any service contract that attempts to change the behavior of contractors to focus more on performance, regardless of the approach or the contractual elements involved.

Lesson 2. PBC at the state and local government levels defines “performance” as consisting of outputs, quality, outcomes, or any combinations thereof.

While some confusion appears to exist at the federal level in terms of what constitutes “performance” in PBC, no such confusion exists at the state and local government levels. “Performance” in state and local government PBC is taken to mean outputs, quality, outcomes, and various combinations. This tripartite conceptualization of performance: (1) provides greater clarity as to the purpose of PBC, (2) gives state and local governments more options in structuring performance-based contracts, and (3) aligns more closely the concept of performance in PBC with the concept of performance contained in the service efforts and accomplishments reporting initiative of the Governmental Accounting Standards Board.

Lesson 3. PBC at the state and local government levels involves varying degrees of being performance based.

A goal of PBC is to make *less use* of design specifications (input and process) and *more use* of performance specifications (outputs, quality, and outcomes). The experiences of state and local governments demonstrate that service contract specifications can be conceptualized on a continuum (inputs → process → outputs → quality → outcomes) from “non-PBC” to “full-PBC.” At the non-PBC end of the continuum are service contracts that make exclusive use of design specifications; at the full-PBC end of the continuum are service contracts

that make exclusive use of outcome performance specifications. In between fall varying degrees of being performance based. Conceptualizing PBC on a continuum allows for an incremental and developmental approach to be taken with certain services and with certain contractors.

Lesson 4. PBC at the state and local government levels challenges the notion that there is one best way to do performance-based contracting.

The state of the art in PBC today is insufficiently well developed to make any claims about how best to implement this new form of service contracting. What can be said is that state and local governments utilize a variety of different approaches in implementing PBC. The common denominator in these various approaches is the conscious attempt on the part of state and local governments to change the behavior of contractors to focus more on performance.

Lesson 5. PBC at the state and local government levels includes share-in-savings contracting, revenue enhancement contracting, and milestone contracting.

The experience of state and local governments clearly demonstrates that share-in-savings contracting, revenue enhancement contracting, and milestone contracting can affect the behavior of contractors to focus more on performance. Thus, these approaches warrant being called PBC. In the case of both share-in-savings contracting and revenue enhancement contracting, contractor behavior is changed to focus on the accomplishment of certain processes and outputs that lead in turn to the accomplishment of certain desired outcomes (reduced service delivery costs and increased revenues). In the case of milestone contracting, contractor behavior is changed to focus more on performance because output, quality, and outcome performance requirements, as well as incentives and penalties, are automatically built into the contract.

Lesson 6. PBC at the state and local government levels makes frequent use of incentives and penalties regardless of mission criticality or the dollar value of the contract.

The federal approach to PBC suggests that positive and negative incentives should be included in a

performance-based contract when the contract is mission critical or when the contract involves the expenditure of a large amount of public funds. State and local governments routinely make use of incentives and penalties in PBC regardless of mission criticality or the dollar value of the contracts. The inclusion of incentives and penalties is a major motivational factor in changing the behavior of contractors to focus more on performance.

Lesson 7. The manipulation of workload can change the behavior of contractors to focus more on performance, exclusive of other PBC considerations.

As the case example of the Illinois Department of Children & Families demonstrates, the manipulation of workload can change the behavior of contractors to focus more on performance without the contract containing all of the essential elements identified in the federal approach to PBC. While use is made of performance requirements, the Illinois DCF approach does not include performance standards or acceptable quality levels, incentives, or penalties—even though the contracts are mission critical—and has no quality assurance or monitoring plan. Despite these “shortcomings,” the Illinois DCF approach to PBC has achieved impressive results in terms of changing contractor behavior to focus more on performance.

Lesson 8. The adoption of “floating” incentives and penalties is a useful approach when a performance-based contract contains numerous important performance requirements.

