

Principles for Assessing the Organization of Central Management Functions of Government

**Statement of
John M. Kamensky
IBM Center for The Business of Government**

before

**The Little Hoover Commission
The Capitol, Sacramento, California**

November 18, 2004

Mr. Chairman and Members of the Commission:

Thank you for the opportunity to discuss insights regarding principles the Commission should consider as it assesses the Governor's reorganizing plans that he will submit to the Legislature in response to recommendations from the California Performance Review.

I am a Senior Fellow with the IBM Center for The Business of Government. The IBM Center for The Business of Government is dedicated to stimulating research and facilitating discussion of new approaches to improving the effectiveness of government at all levels in the United States and across the world. Prior to this position, I served at the U.S. Office of Management and Budget, the U.S. Government Accountability Office, and as deputy director of the U.S. National Performance Review. In these roles, I have had the opportunity to review, and participate in, a number of government reorganization efforts. I hope my insights from these experiences will be helpful to you today.

When first asked if I would share my insights, I immediately recalled three pieces of advice shared with me by several wise practitioners over the years.

First, a number of years ago, I had the opportunity to get to know Donald Stone, a luminary in American public administration who had helped organize the first federal Bureau of the Budget under President Franklin Roosevelt, and later helped organize the United Nations. I asked him how he approached a major reorganization effort. He wisely said:

“If a highly centralized organization isn't working well, the solution is to decentralize it. If it is already decentralized, then the remedy is centralization.”

Second, years later, I had the opportunity to work for Vice President Al Gore when he asked me to help run his Reinventing Government effort. When asked his preference for approaching government reform, he quickly said: “Don’t waste time moving the boxes; fix what’s inside the boxes.” Well, sometimes the problems are so big, we found that you do need to move them, but it is politically challenging to do so.

And finally, I remember a conversation with a former colleague at the General Accounting Office who led the post-mortem assessment of President Jimmy Carter’s reorganization efforts, and he simply showed me the title of the report: “Implementation: The Missing Link.”

So with these timeless pearls of wisdom, I stood back and reflected on my own experiences as I prepared to talk with you today. From this vantage point, I think there are three inter-related issues you face in assessing any reorganization proposals regarding the central “machinery of government”

- How does the governor manage his policy and decision-making functions, such as budgeting, strategic planning, and performance evaluation?
- How does he get results on policy initiatives that span a number of agencies, localities, and nonprofits? and,
- How does he organize the development of common administrative policies that reach across the government, such as personnel, finance, procurement – as well as their delivery?

Based on conversations with your staff, the scope of my presentation today will only address the latter. However, I would be glad to discuss the others at an appropriate time. In addition, please recognize that my remarks are based on my past experience at the federal level, and not any in depth knowledge of the challenges currently facing California’s government, the evolution of the recommendations of the California Performance Review, or the recent experiences of other state government reorganization efforts around the country.

Trends in Public and Private Sectors on Their Treatment of Common Administrative Functions

In my experience, there are three distinct sets of business models in how public sector organizations might approach the organization of their mission and functions:

The Classical Hierarchical Model. Most traditional reorganizations in government over the past 60 years have been based on industry and corporate practices from the mid- to late-20th century. These reflect many of the principles underlying the recommendations of the CPR: Form should follow function. Ensure clear accountability. Coordinate the delivery of services. Consolidate disparate, but common, services to reduce duplication and overlap.

Many of these principles are timeless, but several other organizing models have evolved in the public sector in the past 20 years that are also worth considering.

The Principal-Agent Model. This model is based on a contractual relationship between the “principal,” or the political leader, and the “agent” or the service delivery leader. It is most useful for measurable operations in direct service delivery organizations, such as drivers license bureaus, and payroll services. This model has been used successfully in other countries, such as New Zealand. Mr. McTigue will be sharing some of that experience with you today. In the U.S. federal government, it has been applied to a limited extent via performance-based organizations, such as the US Patent and Trademark Office, and in some agencies as they deliver administrative support services via franchise funds. This approach is also used heavily in the private sector via shared service organizations. At the federal level, common administrative service delivery is currently being reorganized around “lines of business,” such as procurement, grants management, and payroll services.

The Network Model. The third approach that is still evolving in the public sector is the Network Model. This is particularly useful for managing policy outcomes that reach across traditional agency boundaries. It is often customer-centric and addresses a policy outcome from end-to-end, not just the role of each individual program or agency. In some quarters, this is called “portfolio management,” where one political leader is responsible for coordinating a range of programs, regardless of which agency the programs are located. In other quarters, this is referred to as “virtual agencies” or “outcome-based government.” Examples include the New York City Police Department’s Compstat program, and Baltimore’s Citistat initiative. Both have been recognized by the Ford Foundation for their innovative approach and success. Elements of this approach are also reflected in the work of the Washington State budget process, known as “outcome-based budgeting.”

