

## **PERFORMANCE-BASED CONTRACTING FOR HUMAN SERVICES: LESSONS FOR PUBLIC PROCUREMENT?**

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**ABSTRACT.** Performance-based contracting is receiving increased attention today as a method of improving the efficiency, quality and effectiveness of government contract service delivery. While professional interest in performance-based contracting is being focused primarily on traditional government services, some of the more interesting applications are actually taking place in the human services. This article looks at performance-based contracting by selected state human service agencies, the approaches being used and results being achieved. The article concludes that performance-based contracting for human services does appear to be accomplishing its objective: changing the behavior of contractors to focus more on performance. The lessons learned by state human service agencies appear to have relevance for larger issues of public procurement.

### **INTRODUCTION**

Regardless of whether one refers to the phenomenon as “privatization,” “contracting out,” “outsourcing,” or some other appellation, governments at all levels (federal, state and local) today are making increased use of service contracting. For example, the federal Commercial Activities Panel of the General Accounting Office (GAO, 2001a, p. 4) reports that for fiscal year 2000, total federal service contracting reached \$88 billion, surpassing all other categories including supplies and equipment (\$77 billion), research and development (\$24

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billion) and construction (\$17 billion). While similar data are unavailable for state and local governments, two recent studies suggest that the use of service contracting is also increasing. A national survey conducted by the Council of State Governments (Chi & Jasper, 1998, p. 4) reports that a majority (56%) of state departments and agencies has increased its use of service contracting. In the same vein, a national survey conducted by the International City/County Management Association (ICMA) finds that some 66% of local governments are considering increasing their use of service contracting (Martin, 1999a, p. 12).

Given the increasing interest in service contracting, it is not surprising that governments are also increasingly interested in discovering new ways of improving contractor performance. Performance-based contracting is one method governments are using to accomplish this goal (Gordon, 2001; Martin, 2000; OFPP, 1998; Eggers, 1997a). For example, the Bush Administration, through the Office of Management and Budget (OMB), has established an objective of making at least 25% of all federal service contracts over \$25,000 performance-based in fiscal year 2002 (OMB, 2001). Looking farther ahead, the federal Procurement Executive Council has established a goal of making 50% of all federal service contracts performance-based by fiscal year 2005 (GAO, 2001b). Interest in and experimentation with performance-based contracting at the state and local government levels also appears to be increasing. The National Association of State Purchasing Officials (NASPO, 1997a, p. 120) has identified performance-based contracting as one of the “current trends in public procurement” with 31 of 50 state purchasing offices reporting increased use of performance specifications (NASPO, 1997b). The International City/County Management Association (ICMA) has also recently published a how-to-guide on performance-based contracting for local governments (Gordon, 2001).

#### **A CONSENSUS DEFINITION OF PERFORMANCE-BASED CONTRACTING**

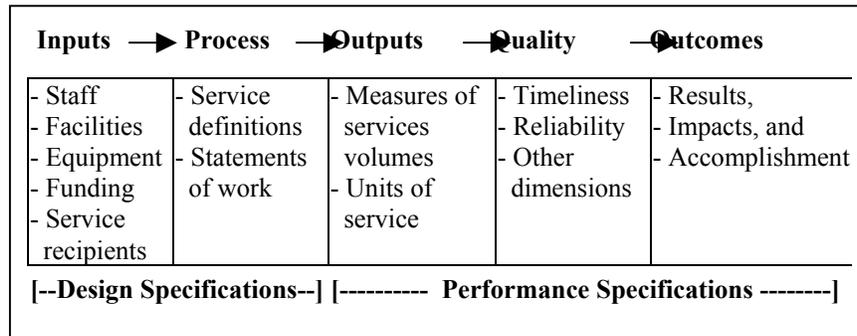
Performance-based contracting represents one of those interesting phenomenon that arise from time-to-time in public procurement where practice is outpacing theory. Consequently, no commonly agreed upon definition of performance-based contracting exists. To fill the void, several public procurement oriented organizations have proposed

working definitions of performance-based contracting. For example, the Office of Federal Procurement Policy (OFPP) defines performance-based contracting as an approach where the statement of work is based on “objective, measurable performance standards outputs” (OFPP, 1998, p. 5). In a related policy memorandum addressed to federal procurement officials, the OFPP provides further guidance stating that a performance-based contract contains “performance standards (i. e., quality, quantity, timeliness)” (OFPP, 1997, p. 2). The Department of Defense (DOD), 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, p. 1). The National Association of State Purchasing Officials (NASPO) has also joined in with its own working definition. According to NASPO, performance-based contracting is characterized by, “specification of the outcome expectations of the contract and the requirement that any renewals or extensions be based on the achievement of the identified outcomes” (NASPO, 1997, p. 120) (emphasis added in all quotations). While not made explicit in these definitions, the implicit assumption in all of them is that contractor compensation, in part or in toto, may also be tied to performance.

