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PERFORMANCE CONTRACTING

**Lessons from Performance Contracting Case Studies
A Framework for Public Sector Performance Contracting**

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LES CONTRATS DE PERFORMANCE

LEÇONS SE DÉGAGEANT DES ÉTUDES DE CAS SUR LES CONTRATS DE PERFORMANCE
CADRE ANALYTIQUE APPLICABLE AUX CONTRATS DE PERFORMANCE DANS LE SECTEUR PUBLIC

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FOREWORD

LESSONS FROM PERFORMANCE CONTRACTING CASE STUDIES

Performance contracting is emerging as a key tool of public sector reform in the national and subnational governments of OECD countries. This report draws some general lessons from performance contracting case studies which were discussed at an expert meeting as part of the Public Management Committee's programme of work on performance management.

The report was prepared by Christine Lidbury of the OECD Public Management Service. It was edited by Diana Joslin, Jim Brumby and Elke Löffler of the OECD Public Management Service. Technical assistance was provided by H  l  ne Leconte and Katherine Poinard.

A FRAMEWORK FOR PUBLIC SECTOR PERFORMANCE CONTRACTING

The purpose of this paper is to set out an analytical framework for public sector performance contracting. The framework aims to help public sector advisors and practitioners assess why and how different approaches to performance contracting are appropriate in different circumstances. The framework combines insights from institutional economics, public sector management, and public law. The report was prepared by Murray Petrie, Principal, The Economics and Strategy Group.

The author would like to acknowledge helpful comments from Jonathan Boston, Jim Brumby, Mai Chen, Derek Gill, Elke L  ffler, David Skilling and Ross Worthington. The report was edited by Jim Brumby and Elke L  ffler of the OECD Public Management Service. Technical assistance was provided by H  l  ne Leconte.

The views expressed are those of the authors and do not commit or necessarily reflect those of governments of OECD Member countries. The report is published on the responsibility of the Secretary General of the OECD.

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LESSONS FROM PERFORMANCE CONTRACTING CASE STUDIES

PART I. INTRODUCTION

Performance contracting offers a framework for generating desired behaviours in the context of devolved management.

Performance contracting is one element of broader public sector reform aimed at improving efficiency and effectiveness, while reducing total costs. Governments are increasingly faced with the challenge "... to do things better, with fewer resources, and above all, differently."¹

New approaches to public sector management have emerged to meet this challenge. These approaches include:

- new institutional structures and arrangements for managing and delivering public programs and services (privatisation, commercialisation, contracting out, and decentralisation to local governments);
- systemic reforms (market-type mechanisms, new budgeting and planning systems, administrative modernisation, decentralisation of management authorities); and
- new methods of service delivery (case management and one-stop shops).

While these new methods are seen as addressing weaknesses in the more traditional centralised and compliance based public management systems, they bring their own set of problems. Most notably, management systems that are disaggregated, decentralised and devolved need a new framework to guide behaviour. These changes do not rely on uniform rules for the management relationship nor for ensuring accountability in the use of public resources and delivery of public policies.

Performance contracts can be defined as a range of management instruments used to define responsibilities and expectations between parties to achieve mutually agreed results.

Performance contracting provides a framework for generating desired behaviours in the context of devolved management structures. Countries view performance contracting as a useful vehicle for articulating clearer definitions of objectives and supporting new management monitoring and control methods, while at the same time leaving day-to-day management to the managers themselves. Specifically, performance contracts include a range of management instruments used within the public sector to define responsibilities and expectations between parties to achieve mutually agreed results.

This paper offers a synthesis of nine case studies that explore the practical application of performance contracting as a tool to enhance performance management and accountability in public sector agencies.

In recognition of the growing interest and relevance of performance contracting, the OECD organised an expert meeting to explore the practical application of performance contracting as a tool to enhance performance management and accountability in public sector organisations. This paper offers a synthesis of the nine country-based case studies emerging from this meeting, identifying key issues and lessons learnt in the application of performance contracting. In addition to the case studies, this paper draws from the results of the expert meeting, literature from selected governments within the OECD and a companion paper by Murray Petrie, which provides an analytical review of performance contracting in different economic and administrative contexts. A list of the case studies are provided in Table 1. Each of these studies can be accessed via the internet at <http://www.oecd.org/puma>.