Elements of all three models are reflected in the current approach used by the federal government in its policy development for, and provision of, common administrative services.

Experience of the U.S. federal government. The federal government’s approach to the provision of common administrative services is through a “federated” system. This system was largely put in place in 1949 as a result of the work of the first Hoover Commission, which is similar to the opportunity California has before itself. In this approach, policymaking is largely centralized. Some of the central policymaking agencies, such as the Office of Personnel Management, provide the direct delivery of services on a cost-reimbursable basis for services that agencies can either provide themselves or contract with the central agency on a voluntary basis to be provided. In selected areas, there is a governmentwide, mandatory direct delivery of services, such as retirement and health care benefits. The general trend over the past 15 years, however, has been largely a shift from mandatory, centralized services to voluntary service provision by central agencies that is customized to the mission needs of the customers. Increasingly, however, this is done in the context of a broader, governmentwide

framework. The federal government's policymaking and service delivery of common administrative services is organized in three tiers:

- Office of Management and Budget. OMB provides budget development, oversight, and execution controls as well as oversees the development of management policies (legislative clearance, procurement, financial management, technology, regulatory clearance, asset management, etc.). These elements are integrated at the agency account level by individual budget program examiners. Much of its management functions are supervised by a Deputy Director for Management.
- Independent support agencies. A series of independent support agencies provide a mix of implementation standards and procedures, regulatory oversight and enforcement, and service delivery functions to other agencies, with some oversight by OMB – Office of Personnel Management (policy, executive development, benefits), General Services Administration (real estate, travel, procurement delivery, fleet management, etc.), financial management and banking (Financial Management Services in Treasury), Office of Legal Counsel (in Justice Department).
- Interagency councils. A series of interagency councils comprised of support function officials advise OMB and the support agencies and coordinate implementation of governmentwide initiatives. These are generally chaired by OMB: Chief Financial Officers, Chief Information Officers, Chief Human Capital Officers, and Chief Acquisition Officers.

Experience of other countries. Some countries, such as the United Kingdom, provide common administrative services through a classical centralized delivery model, which is managed much like a regulated utility. Others, such as New Zealand, have developed a decentralized, market-based model. Mr. McTigue will elaborate on this in his presentation.

Experience of private sector. When IBM faced a financial crisis in the early 1990s, it both restructured its business as well as its internal operating systems. It relied heavily on both the principal-agent/market-based model as well as the network model. For example, it moved its internal operations to common operating standards and provided unified, shared services that were “sold” to IBM’s operating units. It also moved to a common computing infrastructure. In terms of organizational structure, IBM went from 128 Chief Information Officers to one in the 1990s. Over the first eight years of its transformation, it invested \$4.7 billion and saved \$14.5 billion.

It is important to note that, in any reorganization effort, the relative emphasis on approach depends heavily on the existing context – degree of leadership commitment, stability of the systems, the degree of urgency for action, etc. In addition, the scale of the system matters. The entire federal government has about 1.8 million civil servants. In the case of California, for example, its civil service is about the size of the federal Department of Veterans Affairs. So, scale may affect strategy.

It is also important to note that a key lesson from past reorganization efforts is that reorganization is not primarily about savings. Tom Szanton, the leader of President Carter's reorganization efforts, says the primary purposes of a reorganization effort tend to be to shake up an organization, symbolize priorities, improve policy integration, and streamline operations. In fact, even in the private sector, only about half of major reorganizations result in savings. In summary, the primary focus of a reorganization tends to be better program and performance effectiveness.

Organizing Principles

Given this background, I would like to share five organizing principles that you may want to consider applying when assessing any reorganization plan for common state governmentwide administrative services. My bias, as you might have already detected, is that market-based forces seem to work best for larger service delivery systems with multiple stakeholders, such as common administrative services.

1. Separate policy and regulatory functions from service delivery functions.

The first step in the organizational design of a central services support organization is to define its scope and role. A primary consideration should be the separation of policy and regulatory oversight functions from the service delivery functions. The classical public administration axiom applies here: no single element of any agency should outweigh other (in personnel, budget, or policy significance) or it will dominate the whole. This is especially true of a budget office. The role of a classic budget office is that it advocates and advances the governor's agenda and deals with day-to-day fires. This tempo drives out any ability to focus on day-to-day operational issues. At the federal level, the Office of Management and Budget does not have operational responsibilities and it is included in the institutional Executive Office of the President.

