

## **SYSTEM REFORM: GETTING MORE FOR LESS**

**Transcript of remarks to the House bi-Partisan Redesign Caucus  
As given by Walter McClure, Chairman, Center for Policy Studies**

State Office Building, Saint Paul, MN  
Monday, April 11, 2011

I'd like to try to give you a new lens to look at this mess that you are facing. The bad news is it is not going to solve your immediate difficulties. The good news is that it might give you a way to see light at the end of the tunnel so that you won't be endlessly stuck in this same dilemma.

In particular, my colleagues at the Center—Ted Kolderie and Curt Johnson—have been talking to folks up here about system redesign, and the split screen approach to policy. I realize not all of you have heard them, but I will try to give you a very precise notion of what system redesign is, so you can recognize the horse when you see it.

And secondly, I will also try to give you a precise notion of what should be on the split screen and what should not be—because I assure you that if you want to pursue a split screen approach to policy every special interest will try to ride their hobbyhorse onto the split screen, adopting whatever terminology you are using.

The immediate dilemma is whether you raise taxes and spend, or cut taxes and skimp. The problem is there is no right answer, because both sides are right. There are programs that the state does that are absolutely indispensable to the life and commerce of this state. And yet you don't have a lot of money to support them.

So what are we going to do. Well we can push and shove—but maybe there's another way. That is, can we get more for less? I want to talk about that. I'll make three quick points.

First of all, spending more does not necessarily get you more. In education we have done nothing but spend more for six decades. And yet have we seen any notable improvements in graduation rates and test scores? We have great schools, but we also have too many persistently poor schools. The poster boy is health care. You have been spending up the wazoo, along with the private sector, for health care. For six decades the government has been trying to get a handle on this juggernaut unsuccessfully. It pays more and more and more—people aren't really living any longer because of excessive health care. We have great providers—I owe my life to them—but we also have too many persistently poor providers and the whole thing costs far more than it should. The last thing this government needs to do is spend another dime for medical care. It's starving every other social need we have in this country.

Second point: Spending less won't necessarily save you money. We're all familiar with the phenomenon that if the roof is leaking and you don't get to it right away it's much more expensive to fix a roof that's caving in. So if you don't paint your bridges on schedule they rust and they fail prematurely and you've got to replace them. Have you saved money?

Another more significant example—people don't think of it—is that one of the greatest investments the state makes that creates wealth is public health. But people don't appreciate what doesn't happen to them. Cut your public health budgets (we have one of the best public health systems in the country) and have you saved money? Not to the people that get sick. And a lot more will get sick. And the employers—have you saved money because they have employees that can't work? People die prematurely; you lose their talents and all the investment you made in their education. So unwise stinting is going to cost you more.

Can we spend smart—that is, can we get more for less? Everyone agrees that would be the best thing. The good news is you can, but you can't do it right away. You've got to redesign your systems. That brings us to the idea of system redesign, and we will have to do some audacious thinking, and think outside the box, and think outside the building. Because your leadership—your personal leadership, you, the governor, all our government leaders—is going to be as important to this as anything that you legislate.

The split screen approach says that in legislative business as usual you are taking actions that have an immediate effect. But this is often so time-consuming it comes at the expense of thinking about long-term solutions. But what if you could create opportunities for long-term solutions that run parallel while you're doing what you must to manage the system with short-term measures. That's where system redesign comes into the picture.

System redesign is a buzzword. A lot of people are using it. Beware—most of them don't know what it means, and most of them will try to make it mean their usual hobbyhorse with a new name.

There are two kinds of system redesign. One of them is the kind of business you are in now, which we call continuous system improvement, which I also lovingly call omnibus tinkering. Find anything that will make the system work better, or reduce cost without killing the objective of the program. And either require or encourage the system to use it. We've done six decades of that in education, six decades of that in health care.

The advantages are that you can fine tune over time, and over time you can realize some substantial progress. However the disadvantages are the improvements tend to be one-time only. And they require you to stand over the system because the system itself isn't looking for these improvements—that's why you need to intervene.