Table 1

Country-based Case Studies on Performance Contracting	
Australia	Centrelink and the Department of Social Security
Belgium	Emergence of public service performance contracting in Belgium and Flanders
Canada	The Canada-Alberta Agreement on Labour Market Development
Denmark	Contract Management in Denmark, featuring a case study of the Danish National Board of Industrial Injuries
Finland	Finnish performance contracting system: a case study of the Ministry for Social Affairs and Health
France	Contracting and Management of Local Service in the Directorate General for Taxes
New Zealand	Contracting for results: case studies from the Ministry of Justice and the Department for Courts
Norway	Use of Performance Contracting in Norway
Spain	Performance contracting and inter-government agreements in Spain: three examples

This paper is structured into four parts. Part II looks closely at the elements of the contracting environment, including the different types and models of performance contracts found in OECD countries, the legal status of performance contracts in the administrative systems of national governments and costs and risks in the contracting environment. This is followed by a discussion of the different elements involved in designing and managing a performance contract in Part III. Concluding remarks are offered in Part IV.

PART II. PERFORMANCE CONTRACTING IN THE PUBLIC SECTOR

PERFORMANCE CONTRACTING MODELS

Performance contracts in government tend to be “relational”, which focus on the relationship between the contracting parties more so than the fine print of the contract document.

Key features of relational contracts include the need for trust between the contract parties, the need for flexibility in specifications, and difficulty of specifying targets and measuring results.

Public sector performance contracts tend to be built on a “relational” rather than a “classical” contractual model. They are generally not formal legalistic documents at all, but rather quasi-contractual agreements, which get their strength not because of legal sanctions, but because of the shared needs of the parties to do business together.

Petrie notes that classical contracts tend to follow a strict legal rules regime, with the emphasis on formal documents with predictable and narrow avenues of redress should problems arise. On the other hand, relational contracts focus less on the document than on the relationship between the contracting parties and provide less specificity in favour of a “spirit” of the agreement, which leaves room for unforeseen circumstances.

Key features of “relational” contracts are the need for trust, flexibility and generality in contract specifications due to uncertainties in the environment (political or financial), and the difficulty of specifying targets and measuring results. In the context of the public sector, where some public services are not straightforward production-oriented services, targets can be difficult to specify. This difficulty is heightened when one tries to link the efforts of individuals (or groups of individuals) to specific results.

Although the more relational contracts found in many public sector organisations are not formal contracts, they use the language and the form of contracting to structure the exchange (Martin 1995). An excerpt below from the Australian case study describes this distinction in relation to the Centrelink partnership agreement.

Australia
<p>The Australian case study on the development of a contractual relationship between the Department of Social Services and the Centrelink organisation clearly articulates the distinction between relational versus legal-type contracting. The author writes: “it is important to overcome the “we win-you lose” syndrome in a contracting type environment. Partnering is difficult, more difficult in many ways than a relationship based on a legal contractual framework. It is an environment where both parties win or both lose. This is frequently difficult for staff and even managers to grasp. Strategies are developed and implemented to embed the partnership culture in both organisations. Such a culture is very dependent on the factors ... such as the quality of communication, trust and respect in business dealings.”</p>

Successful relational contracting requires a framework for ongoing relationship management, dialogue and negotiation.

Highly relational contracts tend to focus on improving performance through management improvement activities, rather than through sanctions (Martin 1995, p.39). Discussions in the case studies emphasise how disagreements over performance and remedies for performance can become adversarial and undermine the trust and dialogue between the contract parties.

An environment of trust and openness fostered in good performance contracting can improve the evaluation process and open up a dialogue for assessing performance and coming to terms with how to remedy problems with performance without necessarily having it be an adversarial or punitive issue. However, to do this, the contractual relationship must include a framework for building relationship, dialogue and negotiation, that can lead to:

- clearer and more realistic performance measurements;
- more buy-in on both sides to the results;
- a basis for ongoing dialogue throughout the year to improve the likelihood of achieving results; and
- capacity for learning and improvement.

TYPES OF PERFORMANCE CONTRACTING -- ARRANGEMENTS FOUND IN OECD COUNTRIES

Among OECD countries, there are a wide variety of quasi-contractual arrangements being used to increase performance. Although there are many common features in these arrangements, commonalities have more to do with process issues for developing agreements and in the use of contractual language for performance specification, than with the types and details of the agreements themselves.

