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Contracting Out in the Public Sector : Concepts and Issues

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Introduction

As we stand at the brink of the next millennium, the future of the state has reached crucial crossroads. The state is under intense scrutiny. Basic questions regarding its role, size and operations are being raised and there is a growing consensus about its limitations and capabilities. During the 1950s and 1960s, when the public sector had the primacy as the creator and implementor of development strategies, public enterprises was used by the state both as a producer and provider of goods and services. However, during the last fifteen years or so, criticisms about the supremacy of the public sector both in academic and political circles have increased considerably. There have been calls for 'rolling back the state', 'shrinking the state' and giving the market a greater leeway rather than the state controlling the market. In fact, the relations between the state, market, non-governmental sector and the citizens have changed considerably during the last decade. This has paved the way to reexamine the role of the public sector in a different light. Nowadays it is being seen more of facilitator who steers others who can

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deliver better services and acts as a catalyst to inject competition in service delivery.

Thus governments across the globe are searching for ways for improvements in the public sector. In some, the state has been rolled back considerably while in many the public sector is being changed albeit slowly by employing many tools and options. As such, greater use of markets is creating competitive pressures and offering more alternatives to public provision for users seeking quality or lower cost. Among the various choices is one where governments are operating performance based agencies in the public sector and entering into formal contracts with them by providing required management flexibility and at the same time making them more and more accountable for outputs/outcomes. Moreover, governments are also entering into contracts with private firms or NGOs for provision of certain goods and services.

The focus of this paper, therefore, is to give an overview of the concept of contracts and then point out their strengths, weaknesses and effectiveness when used in the public sector.

Contracts : The Concept

The linkages between the government and the governance of public enterprises have been subjects of discussions/debates since the inception of public enterprises (PEs).

However, in an era of privatization and downsizing the government, various instruments have been developed (originally in certain European countries like France) to change the relationship between government and PEs. These instruments are known as 'contracts'. They were devised to rationalise vague objectives of PEs, enhance management autonomy and reduce excessive controls of governments. They

are, in fact, alternatives to the concept of direct control by the government and attempts to avoid the defects of the traditional regulating action/mechanism. The contract becomes an instrument through which relations between parties (government agencies, private sector firms or NGOs) are managed and regulated. Contracting out is also described by many as operational privatisation.

Contracting arrangements are often associated with decline in evaluation of programme outcomes and when assessment of client outcomes and quality of services of public sector organizations have been avoided due to political and technical difficulties.

What then is a contract? Terminology varies from country to country and over a time period within a country, e.g. it is known as 'contract de programme' in France, 'competitive tendering' in U. K. and 'memorandum of understanding' in India. However, the essence of them all are that contracts are "Procedures to make state-owned enterprises more independent of their sponsoring departments and to embody the mutual understandings of both sides in a formal contractual agreements." (Drumaux, 1994 : 103). Nellis (1991 : 279) described it as a negotiated agreement between the government, acting as owners of state-owned enterprises and the enterprises themselves. There are other definitions given by the authors like Ascher (1987) and Alford & O'Neill (1994). However, for our purpose, we will focus on the World Bank definition of contract as *"an agreement between the government and another party based on shared expectations about obligations and outcomes"* (World Bank 1995 : 107). The distinguishing factor between a contract and a set of directives imposed by owners of a firm or from a corporate plan designed by enterprise itself, is that the contract spells out

the obligations and limitations of both parties. Normally activities related to audio-visual services, maintenance, catering, cleaning services, construction, IT management, estate management, publicity and marketing, R & D, security services, market research, transportation, etc. are contracted out.

An Overview of 'Contracts'

Due to variations of focus, opinions seem to vary on the types of existing contracts. The World Bank (1995 : 107) identifies three types of contracts, which are relevant to PEs. They are (i) **Performance Contracts** involving the relationship between government and public managers with a focus on performance. (ii) **Management Contracts** which define relationships when the government contracts management of the enterprise to private management, and finally, (iii) Regulating **Contracts** between the government and a private regulated monopoly (World Bank Research Report, 1995). The World Development Report (1994 : 42) on the other hand, identifies yet another type of contract known as (iv) **Service Contracts** that involve transfer to private providers the responsibility for delivering specific services at lower costs or obtaining specific skills or expertise lacking in the public sector.