Conventional wisdom suggests that PBC should involve a small number of incentives and penalties tied to an equally small number of performance requirements and associated performance standards or acceptable quality levels. The Ontario (Canada) Realty Corporation case example demonstrates how this rule can be applied to a complex contract with multiple (112) important performance requirements. By tying incentives and penalties to a small number (12) of performance requirements and AQLs, but maintaining the unilateral right to change the mix with 30 days’ notice, the contractor is forced to concern itself with all 112 performance requirements. Because the contractor can never be sure which mix of performance requirements will have

associated incentives and penalties, it must ensure that none diverge too far from their performance standards or AQLs.

Lesson 9. Third party certification is a low-cost and highly reliable approach to quality assurance and monitoring.

The DeKalb County, Georgia, case example demonstrates how the quality assurance or monitoring function can be delegated to an independent third party when licensure, certification, or accreditation requirements exist. Third party certification is low cost as well as highly reliable in that licensure, certification, and accreditation usually require meeting multiple performance requirements, including *quality* and *outcome*. Third party certification can be used to either augment or replace other approaches to quality assurance or monitoring. The use of third party certification for quality assurance or monitoring is a good example of “working smarter, not harder.”

Lesson 10. The step-up/step-down method is a useful approach to structuring incentives and penalties.

Structuring incentives and penalties to step up and step down from the performance standard or acceptable quality level makes clear to contractors the implications of acceptable performance and unacceptable performance. As detailed in the City of Charlotte case example, step-up/step-down incentives and penalties tend to keep the contractor focused on the performance standards. Additionally, the contractor also has positive and negative motivations to achieve the performance standards. When incentives and penalties step up/step down in similar fashion, and in similar quantities, an appeal is also made to fairness.

Lesson 11. Contracting for non-specific performance is a creative approach to structuring PBC that may be useful in at least some situations.

The idea of contracting for non-specific performance tied to the benchmark of another service provider (a contractor or an in-house department) represents an interesting approach to PBC that may be useful to some federal departments and agencies in at least some situations. As the Arizona Department of Economic Security case example

demonstrates, contracting for non-specific performance represents a way of automatically adjusting for changes in economic conditions and other factors that may affect contractor performance during the term of the contract. This approach has the added advantage of simulating a classic experimental research design, with the benchmark provider representing the control group and the performance-based contractor representing the experimental group.

Recommendations

The Office of Federal Procurement Policy formed an interagency working group in April 2002 to address performance-based contracting. The working group, comprised of procurement and program analysts from a number of federal departments and agencies, is examining the basic tenets of PBC including the essential elements and goals. The working group will make recommendations to the administrator of the OFPP concerning possible changes to existing guidance and regulations. The following recommendations are addressed to the working group and to the OFPP.

The OFPP should consider revising the guidance it provides federal departments and agencies on performance-based contracting to:

Recommendation 1. Make federal PBC more compatible with the performance accountability framework and language of the Government Performance and Results Act and the Service Efforts and Accomplishments (SEA) reporting initiative of the Governmental Accounting Standards Board.

This action will make PBC more compliant with what is rapidly becoming a common language of government performance accountability. Also, if PBC is to become a primary tool of federal procurement, then it must become more compliant with the primary performance accountability frameworks of the federal government and state and local governments.

Recommendation 2. Operationally define “performance” as including outputs, quality, outcomes, or any combination thereof.

This action will resolve the current conflicting and contradictory operational definitions of PBC provided by:

- the OFPP, which views PBC as contracting for outputs and quality
- the Department of Defense, which views PBC as contracting for outcomes
- the Federal Acquisition Regulation, which views PBC as contracting for outcomes and quality

This tripartite conceptualization (outputs, quality, outcomes) will also ensure that federal PBC takes a comprehensive view of performance to include considerations of efficiency (outputs), quality, and effectiveness (outcomes).

Recommendation 3. Recognize that varying degrees of being performance based can exist.

This action will recognize PBC as existing on a continuum from “non-PBC” to “full-PBC” and will allow for an incremental and developmental approach to be taken with some services and with some contractors. The federal perspective is that a service contract is either performance based or not depending upon the presence or absence of four essential elements:

- performance requirements
- performance standards or acceptable quality levels
- a quality assurance or monitoring plan
- positive and negative incentives if the service is mission critical or involves a large expenditure of public funds

The “all or nothing” federal perspective may result in federal departments and agencies choosing not to attempt PBC with some services and with some contractors.