Also, the experience at the federal level is that if a service delivery agency also controls policy and oversight, it tends to bend (or create) the rules in its favor, not the customers. This was true in the federal General Services Administration and the Office Personnel Management until they removed all policy and oversight functions from their service delivery functions and put them in a separate office. In some cases, these functions are located in a separate agency to ensure a clear separation.

2. Do not create service delivery monopolies.

My observations about monopolies are two-fold, and negative. First, efforts to achieve economies of scale generally lead to diseconomies of service responsiveness. This is because central agencies tend to see the world differently than mission-oriented agencies. A classic story is about the purchase of steam traps in the Defense Department in the early 1990s. Steam traps are used in radiator heating systems to remove dirt from the steam lines. When they leak, building engineers say they waste about \$50 of steam a week. Replacements cost about \$100. But the centralized procurement office has an

efficiency incentive when making purchases. This is part of the procurement culture. So they save up requests for new steam traps until they can bulk order them to get a \$10 discount. This takes about a year. Meanwhile the leaking steam trap has wasted \$2,500 in steam. But the procurement office saved \$10!

Second, the goal to reduce duplication and overlap in services and functions can have the unintended consequence of creating the inability to recover from unanticipated events – earthquakes, floods, sudden surges in demand for services, etc. For example, when the Veterans Affairs’ record storage unit in St. Louis burned down a number of years ago, nearly an entire generation of veterans have been hobbled in their ability to receive benefits. While unnecessary duplication should be avoided, continuity of operations needs to be a serious consideration when developing a reorganization plan.

3. *For the service delivery functions, create a governance system that is customer-focused, responsive, and accountable to the users.*

For example, if you choose to use a regulated utility approach, where all services are provided centrally instead of a pure market-based approach, consider creating a shared services Board of owners, which in turn, hires the director for a term appointment with salary based in part on performance. Alternatively, the board could be advisory and be a key input into the assessment of performance of the director. The director should be given substantial latitude in how he or she chooses to meet the expectations of the customers, such as whether to use government employees or other providers to deliver services.

4. *For the service delivery functions, introduce market-based incentives and performance transparency.*

For example, service users should pay for agreed-upon services. The organization would not be appropriated any funds; its support would be fee-based from its customers. This has important implications. It means the customer agencies have to know what services they need, they need to be able to determine what they are able to pay for those services, and they need to be able to specify both in a performance-based contract with the service provider. Experience at the federal level is that this is not a trivial task, but has significant savings implications. For example, the Federal Aviation Administration’s Logistics Center for spare parts realized savings of more than 20 percent when it applied this approach to its business.

Other market-based elements that might be considered include:

- Creating a revolving fund, with written service level agreements with each customer agency. There may be a need for an appropriation for an initial start-up capital fund, but it should be repaid to the state treasury after an agreed-upon period, with interest. This approach has been used with federal franchise funds in a number of agencies.

- Publicizing organizational performance metrics, using proven methods such as balanced scorecard and benchmark its performance against industry standards. This would both keep the agency on its toes with its customers, but its customers could also see what are appropriate expectations for service. The federal Public Buildings Service uses this approach successfully with its customers.
- Requiring customer agencies to join initially, but allow an opt-out after 3-5 years, with renewable term contracts. If agencies feel they are stuck, and have no ability to influence the quality of the services they receive with an “exit” provision, they will strongly oppose a centralization effort. However, if they feel that they have a “trial period,” this might work.

5. For the service delivery functions, manage services and costs from the user perspective.

For example, each operating division within the organization, such as the procurement and the human resources operations, should prepare their own revenue and expenditure statements. Look at the standards for the Federal franchise funds, which are attached to this statement for an example of other business operating principles that are being applied at the federal level for common administrative services.

The decisions regarding the scope of functions to be included in a new organization, as well as its purpose and business model are important. However, the implementation strategy should not be ignored at the design stage. Remember the GAO report mentioned earlier!

Best Practices in Implementing Large-Scale Changes

Probably one of the biggest organizational transformations has been undertaken by IBM, which has been ten years in the making. IBM is a company with about \$85 billion in revenues and about 320,000 employees worldwide. So its scale is somewhat larger than California’s state government.

In 1993, IBM was at a crossroads. Serious financial crises led it to the verge of a breakup. But a new chairman, Lou Gerstner, decided that keeping IBM as a single company made good business sense. He found, though, that IBM did not act as a single company. It had 24 separate business units, 5,000 different hardware products and 20,000 different software products. Internally, it had 16,000 unique applications deployed companywide.

“Simplicity” became a key theme in IBM’s transformation. It went from 155 data centers to 12; from 31 separate networks to one, from hundreds of different PC configurations to four. It cut its IT spending by over 30 percent, even with an increase in volume. It outsourced its own computer operations, saving more than half-a-billion dollars. These changes allowed IBM to focus on strategic issues, resulting in both process and cost efficiencies.