Performance Contract is based on the negotiations between government representatives and enterprise managers, setting out intentions, objectives and responsibilities. A typical performance contract may specify enterprise objectives in terms of desired socio-economic impacts, production goals, and/or quantitites and quality services to be provided. It defines policies and directions regarding size of personnel, social or non-commercial activities of the PEs. It also lays down the PE's financing and investment program detailing

the contribution of the enterprise, the government or from credit sources (Nellis 1991 : 280). Performance contract is advocated as a mechanism to smooth PE and government interface and as an alternative to privatisation especially in cases where PEs are financially viable.

This kind of contract originated in France in late 1960s and later on theirs use spread to Francophone Africa and in recent years in varied form to some countries in South America and South Asia. The World Bank Report (1995) notes that this form exists in 32 developing countries and that China has the maximum of such contracts (almost 100,00). There are basically two types of performance contracts, i. e. (i) French System-which is prevalent in France, Francophone Africa and Latin America; and the (ii) Signaling System which initially started in Pakistan and Korea but is now prevalent in Bangladesh, India (where it is know as MOU), Nigeria, Ghana, and many other countries. The difference between the two is that in the French system weights are not allocated to targets. Thus there is no distinction between targets in terms of emphasis and as such performance evaluation is affected by subjectivity. In the Signaling System used in Pakistan and Korea, the system aims at motivating management to maximize returns on the sunk capital. In Bangladesh, till 1994, 20 public enterprises were under performance contracts with one of them starting as early as 1986 (Mazumder 1994 cited in Commonwealth Secretariat 1995).

The World Bank Report points out the existence of management contracts in 44 developing countries. It is an instrument for improving PE performance and where outright privatisation is desired- it is used as a 'preparation phase' before the final sale to the private sector. The World Bank

(1995 : 134) defines management contract as "an agreement between the government and a private party to operate that firm for a fee (usually a success fee, but sometimes for a fixed fee as well)". As such, the government does not receive a fixed rent (as in the case of lease); is responsible for fixed investment of the enterprise and it holds majority ownership in the enterprise. It is distinct from a joint venture-where the government may or may not hold majority shares. It also includes contracts where a private contract provides working capital or owns a minority equity share in the enterprise.

This kind of contract is predominant in the hotel industry. It is also found in agriculture, and especially in Sri Lanka which has a maximum number of such contracts mostly related to the tea and rubber plantations. No country relies extensively on them, and the biggest number of such contracts are found in Africa mostly in enterprises which were formerly owned by multinational companies. This probably could stem from the concept that enterprises operate well under private management, as well as due to paucity of public sector technical expertise (Ibid. : 133-134). Recently, in Bangladesh the management of Bangabandhu Jamuna Multi-Purpose Bridge was contracted out to a private company.

Regulating Contracts are increasingly being used in monopolies like telecommunications, electricity, transportation sectors and other infrastructure, which are being privatised. It provides a flexible and cost effective tool increasing responsiveness to users and taps expertise too expensive in the public sector. Regulation Contracts provide sufficient incentives to persuade the new owner to invest, expand services, and operate the firm efficiently, while protecting consumers form exploitation of the monopoly (ibid : 108 and 150). This kind of contract may include explicit agreements about

pricing or performance and implicit expectations about the extent of the power of regulators.

We believe **Service Contracts** to be quite distinct form **'Management Contract'** as mentioned by the World Bank (1995), since this type of contract entails only certain specific functions/services. Moreover,it permits more healthy competition among multiple private providers of services and its most common form is used in maintenance services, design and construction of major infrastructure works. This type of contract is also used for acquiring standard professional services like auditing, data processing, catering, cleaning, fee collection and even recruitment. The concept was first inspired by the Japanese auto industry and allows enterprises to concentrate on building up their skill base and meeting the needs of the customer without being tied up in doing everything themselves. Recently in Bangladesh, janitorial services in several important government offices (like PM's Office), railway services on certain lines and the transportation services of the government run transportation corporation (BRTC) have been contracted out on basis of service contracts.