There are seven broad types of performance contracts:

- ✓ *framework agreements*
- ✓ *budget contracts and resource agreements*
- ✓ *organisational performance agreements*
- ✓ *chief executive performance agreements*
- ✓ *purchaser-provider agreements*

There are seven broad types of performance contracts being used in the public sectors of OECD countries:

Framework agreements cover overarching strategies and priorities for a department or agency made between a minister and a chief executive. The agreement provides the chief executive with autonomy in managing the organisation in exchange for a commitment to meet specified strategic goals. E.g., *framework documents* for “Next Steps” Agencies in the United Kingdom and *letters of allocation* in Norway.

Budget contracts and resource agreements focus on budget levels between the central budget office or finance ministry and the chief executive of a department or agency. They provide aggregate budget authority and flexibility (autonomy) for managing resources, in exchange for agreed performance targets and a method for monitoring performance. In setting performance targets, a detailed budget contract may be the same as an organisational performance agreement. E.g., Danish contract agencies originally offered budget guarantees for the multi-year contract period. However, these guarantees have since been eliminated.

Organisational performance agreements, such as between a minister and chief

✓ *inter-governmental performance contracts and partnership agreements*

executive or between a chief executive and senior managers, break down overall strategic goals into programme elements, setting specific, often detailed, operational, process and output oriented targets in exchange for increased operational autonomy in achieving targets. E.g. Danish Contract Agencies, French Tax Administration, U.S. Performance-based Organisations². They are also found in the management of state-owned enterprises in many OECD countries.

✓ *customer service agreements*

Chief executive performance agreements made between ministers and chief executives (often to complement organisational performance agreements), or between senior management and staff at various levels. Chief executive agreements can be found in agencies in Australia, Denmark, New Zealand, Norway, and the United Kingdom, and are also generally used for chief executives of public enterprises in most OECD countries. Use of performance agreements for line managers and staff varies considerably, even between organisations in a country, but in most cases are limited to individual performance agreements (not linked explicitly to employment).

Funder-provider agreements focus on clarifying responsibilities by separating the role of the funder and the provider of the services. E.g., in New Zealand ministers and chief executives negotiate agreements for the purchase and supply of specified outputs, detailing factors such as timing, volume, cost and quality. Purchaser-provider agreements may also be found within organisations. Purchaser-provider agreements based on a purchase-provider model can be found in Australia (on a limited basis) and New Zealand.

Intergovernmental performance contracts and partnership agreements are often linked to devolution of programmes or funding from national to sub-national government, providing state and local governments with funding in exchange for providing specified levels and quality of service. Such contracts are more common in the education, health care and labour market services areas where the national government may still retain formal responsibility and accountability for the provision of the service, but find that programmes are more effectively implemented by local authorities. Many such arrangements tend to focus on distribution of financial resources without necessarily including links to performance. Partnership agreements between levels of government can be found in Canada, France, Germany, Norway, Spain, Sweden and Switzerland.

Customer service agreements are statements of service standards provided by a programme or service to its clients specifying the quality and level of services to be expected, and, in some cases, avenues of redress and compensation where services fail to meet standards. Customer service contracts are not “negotiated”, but are often developed with input from customers. Customer service agreements can be found in national and/or local governments in Australia, Belgium, Denmark, France, Italy, the United Kingdom and the United States.³

OBJECTIVES OF PERFORMANCE CONTRACTING

The unifying theme in performance contracting is a core focus on three key objectives: savings, effectiveness and responsiveness.

The unifying theme in performance contracting arrangements is in the value of contracting as a management tool to promote savings, effectiveness and responsiveness. These key objectives are expressed in terms of performance expectations linked to budget (inputs), service (outputs) impacts (outcomes) and management (corporate capacity). In the case studies, the balance of these priorities varied considerably among countries (and even between departments and agencies within a country). Usually one of the objectives tended to predominate at a particular time, with the balance tending to shift and change through time.

The focus of different objectives impacts on the type and design of agreements employed. For example, an objective to improve efficiency and effectiveness through improved accountability could be achieved by using agreements such as purchase agreements and chief executive agreements to clarify roles, expectations and responsibilities within an organisation. Alternatively, an objective to improve efficiency through improved resourcing decisions may be achieved by using agreements such as framework agreements and organisational agreements to improve information for resourcing decisions.