Structuring incentives and penalties to step up/step down from the performance standards or acceptable quality levels will make clear to contractors the implications of acceptable performance and unacceptable performance. When incentives and penalties step up/step down in similar fashion, and in similar quantities, an appeal is also made to fairness.

Recommendation 4. Include share-in-savings, revenue enhancement, and milestone contracting as recognized optional forms of PBC.

This action will recognize the validity of existing practices. Share-in-savings, revenue enhancement, and milestone contracting all seek to change the behavior of contractors to focus more on performance (outputs, quality, and outcomes). As such, they constitute optional forms of PBC and should be so recognized. This action will also begin the process of identifying and classifying various approaches to PBC.

Recommendation 5. Adopt third party certification as an acceptable optional approach to quality assurance and monitoring.

This action will add a low-cost and highly reliable form of quality assurance and monitoring to the list of recognized and acceptable approaches. Currently, the federal approach to PBC recognizes only: (1) 100 percent inspection, (2) random sampling, (3) periodic inspection, and (4) customer input. Third party certification (licensure, certification, or accreditation) usually requires meeting multiple performance requirements, including *quality* and *outcome*. Third party certification should be allowable to either augment or replace other approaches to quality assurance or monitoring.

Recommendation 6. Promote the use of the step-up/step-down method for structuring incentives and penalties in PBC.

This action will provide federal departments and agencies with a simple and easy-to-use strategy for structuring incentives and penalties in PBC.

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ABOUT THE AUTHOR

Lawrence L. (Larry) Martin is an Associate Professor at the Columbia University School of Social Work, where he also serves as Director of the Social Administration Program. He earned his B.S., M.S.W. and Ph.D. from Arizona State University and his M.B.A. from the American Graduate School of International Management (Thunderbird). From 1988 to 1994, he was on the faculty of Florida Atlantic University's School of Public Administration.

Dr. Martin has served in a variety of state and local government positions including director of Aging Programs for the Arizona Department of Economic Security (1976–78), assistant and deputy director of the Maricopa County (Phoenix, Arizona) Human Resources Department (1980–1982), and director of the Maricopa County (Phoenix, Arizona) Office of Management Analysis (1984–1988).



Dr. Martin is the author of *Financial Management for Human Service Administrators* (2001), *Contracting for Service Delivery: Local Government Choices* (1999), and *Total Quality Management in Human Service Organizations* (1993). He is the co-author of *Designing & Managing Programs* (1999), *Measuring the Performance of Human Service Programs* (1996), and *Purchase of Service Contracting* (1987); and co-editor of *Handbook of Comparative Public Budgeting & Financial Management* (1993). He is also the author of a previous PricewaterhouseCoopers Endowment grant report, "Determining a Level Playing Field for Public-Private Competition" (1999). In addition, he has published over 70 articles, book chapters, and monographs dealing with performance-based contracting, service contracting, public-private competition, performance measurement, financial management, and human service administration.

Dr. Martin has taught courses in social administration, financial management, program evaluation and performance measurement, public management, and state and local government. He has provided consultation and training for state and local governments and nonprofit organizations nationally and has lectured and delivered invited presentations to governments and non-governmental organizations in Canada, France, Germany, and Sweden. He is currently working with the National Institute of Governmental Purchasing to revise and update its training and certification materials dealing with contracting for public sector services.

K E Y C O N T A C T I N F O R M A T I O N

To contact the author:

Lawrence L. (Larry) Martin

Associate Professor
Columbia University
School of Social Work
622 W. 113 Street
New York, NY 10025
(212) 854-2735

e-mail: LLM15@columbia.edu.

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For additional information, contact:

Mark A. Abramson

Executive Director

IBM Endowment for The Business of Government

1616 North Fort Myer Drive

Arlington, VA 22209

(703) 741-1077, fax: (703) 741-1076

e-mail: endowment@businessofgovernment.org

website: www.businessofgovernment.org

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