Contracts : Do They Really Work?

Even though contracts have in vogue for quite sometime, but the heart of the matter is whether 'contracts' are effective. As Alford and O'Neill (1994 : 18) ask "is the Contractual Model-with its foundation in unambiguous incentives and penalties, its focus on outputs rather outcomes, and its linear form of accountability-the best way to move public management forward....?" They contend that the answer to the above is relative and the issue whether it is better or worse than the alternatives. Experience and research (Nellis, 1991; Stewart and Walsh, 1992; Shirley and Nellis, 1991; Prager, 1994;

Drumaux: 1994; Mol, 1989; Alford and O'Neill, 1994; and World Bank Reports 1994 & 1995) indicate that although the concept is not a panacea, it still is effective. Moreover, not all government activities can be subject to contracts. The World Bank Research Report of 1995 points out that factors of information, rewards and penalties and commitment are crucial incentives which contribute toward the success of contracts. Effective contracts are those that include effective mechanisms for exchange of information; are bounded by rewards and punishment for both parties to exchange information and comply with contract provisions, and that the parties involved should be convinced of the commitment of each other.

Let us now examine the different kinds of contracts. Performance Contracts have several disadvantages. Shirly and Nellis (1991 : 22-24) point out that governments can and often violate them. Moreover, they are complex and take a long time to negotiate and put a burden on the limited supply of skill and information in most of the developing countries. As targets fixed in many cases are flawed or soft, a firm attaining its contracted economic target is not necessarily operating more profitably productively. For most PEs, rate of return on assets reflect government behavior instead of management behavior-as the government still control wages, input-output prices, etc. In fact, the World Bank Report (1995 : 118) indicates that in terms of total factor productivity, performance contracts seem to be doing as much harm as good. They point out that PE managers have an information advantage, which they use to negotiate easy targets, as rewards and punishments do not motivate them to perform better. Moreover, governmental constraints hamper the autonomy of management, and contracts often do not specify enforcement

mechanisms. Political processes also often hamper the proper functioning of contracts leading to undermining of government commitment. In case of Bangladesh, only one out of the 20 enterprises having performance contracts showed consistent improvement in its performance. Here political interference and linkages between the trade unions and the government, absence of clear direction/vision of the controlling ministry, shortage of trained manpower and lack of political will have been identified by a analyst (Mazumder 1994).

As a result, the World Bank declares that there is little support to the premise that detailed performance contracts improve PE performance. This led Nellis (1991), Commonwealth Secretariat (1995) and the World Bank Report (1995) to suggest the following lessons to be taken into account in case of implementing performance contracts :

- Performance contracts should be short, single and flexible.
- They should be used sparingly and only when the government's commitments are clear.
- Contract to be effective must ensure the acceptability of those who are involved in its implementation process.
- None of the parties involved in the contract can have goal incongruent behavior and interests.
- The outcomes of the contract depend not only on management incentives but also on the power and quality of government negotiations involved.
- The involvement of outsiders (3rd party) may help prevent reneging of commitments.

Shirley and Nellis (1991), therefore, aptly comments that the performance contract should be a part, rather than the

foundation of any reform effort and that negotiation of such contracts should be a part of the governments budgetary process, otherwise it is disregarded in budget decisions of the government.

Compared to performance contract, the World Bank favors management contract as a tool for improving PE performance. It points out that in terms of productivity and profitability, management contract fare well'. Competition plays an important role in the availability of information, which in turn is used to shape rewards and punishments (in terms of power and money). However,management contracts work better in some sectors than in others as they have lower political costs than privatization and they have lower political gains. In fact, management contracts work well under the following circumstances (World Bank 1995 : 139-150):

- When the contracts are bid competitively.
- When both parties face risks.
- The contractor is given success fees from profits and has the autonomy take actions needed to improve performance.
- Proper encouragement of the donor community by appropriate financing

However, the use of management contract in PEs raises the question of accountability. Such a process removes some of the norms of public accountability, as the management of PEs is only contractually accountable (Walsh and Steward 1992: 514-515). Moreover, the limitations of applicability in all sectors delimit the extensive use of this kind of contract.