The worst case is like education and health care, where the system simply resists everything you do. They either distort it, or they evade it, or they reduce it to tokenism. And yet the results haven't changed much over six decades. They are still much the same problem they were to your predecessors.

So what do we do? This brings us to system reform. System reform is harder to do and takes longer to do than system improvement. To explain this, I'm going to introduce the notion of large system architecture (LSA). Large system architecture is two things: It is a theory of why organizations in these large systems do what they do. If you want to know what to fix you have to know why they do what they do. The second thing is, it is a set of methods to design and implement new arrangements to change the nature of the system and the behavior of the organizations in it. Those two things.

It's not academic. I have been doing this since 1970 in health care. You actually have a piece of my strategy at play in Minnesota. You actually have two pieces: one the legislature has done; the other both the private sector and the legislature have done.

The other is an education strategy, which the state is also engaged on. My worry is that unless you understand the big picture, the overall strategy, you won't know how to put the pieces together to get the effect you want. We think if you do it right you will put Minnesota in the forefront of both health care and education.

Let's start with the theory. I'm giving a handout that does three things: discusses the theory and methods of system reform; secondly it has a couple two pagers, one on the education strategy and one on the health care strategy. They are unique in the country; I don't know anyone else in the country that is advancing this kind of strategy. Additionally the handout describes the type of leadership required for Minnesota to lead in system reform.

So why do organizations do what they do. How many times have you heard that the reason why organizations are mal-performing is because the people in them are incompetent; or they're immoral, greedy, or they're for-profits. In health care we hear doctors are greedy; or it's those big for-profit insurance companies; or consumers are overusing the system and living unhealthy lifestyles.

If you work on that diagnosis you aren't going to get anywhere. I'd like to give you a counter example so we can examine these kinds of claims. Let's take a really well-performing macrosystem—we'll call these large social systems that accomplish a purpose for society a macrosystem (health care, education, criminal justice, the auto industry, and so on)—systems of organizations and people that accomplish purposes for society.

Note, in a sense the state doesn't so much run organizations as it runs macrosystems. It's up to you to make sure these macrosystems are doing their job so that people can carry out stuff that meets what society wishes. That's kind of your job.

Alright, here's the auto industry. Notice that the world could not make better automobiles today for the money, in the variety people want, than it's making now. They couldn't be better. Every time you turn around you can buy a better car. And it really hasn't been increasing in price much. They milk the demand curve—whatever people are willing to spend, they have a car for you.

And it's a much better car. I bought a '77 Accord, now I have a 2010 Acura. It cost the same amount of money in real dollars. It's a better car in every possible way. More powerful, better handling, more fuel efficient, safer—now that's a well-performing system. Not only are they doing

what we want them to do, they are continually self-improving. We don't have to tell them how to make a better car.

Now, how many of you would ascribe this to the virtue or altruism of the automobile executives? Would you ascribe this to their for-profit nature (notice they're for-profit)? And I would also say notice they are a very large group of people; and in a very large group of people you will find people who will give you the shirt off their back and people who will try to take yours. We're the human race, and the auto industry is the human race and the education industry is the human race and the health care is the human race. They have just as many saints and sinners, just as many brilliant people in education as there are in health care as there are in the auto industry.

So why does one work well and the other doesn't? Because notice in the auto industry it doesn't make any difference what your motives are or whether you're for-profit or non-profit. If you can't make a good car for the money you're out of business.

What's not obvious to people is the flip side is also true. If you see a large system like health care or education that is malperforming in a particular way, it turns out that if the organizations—no matter what their intentions, whether they are saints or sinners—if they don't malperform in that way, they won't be around very long. Pretty soon in these malperforming large systems everybody is malperforming roughly the same way. Or they aren't around. The only ones that are left that survive and prosper are the mal-performing ones.