The various working definitions of performance-based contracting that have been proposed may appear at odds with one another, particularly given their various emphases on: outputs, quality, quantity, timeliness, and outcomes. In reality, however, a great deal of commonality exists. One can argue that these various definitions, rather than saying different things, are merely saying the same thing differently. As Figure 1 illustrates, all the proposed definitions have a similar perspective: they are attempting to move service contracting away from its historical reliance on input and process *design* specifications (telling contractors how-to perform the work) in favor of output, quality and outcome *performance* specifications (telling contractors what is expected and leaving the how-to up to them). By allowing contractors to determine how best to accomplish the work, performance-based contracting strives to increase creativity and innovation in government service delivery.

By building upon the various definitions that have been proposed, a consensus definition of performance based contracting can be derived. A performance-based contract can be defined as one that “focuses on

**FIGURE 1**  
**The Systems Framework and Service Contracts**



the *outputs*, *quality* and *outcomes* of service provision and may tie at least a portion of a contractor's payment as well as any contract extension or renewal to their achievement" (Martin, 1999b, p. 8). This consensus definition has several advantages. It is expansive, rather than restrictive, by suggesting that performance-based contracting can involve outputs, quality, outcomes or any combination thereof. This consensus definition is also compatible with The Government Performance & Results Act (GPRA) at the federal level as well as the service efforts and accomplishments (SEA) reporting initiative of the Governmental Accounting Standards Board (GASB, 1994) at the state and local government levels. Because this consensus definition is compatible with GASB's SEA reporting, it is also compatible with most state government performance measurement and performance budgeting systems (Melkers & Willoughby, 1998). Finally, the consensus definition is reflective of the actual performance-based contracting activities of state human service agencies.

#### **PERFORMANCE BASED CONTRACTING FOR HUMAN SERVICES**

When one thinks of public procurement and performance-based contracting, the human services (also called social services) do not usually leap to mind. In general, public procurement professionals are not as knowledgeable about contracting for human services as they are about other government services. Conversely, most human service professionals have only limited knowledge of public procurement. This situation of mutual ignorance is unfortunate. Many human service agencies find themselves involved in less than satisfactory service

contracts because they are not well grounded in public procurement and government contract administration. And even when human service agencies do turn to their public procurement departments for assistance, the lack of knowledge about human services on the part of purchasing professionals can be an impediment to a successful procurement. Human service contracting, as well as public procurement in general, might both be improved if human service professionals and procurement professionals would communicate more with each other and learn from each other's successes and failures.

A little known fact among public procurement professionals is that state human service agencies have been making significant use of service contracting since the late 1960s (Wedel, 1974.) More publicly funded human services are provided via contractual arrangements than are provided directly by public employees, and this situation has existed for over 30 years (Benton, Field & Millar, 1978). It should come as no surprise that state human service agencies, given their history with service contracting, have been among the first governments to experiment with performance-based contracting (Martin, 2000; Kettner & Martin, 1995, 1993). The remainder of this article is devoted to a review and assessment of some of the more interesting case examples of performance-based contracting initiatives that have been undertaken by state human service agencies. The states were selected based on their reputations as innovative leaders in applying performance-based contracting concepts to the human services (Martin, 2002). Some of the state initiatives reviewed are broad based and involve many different types of human services (e. g., child welfare, mental health, refugee resettlement, job training, etc.). Other initiatives are more experimental in nature and tend to be targeted at one or a small number of human services. At least some of the lessons learned by state human service agencies would appear to have relevance for public procurement, government contract administration and the application of performance-based contracting to other government service areas.