Regulatory contracts involving the government and owners of private monopolies (regulated by government) are most

successful when governments reduce the enterprise's information advantage by increasing competition; devise rewards and penalties primarily in the form of pricing regulations that induce the enterprise to operate efficiently and pass on some of the savings to the consumers (in terms of reduce prices). And finally, the government ensures adequate safe guards to protect the private producers from unwarranted attitude/ actions from future regimes-so as that they invest in the enterprises (World Bank 1995 : 151-152). Nevertheless, in spite of variances, there is improved productivity in enterprises after introduction of regulatory contracts. The difficulties arise when countries failed to tackle the preconditions stated above. Moreover, some differences due to country based peculiarities cannot be removed in the short run. Moreover, regulatory contracts are difficult to design, but even with imperfections in design, important gains can be made (Ibid. : 168-169).

Service contracts are more cost effective. They do not involve handing over the entire management to the private sector, and only 'unbundling' some of the non-core activities/services on to the private sector. Therefore, the criticisms of accountability that are raise in the case of management contracts do not arise in this case as the enterprise remains public, while its services to its customers improve.

According to World Bank (1995), management contracts, regulatory contracts and service contracts function more effectively than the pioneering performance contract. However, choosing the right kind of contract instrument depends on the sector and specific characteristics of the country in which they are to be utilied. In addition, ways and means should be found to improve the effectiveness of performance contracts-the only form of contract where the overall scope and dominance of the public sector remains.

Conclusion

Contracts enhance competition in the market. In places where competition in the market is not feasible, it might still be possible to foster competition for the market by usage of contracts. There the government can play a crucial role by striking a balance between regulating and facilitating economic activities and services. Even in developing countries, where both markets and states are weak, competition can be managed through contracting out.

According to the literature surveyed in this paper, experiences with contracts indicate that they do achieve results but they are certainly not the panacea for all the ills of PEs. The bottom line is that contracting can work for public sector reform only if incentives are aligned so that the government and public enterprise management can strive together for greater efficiency. As management of public services has to be grounded in the purpose and conditions of the public sphere of activity, one has to be careful in choosing the right instruments in achieving the best possible results under the prevailing circumstances. Prager (1994 : 183) therefore aptly remarks that government policy makers must approach the concept of contracting out on pragmatic, not ideological grounds. Some activities may be more cost effective when contracted out, others will not. And the challenge for public authorities is to distinguish them. That is why Alford and O'Neil (1994 : 164-165) at the end of their analysis in their book 'The Contract State' do not offer a definite answer to the question whether 'contractualism' was the best answer for public management. They conclude that there is no one best way to manage a diverse and complex entity as the public sector, and that a contingent approach is more sensible.

In fact no one claims that contracting out government functions is the best option for increasing productivity as

there are costs and complexities involved in enforcing and monitoring contracts. Therefore the best way for determining in the effectiveness of 'contracting out' is to examine them on case by case basis.

However, certain considerations need to be borne in mind when introducing contracting out in the public sector. And they are :

- Level of government activities, which are proposed to be contracted out-at lower levels activities are less complicated and can easily be contracted out.
- Existence of competition.
- Contracts can be determined by price.
- Existence of in-house capabilities, in which case it is often pointless to contract out.
- If the organizations under consideration of privatisation, then contracting can act as an intermediate stage where the scope of privatisation can be assessed.
- Whether the market has necessary competence to offer services to be contracted out. (Kaul,1998)

The policy makers and planners must also take into account the possibility that contracting out may expose certain socioeconomic sectors of a country to foreign interests as they may take part in the tendering process. In such cases care should be exercised so that strategic and sensitive areas of a country are not opened up for contracting and that the domestic economy may not be adversely affected by global developments.

Given the complexity and diversity of the situations in which contracts are to operate, government must take into account the nature and scope of the public sector, the concept of equity (which contracting cannot uphold) and the question of

accountability before taking concrete decisions about contracting out products and services provide by the public sector.

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