The balance of the objectives will influence the kinds and number of performance targets, the method for setting targets and the way the information is used. For example, in some organisational performance agreements the emphasis is on management improvement and service delivery targets, while in others clear emphasis is given to financial performance (often in terms of achieving savings) and efficiency targets.

The objectives of the contracting regime will shift and change over time. Performance contracting should be viewed as a dynamic tool that requires ongoing attention to ensure the process and components used in the system are in line with the overarching goals.

The Danish National Audit Office found that performance contracts are well suited to managing complex organisations and have a positive effect on performance management and efficiency and quality improvements.

In Denmark, contract agencies operate on Organisational Performance Agreements linked to Chief Executive Performance Agreement and Employment Contracts. A recent evaluation of the system by the Danish National Audit Office (1997) found that development of efficiency gains for contract agencies outpaced gains for government institutions that did not use contracts. They found that performance based contracts may contribute to efficiency and quality improvements of the state. While Denmark is the only OECD country to have evaluated its performance contracting regime in this way, other countries such as Finland, New Zealand, the United Kingdom report other evidence that performance contracting appears to have a positive effect on performance management, efficiency and quality of services.

Some examples from the country case studies on the objectives of performance contracting and the value of performance-based contracting for supporting the themes of savings, effectiveness and responsiveness are provided below.

In Denmark and Finland ...

The case studies from Denmark and Finland both conclude that performance contracting supports a focus on outputs and results instead of on inputs and rules. It is used to improve target setting and follow-up on results. Performance contracting is seen as a decentralised and flexible way of making agencies more cost-conscious, responsible and accountable. It is also seen as a key instrument for enhancing the strategic thinking and prioritisation among the ministries. As a management tool, use of the contractual model aims to reducing principal-agent type problems, such as moral hazard and adverse selection by building a mutual trust relationship instead of strict ex-ante controls of the detailed budget appropriations.

In Spain

The case study provides that performance contracting occurs in an ad hoc, rather than systematic, way. It can be found variously in collaborations between levels of government, between a ministry and its subordinate agencies, and between ministries and state-owned enterprises. In general, contract management has been encouraged as part of modernisation and administrative and political decentralisation. However, the most common objectives for performance contracting appear to be improved savings, efficiency and customer service. Performance contracts are also used as a tool for transparency and precision of objectives, and to clarify roles and financial responsibilities of the contract parties.

In Canada

Performance contracting is being used to manage Federal-Provincial partner-ships for the design and delivery of active labour market development measures. According to the case study, objectives of the partnerships include addressing duplication and overlap, improving client services, remedying lack of decision-making flexibility at the local level, and the need to monitor, assess and evaluate results more closely. According to the case study, the performance contract provides clarity, transparency and specificity in the roles and responsibilities of the parties for carrying out the partnership agreement. The *partnership agreements* are unique within the Canadian administration. The agreement clearly identifies inputs, outputs and expected outcomes as well as establishes mechanisms for measuring results. It is designed to give structure to the demands and expectations of both parties, and the public, for efficient and effective management, value for money, accountability, and mutual agreement on governance arrangements, results and assessment.

In New Zealand

<p>Quasi-contractual arrangements are a key piece of a larger reform programme of the public sector management system. According to the case study, networks of contracts are used to pursue several goals: cost and service (“purchase interest”), accountability (achieving key results), and management/corporate capacity (“ownership interest”). Reforms have been concerned with structures and systems, as well as roles, responsibilities and relationships in pursuit of performance improvement. The case study reports that chief executives’ performance agreements clarify the strategic areas that the department will contribute to and priority areas for its work, enabling them to be clear about responsibilities in terms of the ownership, collective and purchase interests, and provides a clear statement of outputs to be delivered in the agreement.</p>
--

LEGAL STATUS OF PERFORMANCE CONTRACTING

Performance contracting is most commonly implemented under the administrative or managerial discretion rather than under a statutory or legal basis.

Performance agreements and contracts within government are rarely legally binding. In most cases performance contracting is implemented by administrative or managerial discretion rather under a statutory or legal basis. They are mutually negotiated, or even implied, *agreements* between agencies or individuals within the bureaucracy to clarify undertakings of mutual interest. As discussed earlier, these contracts are governed by the “spirit” of the agreement, which is used as the basis for settling disputes, addressing contingencies and adjusting for unforeseen events.