### **Maine Department of Human Services (Maine DHS)**

By mandate of the state legislature, all human service contracts entered into by the Maine Department of Human Services (Maine, DHS) after July 1, 1997 must be "performance based" (Maine DHS, 1997). All

contractors were transitioned to performance-based contracts during fiscal years 1997 and 1998 (Martin, 2000, p. 38). Today all contracts issued by the Maine DHS contain performance (e.g., output, quality and outcome) standards. The Maine DHS has not attempted to directly tie contractor payments to performance, but does link contract renewals and extensions to the accomplishment of performance standards (Clary, Ebersten & Harlor, 2000). The approach being pursued by the Maine DHS is predicated on granting contractors sufficient time to gain experience in collecting and reporting performance data and computing and verifying service cost data before performance-based contracting is taken to the next level. The Maine DHS refers to its approach as a “partnership” model of performance-based contracting (Clary, Ebersten & Harlor, 2000).

Commons, McGuire and Riordan (1997) conducted an early evaluation of the Maine DHS’s use of performance-based contracting for substance abuse services. Their study reported two major findings: (a) the achievement of outputs and outcomes increased when tied to contract renewal, and (b) the greater the proportion of a contractor’s operating budget that came from a performance-based contract, the greater the performance. While the findings are not startling, they do confirm the basic premise of performance-based contracting: that contractor behavior can be influenced by the design of the contract. More importantly, the study suggests that contractor behavior can be changed to focus more on performance even without directly linking contractor compensation to performance.

### **Minnesota Department of Human Services**

For several years now, the Minnesota Department of Human Services (Minnesota DHS) has been experimenting with performance-based contracts for job placement services for refugees (Vinson, 1999). Each performance-based contract entered into by the Minnesota DHS includes several national performance standards required by the Department of Labor, with the emphasis being on job placements.

Each contractor has quarterly job placement (outcome) and other performance goals that the Minnesota DHS closely monitors. If a contractor’s actual quarterly performance is less than the contractor’s quarterly performance goals, a corrective action plan must be developed by the contractor describing how it intends to improve performance. Contractors are compensated based on the number of clients they

propose to serve and the cost per placement. The approach to contractor compensation is cost reimbursement in accordance with a mutually agreed upon operating budget (Minnesota DHS, 2000).

As Table 1 illustrates, the Minnesota DHS's approach to performance-based contracting has achieved some impressive results. Over a five-year period (between fiscal year 1995 and fiscal year 1999), total statewide full-time job placements increased over 240%.

**TABLE 1**  
**Minnesota Department of Human Services**  
**Performance-Based Contracting for Job Placement Services**

| <b>Assessment of Performance-Based Contracts</b> |      |       |       |
|--|------|-------|-------|
| Fiscal Year                                      | 1995 | 1998  | 1999  |
| No of Job Placements<br>(Outcomes)               | 591  | 1,136 | 1,423 |

Source. Adapted from Minnesota DHS (2000) & Vinson (1999, p. 5).

### **Florida Department of Children & Families**

The Florida Department of Children & Families (Florida DCF) is under a legislative mandate to contract out all department services by fiscal year 2003 (Snell, 2001). As part of its strategy for achieving this objective, the Florida DCF is using performance-based contracting. The Florida DCF spent several years working with its contractors to develop mutually acceptable performance standards to be used in its performance-based contracts. Thus, there is general acceptance, if not universal agreement, between Florida DCF and its contractors on how human service performance will be assessed.

To date, the Florida DCF has not attempted to directly tie contractor compensation to performance but does tie the award of new contracts to performance. Contractors that meet or exceed the standards (output, quality and outcome) in their performance-based contracts receive new contracts; those contractors that fail to meet their performance standards have their current contracts extended and are provided technical

assistance to help them improve. Contractors that repeatedly fail to meet their performance standards may have their contracts terminated.

Table 2 presents a summary assessment of the results achieved by contractors under the performance-based contracts awarded by the Florida DCF for substance and mental health services during fiscal year 2000. Florida DCF staff compiled that data by comparing contract performance (output, quality and outcome) standards with contractor quarterly reports. As can be seen, the Florida DCF has had considerable success with its performance-based contracting initiative. The proportion of contractors meeting all their client specific performance standards in fiscal year 2000 was 80%. The Florida DCF case example raises the intriguing possibility that contractor involvement in the establishment of performance standards may lead to greater acceptance of the performance standards by contractors and perhaps ultimately to greater contractor performance. The Florida DCF case example also makes the point that moving to performance-based contracting does not necessarily negate the need for contract monitoring and oversight. Some 44% of contracts required at least some corrective action; 61 contracts had payment reductions and three contracts were terminated.