I'm going to skip the formal details of the theory and I will put it in a nutshell (you can read the details and methods in the paper) but the point is that organizations exist in a larger system—call it the macrosystem—that has a very definite structure (and if you think the health care system or education system doesn't have a structure than you haven't tried to change it). And that structure creates incentives on these organizations and they are powerful enough—these incentives and constraints are powerful enough—to help these organizations prosper or kill them. If you go against the incentives of your macrosystem you won't be around very long—it makes no difference what your intentions are.

In other words the behavior of organizations is not determined by their innards—who's in charge, what their motives are, how clever they are about technology. The behavior of organizations is ultimately determined by their “out-ards”—by this macrosystem structure and the incentives it puts on those organizations. The innards only determine whether an organization can adapt, or perish.

What's going on in health care and education are powerful incentives for the undesirable performance you observe. Let me make a couple of points as examples:

The medical care system is rewarded for cost. Service is not an outcome of the system, it is an input. The more services you do to get a health result—which is the output—the less efficient you are, but the more money you make. Anybody who does more services prospers; anyone who does fewer services gets hurt. And in fact they can hurt themselves right into bankruptcy.

Here's the good news: if every provider practiced as efficiently as the highest quality, best, most efficient providers today—and most providers could—we would be spending at least 20 percent less than we are spending now.

Unfortunately we know if they all were to practice that good efficient style—they know how to do it, the journals are full of this stuff—the 20 percent that would go out of business would be the most efficient because they make the least money. And anybody who finds themselves going out of business can always gin up more services to keep themselves in business. If you're the Catholic hospital and there's the Baptist hospital across the street and the Baptists are going out of business the board will come in and say to the management, "We didn't bring you in here to put the Protestants out of business while the Catholics are doing so well." So guess what; they increase revenue by raising their costs, because we pay them by cost.

This industry can be incredibly well-managed. Some of the most well-managed operations are in the for-profit chains. They are vigorously managed for inefficiency because that is what makes money.

Innovation occurs constantly in health care, but because the incentives in health care reward cost, these innovations increase costs. Innovation doesn't help in an industry whose incentives are wrong. If the innovation works against those incentives people will forget about it.

Public education has the same kind of problem: bad macrosystem incentives. There are powerful incentives against change. And so the secret is, can we change the incentives of a macrosystem. We can only change them by restructuring it. That's the job of the architect. He has to come up with the design—a set of new arrangements for this macrosystem that create the incentives for the performance that you, the public, wants. And then he has to come up with a practical strategy to implement it, to get from here to there.

In 2008 the legislature got behind measuring health care outcomes, but the private sector was ahead of you. Minnesota is way ahead of the rest of the country on measuring outcomes for health care. If you have the big picture and know outcomes assessment is a crucial piece of a much larger strategy to contain cost as well as improve quality, you will know the additional steps you need to add to complete the strategy. But if you don't know that, you'll just consider it another good thing and maybe you'll let it drop.

So you've got to understand the big picture, the big strategy, and where the pieces fit.

As you've noticed, legislatures are largely unaware of this idea. They are largely unaware of these powerful underlying incentives generated by the macrosystem structure for which they're legislating. And so they're constantly requiring the organizations to do things against the incentives of the system. And that's why they don't stick. The organizations have no choice but to evade in some way what you are asking them to do.

If you become aware of this, then you can begin to say, can we get these new system reform strategies—a design with proper incentives for the future model of a macrosystem, and a change strategy to get us from here to there—and begin acting on them. You can, but you can't do it yourself. You're too busy. You're already overloaded. You're like any executive that has a problem. You've got to stop thinking 'how am I going to solve this problem' and start thinking who will I get to solve this problem. You're going to have to find someone who can think about it full-time, someone who doesn't have to worry about getting elected and a hundred other bills, someone who doesn't have to worry about faculty meetings or teaching students—someone who can be

thinking on it and nothing else full-time all the time. Someone who, once they bring you a design that you like, can assist you on how to advance and implement the strategy.