A key approach was to not reengineer individual processes, but to look at the big picture and look for end-to-end integration opportunities across the “value chain,” such as the purchase, transportation, storage, use, and disposal of supplies.

To manage this transformation, IBM created a “Business Process Council” comprise of a matrix of newly designated value chain owners and business transformation executives. Each of the seven “value chain owners” would be responsible for a key element in the company, such as distributed software or OEM hardware. A “business transformation executive” would be designed within each value chain and be responsible for driving implementation and end-to-end business integration. In addition, IBM designated customer, employee, and supplier collaboration executives to ensure these stakeholders were engaged in the process.

While IBM’s experience may not be directly applicable to the design of California’s reorganization plan, lessons in how it implemented its restructuring may be very valuable down the road, and I would be more than glad to connect you with senior executives in the company who experienced that effort first-hand.

Conclusion

Mr. Chairman, this concludes my prepared statement.

I have appended to my statement references to several IBM Center for The Business of Government resources that may be helpful. One is a report by Professor Peter Frumpkin, *Making Public Sector Mergers Work: Lessons Learned*, which will provide useful implementation guidance when bringing agencies together. Another is a report by Tom Stanton, *Moving Toward More Capable Government: A Guide to Organizational Design*, which may be helpful as you assess reorganization proposals.

I would be pleased to respond to questions.

Operating Principles for Federal Franchise Funds

- **Competition:** Interagency support organizations cannot be monopolies and should offer services on a fully competitive basis.
- **Voluntary exit:** Customers should be able to go elsewhere for services, after appropriate notice to the service provider.
- **Unsubsidized full cost recovery:** Operations should be self-sustaining, with fees established to recover full costs as defined by federal accounting standards.
- **Surge capacity:** Resources to provide for capital investments and peak business demand should be available.
- **Full-Time Equivalent Staff accounting:** Staffing should be accounted for consistent with the Federal Workforce Restructuring Act and OMB circulars.
- **Initial capitalization:** The organization should support enough staff to meet initial projected commitments.
- **Flexibility:** Operations should maintain the ability to adjust capacity and resources up or down, as business volume or other conditions dictate.
- **Cessation of activity:** Service providers should give reasonable notice when curtailing or eliminating service.
- **Organization:** Operations should maintain a clearly defined structure with separately identifiable units for accumulating and reporting costs and revenues, without commingling with another organization.
- **Services:** Only common administrative support services should be provided.
- **Performance measures:** Comprehensive performance measures should be used to assess each service provided.
- **Benchmarks:** Organizations should maintain and evaluate cost and performance benchmarks against competitors.

Source: John Callahan, *Franchise Funds in the Federal Government: Ending the Monopoly in Service Provision*, IBM Center for The Business of Government (February 2002), p. 12.

Additional Resources

IBM Center for the Business of Government

(available at www.businessofgovernment.org)

Callahan, John, *Franchise Funds in the Federal Government: Ending the Monopoly in Service Provision* (February 2002)

Frumkin, Peter, *Making Public Sector Mergers Work: Lessons Learned* (January 2004, second edition).

Gansler, Jacques, *Moving Toward Market-Based Government: The Changing Role of Government as the Provider* (March 2004, 2nd edition)

Stanton, Thomas H., *Moving Toward More Capable Government: A Guide to Organizational Design* (June 2002).

Other Resources

Benda, Peter and Charles Levine, “OMB and the Central Management Problem: Is Another Reorganization the Answer?” *Public Administration Review*, Sept/Oct 1986, Vol. 46, No. 5, pp. 379-391.

Kettl, Donald and John DiIulio, Jr., *Cutting Government*, A Report of the Brookings Institution’s Center for Public Management, May 22, 1995.

IDC, “IBM Business Transformation Through End-to-End Integration,” August 2002.

Szanton, Peter, ed., *Federal Reorganization: What Have We Learned?*, Chatham House Publishers, Inc. 1981.

U.S. Government Accountability Office, *Government Management Issues*, GAO/OCG-93-3TR, January 1993.

_____, *Improving Government: Need to Reexamine Organization and Performance*, GAO/GGD-93-9, March 11, 1993.

_____, *OMB 2000: Changes Resulting from the Reorganization of the Office of Management and Budget*, GAO/T-GGD/AIMD-96-68, February 7, 1996.

Submitted by:

John M. Kamensky, Senior Fellow
IBM Center for the Business of Government
Suite 400, West Tower, 1301 K St., NW
Washington, DC 20005
(202) 515-4102
john.kamensky@us.ibm.com