**TABLE 2**  
**Florida Department of Children & Families Performance-Based Contracting for Substance Abuse & Mental Health Services**

| <b>Assessment of 516 Performance-Based Contracts</b>  |              |
|---|--------------|
| The proportion of contractors meeting all client specific performance (output, quality and outcome) standards | <b>= 80%</b> |
| The proportion of contracts requiring corrective action   | <b>= 44%</b> |
| (1) the number of contracts with payment reductions   | <b>= 61</b>  |
| (2) the number of contracts extended for six months   | <b>= 18</b>  |
| (3) the number of contracts terminated  | <b>= 3</b>   |

Source. Adapted from Florida DCF (2000, p. 15).

### **Oklahoma Department of Rehabilitation Services**

The Oklahoma Department of Rehabilitation Services (Oklahoma DRS) has been experimenting for some time now with performance-

based contracting for employment services (services designed to prepare and place people in jobs). The Oklahoma DRS calls its approach “milestone” contracting because each person served under the contract is treated as an individual project. The Oklahoma DRS’s approach is perhaps best explained by an illustration (see Table 3).

As Table 3 demonstrates, each person served by a contractor is treated as an individual project with a definable start point (entrance into service), end point (exit from service) and major milestones along the way. The payment mechanism used by the Oklahoma DRS equates to a fixed-fee with progress payments. A fixed-fee per person is established in the contract and the contractor earns a portion of that fee every time a person achieves one of the milestones. An evaluation of 13 performance-based contracts awarded by the Oklahoma DRS between fiscal years 1992 and 1997 found that the time people spent waiting to receive services declined 53%, case closures increased 100% and contractor costs decreased 35% (Oklahoma DRS, n.d.).

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**TABLE 3**  
**Oklahoma Department of Rehabilitation Services Performance-Based “Milestone” Contracting for Employment Services**

| <b>Milestone</b>          | <b>Type of Milestone</b> | <b>% of Fee</b> |
|---------------------------|--------------------------|-----------------|
| 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              |

waiting to receive services declined 53%, case closures increased 100% and contractor costs decreased 35% (Oklahoma DRS, n.d.).

Two features of the Oklahoma DRS approach to performance-based contracting warrant special mention. First, the idea of treating each person served under the contract as an individual project should be intuitively appealing to public procurement professionals because it is simply a derivation of classic project management. Second, the idea of tying portions of a contractor's compensation to performance specifications (outputs, quality and outcomes) and other portions to design specifications (process and perhaps even inputs) demonstrates that performance-based contracting does not have to be conceptualized as an "all or nothing" proposition where contractors are only paid for performance with no other factors being taken into consideration.

### **Pennsylvania Department of Welfare**

The Pennsylvania Department of Welfare (Pennsylvania DW) has been experimenting with performance-based contracting to implement an experimental job-training program called "community solutions." The Pennsylvania DW approach is another variation of milestone contracting similar to, yet substantively different from, the Oklahoma DRS approach. Again, an example is perhaps the best way to explain the Pennsylvania DW approach (see Table 4). Unlike the Oklahoma DRS approach, the Pennsylvania DW does not compensate contractors for the accomplishment of any process milestones; contractors are compensated only for performance (output, quality and outcome). The Pennsylvania DW approach also differs in that a fixed-fee is paid to contractors for accomplishing any or all of the four performance milestones. For example, contractors receive a payment of \$1,000 for placing a person in a job, another payment of \$400 if the job includes medical benefits and a payment of \$1,600 if the person stays on the job for 12 months (Table 4).

An assessment of the Pennsylvania DW approach to performance-based contracting was conducted in 1999 (Paulsell & Wood, 1999). The evaluators reviewed some 70 performance-based contracts that had been awarded by the Pennsylvania DW up to that time. As part of the evaluation, the researchers conducted in depth interviews with contractors. According to the evaluators, and in keeping with other study findings cited above, contractor staff reported focusing more on

**TABLE 4**  
**Pennsylvania Department of Welfare Performance-Based Contracting for Job Training Services**

| Milestone  | Type of Milestone | Fee     |
|--|-------------------|---------|
| 1. Participation (client completes an assessment)        | Output            | \$1,000 |
| 2. Placement (client obtains unsubsidized employment)    | Output            | \$1,000 |
| 3. Medical Benefits (job includes medical benefits)      | Quality           | \$ 400  |
| 4. Job Retention (client remains Employed for 12 months) | Outcome           | \$1,600 |

Source: Adapted from Paulsell & Wood (1999, p. 7).

performance after the change to performance-based contracting than they did before the change. A finding not previously reported, however, was that some contractors made payments to clients presumably to continue their employment long enough for the contractor to receive the final \$1,600 payment (see Table 4). This finding suggests that while performance-based contracting may resolve some contract service delivery problems, it may create new ones. Fortunately, in this instance the newly created problem can easily be rectified by simply including contract language that prohibits this practice.