The Center for Policy Studies does two things: We design these system reform strategies, and we assist people who want to try them. We call ourselves large system architects. We're a policy program—nonprofit, non-partisan. And that's the kind of people who need to be doing this sort of thing. So if you want Minnesota to be working on its large systems, say its criminal justice system, making it better for less, or long-term care, then you're going to need people thinking full-time about this for you. And I don't think you'll be able to do this in government because there's going to be too many other demands and political tugs on it. You know how this works—you can't have people who are politically against each other working together on the strategy. You'll need to find ways to encourage non-partisan professional architect groups like ours to come up with these designs and strategies and bring them to you for your approval or rejection. That's your job, you not the architects must make the call. If you don't like it you send them back to the drawing board, or you fire them, say this isn't good enough let's find someone new. But you are the legitimate decision makers, and that's why we (the Center) bring our stuff to you. If you like it we'll help you do it. If you don't tell us what's wrong with it and we'll try to fix it. But you can't do it yourself.

And I don't think you can do it in the legislature or the governor's office. I don't think you can do it in the bureaucracy. I've never seen a bureaucracy produce a strategy like this. I've never seen a university produce a strategy like this. The only way I found to do it was to start my own shop. Ted tried to the university; he decided to join our shop. Suddenly we were working on health care and education. And you seem to have a very good application to welfare in Steve Rothschild, who has a similarly independent organization focusing on making nonprofit charities perform. I think funding for such groups comes best from long-term core support by foundations, rather than the rigidity and uncertainty of appropriations. So you'll need to work with foundation leaders to make sure you have groups working on all the important macrosystems for the state.

The bottom line here is you need such architect groups doing this, and what goes on the split screen is strategies that do system reform. Any system improvements that don't alter underlying incentives is regular business. What goes on the split screen should only be those strategies that fundamentally redo the incentives of a system. It can't be little incentives on the edges—that's like trying to spit into the wind. You need to overhaul the structure of the system—remove bad incentives, install strong good incentives—so that the fundamental system incentives align with the goals that you want for that system. That's what goes on the split screen. If you don't see that change in the whole structure of the incentives of the macrosystem then that strategy doesn't belong on the split screen.

### Questions

**Q:** Why do you give the auto industry so much credit? They have been late to the game building energy efficient cars.

**A:** The reason we don't have fuel-efficient cars is because the price of gas is so low. The moment the price of gas rose what happened to the auto industry? It isn't that every car company is smart. The private sector is as stupid as the public sector, and as brilliant. General Motors ran itself into the ground. But they're not representative of the entire industry.

If you want fuel-efficient cars look to Europe where they tax gas there. If I make fuel efficient cars that cost more and can't do as much as gas guzzlers, why would anyone want to buy them unless the price of gas rises? The incentives on consumers are not there. You have to have not only incentives on producers, but also incentives on consumers. Everyone has to have incentives. When you get the courage to tax gas at a rate that makes people buy green cars people will buy them. You may not be in office...

**Q:** Isn't this an argument for free markets?

**A:** I'm a big advocate of markets, but I'm not an advocate of free markets; I'm an advocate of sound markets. Anyone who suffered through Econ 101 learns certain preconditions that a market must have in order to maximize consumer wellbeing. To maximize consumer wellbeing you have to have these conditions; and without these conditions you will not maximize the public wellbeing—you will maximize someone else's wellbeing at the expense of the public. Very often it will benefit the producers' wellbeing, or nobody's wellbeing.

In our health care strategy, for example, to change the incentives there are three main steps: (1) Measure the outcomes, adjusted for severity; (2) measure the costs and determine who is better for less; (3) give consumers incentive to choose better for less. Together these institute the essential conditions for a sound market.

**Q:** Who provides leadership?

**A:** The Governor and Administration have to talk about it in their speeches. The House and Senate leadership need to talk about it in their addresses: "This is where we're going. It may take longer than our tenure here to accomplish. But we're proud of our legacy of leading the state on this course. (John Kennedy knew the moonshot could come to fruition after he moved on, but he was enormously proud of that initiative.)"

[END]