#### **Kansas Department of Social & Rehabilitative Services**

The Kansas Department of Social & Rehabilitative Services (Kansas SRS) has been using performance-based contracting for child welfare services, including family preservation, foster care and adoption (Gurwett, 2000, Martin, 2000). Kansas SRS 's original approach to performance-based contracting was arguably the boldest such experiment ever undertaken by a state human service agency (Petr & Johnson, 1999; Eggers, 1997b). The original Kansas SRS approach can be thought of as contracting for outcome performance.

Under the original Kansas SRS approach, contractors were paid a one time up-front fee per child. This approach is generally referred to as “managed care.” Contractors were then required to provide all services the child might need until he/she exits service and the case is closed (an outcome). For example, contractors providing adoption services were paid a one time up-front fee of \$18,000 for each child placed in their care by the Kansas SRS. Since contractors received no additional compensation, a strong incentive existed for the contractors to place children for adoption as quickly as possible (Eggers, 1997b). In order to insure that contractors did not attempt to cut corners, numerous quality standards were included in the contracts. If contractors quickly placed children for adoption, then at least theoretically they could earn a profit on the contract. However, the contractors were legally obligated to continue to care for children until such time as they were placed for adoption regardless of the length of time required.

The Kansas SRS experiment with performance-based contracting can be considered both a success and a failure. On the success side of the equation, an evaluation conducted by the U. S. General Accounting Office (GAO, 2000) found that the outcomes achieved by the contractors equaled or exceeded the contract requirements. On the failure side of the equation, the Kansas state legislature (State of Kansas, 2000) found that the funding arrangements created severe problems for contractors, pushing some to the brink of bankruptcy. The problem with the Kansas SRS’s approach to performance based contracting can be described as going beyond the capacity of its contractors. Unfortunately, many of the human service contractors in Kansas lacked the cost accounting systems necessary to identify the full cost, or total cost, of service provision. As a result, contractors tended to underestimate their true costs of service provision. The Kansas SRS subsequently changed to a milestone approach to performance-based contracting. The Kansas SRS case example underscores an important point: before governments begin tying contractor compensation to performance, they should consider the extent to which their contractors have the capacity to operate under this type of contractual arrangement, particularly non-profit organizations. Performance-based contracting represents a new way of doing business. For many contractors this change may pose no problem; for others the change may create significant problems.

### SUMMARY AND CONCLUSION

This article has looked at the performance-based contracting experiences of a small group of state human service agencies. What do these experiences suggest for larger issues of public procurement and government contract administration? Some tentative suggestions can be proffered:

First, performance-based contracting appears to accomplish its primary objective, to influence the behavior of contractors and to cause them to focus more on performance. All of the performance-based contracting case examples reported on in this article were able to alter contractor behavior to focus more on performance, some with quite remarkable results.

Second, if performance-based contracting can be successfully used for human services, then there is reason to believe that it can be successfully used for other types of government services. State human service agencies have demonstrated that performance-based contracting can be utilized for “soft-services” (services dealing with people). The application of performance-based contracting to “hard services” (services dealing with things) such as parks maintenance, street maintenance and repair, custodial services, etc. should be easier to implement.

Third, performance-based contracting can involve outputs, quality, outcomes or any combination. Several of the state human service agency case examples reviewed in this study clearly demonstrate that outputs, quality and outcomes can be successfully mixed and matched in performance-based contracts.

Fourth, performance-based contracting does not require that all contractor compensation be tied to performance. The state human service agency case examples reviewed in this article demonstrate the successful application of performance-based contracting when contractor compensation is only partially tied to performance and even when little or no contractor compensation is tied to performance.

Fifth, performance-based contracting represents a new way of doing business, not only for contractors but for governments as well. Before implementing performance-based contracting, public procurement professionals should assess their contractors’ and their own capabilities to operate under this type of contractual arrangement.

The point should be stressed that these conclusions are *tentative*. For some government services and in some contexts, the lessons learned about performance-based contracting by state human service agencies may not be readily transferable. Nevertheless, the successes of state human service agencies do suggest that performance-based contracting should at least be considered for many, if not most, other types of government services.

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