Petrie explains that legally based performance contracts are more appropriate, and found more often in situations where organisations are distinct legal entities, such as between central government and state owned enterprises where there is a strong commercial element. They can also be used for contracts between levels of government. These contracts are closer in their goals and resource allocation implications to contracts between the central government and the private sector than internal performance (quasi) contracting.

While the lack of clear legal status can be problematic conceptually, many countries across the OECD have successfully implemented performance contract regimes on this basis. Countries such as Australia, Denmark and the United Kingdom have purposefully kept performance contracting away from relying on formalised legal contracts. They argue that they are reluctant to introduce legal rules into the way the relationship between ministers and chief executives, or departments and agencies, are managed. The Danish and Australian case studies both raise the concern that a series of internal legal contracts on performance would soon lose their focus on efficiency and management improvement and descend into a legal quagmire of legal disputes over language, intent (the “fine print”) and compliance.

In Denmark ...

Performance contracts are quasi-contractual arrangements between a Ministry and its subordinate agencies. The Danish National Audit Office emphasised that to achieve the potential for efficiency improvements through performance-based contracting, it is essential that contracts not be seen as legal documents. Irrespective of the contract, the Minister maintains political responsibility for an agency's activity and the Minister can, at any time, terminate the contract.

In Belgium ...

The Belgian case study, describes how performance contracts at the federal level fall under private law (as mutual agreements). This creates a number of complications in using performance contracting as a managerial rather than legal tool. For example, under private law, the contractual relationships can be dissolved by one of the contracting parties when the other party does not meet its contractual obligations. This may be at odds with the public sector principle of continuity of government, which restricts the full implementation of private law. At the regional level in Belgium, performance contracting practices are more ad hoc and the legal status of performance contracts more ambiguous.

In the United Kingdom ...

Next Steps Agencies have no separate constitutional or legal status and are simply an administrative arrangement to organise selected departmental activities. The Office of Public Service provides that agencies do not have any legally enforceable guarantees of autonomy, it is only the terms of the Framework Document (performance contract) that gives Agencies and their chief executives the status and legitimacy to operate on their own behalf (OPS, Research Paper 97/4). Even so, the Minister may change or revoke the terms of the agreement at any time. While there is some pressure on government to give Framework Documents clear contractual status, the government continues to be reluctant to introduce legal rules into the way the relationship between Ministers and Chief Executives is managed.

WHEN IS PERFORMANCE CONTRACTING THE RIGHT TECHNOLOGY?

Factors Influencing the Performance Contracting Decision

Performance contracting practices span a broad spectrum, from the more general performance agreements focusing on managerialism (Denmark, Sweden, United Kingdom) to the more hard-edged and comprehensive performance contracting focused on more detailed specification of results found in New Zealand. There is no agreed template or checklist for determining whether performance contracting is the

right performance management tool for a particular management problem. Each type of contract emphasises different objectives and priorities (budgetary, individual, organisational, outputs, outcomes, links to the public, etc.). The design of the contracting arrangement will depend on a variety of factors, including:

- the nature of the transactions;
- the objectives of a pursuing a contractual or quasi-contractual approach;
- features of the legal and administrative systems;
- risk management factors; and
- the broader governance arrangements within which the contract would function.

Optimal contractual form is country and cultural specific, depending on factors such as trust, type of transaction, objectives, legal and administrative limitations, risk management and institutional history

In assessing whether performance contracting is the right technology, the case studies highlighted several generic factors that should be considered for each situation. These factors are listed in the box below. An excerpt from the Australian case study illustrating some issues involved in selecting the appropriate technology is also provided below.

Factors to consider in performance contracting design
<ul style="list-style-type: none"> • Performance contracting exists only as one element of a broader performance management regime; • Performance contracting is not a substitute for ensuring the right people are in the right jobs; • Where there is little prior experience in disaggregating programs, the time involved and the start-up costs of developing performance contracts may be high; • Experience with developing and linking appropriate performance targets and performance measures to programs and services is also an important aid to developing performance contracts; and • Test performance contracting against other options.

Australia
<p>In the case study on the partnership agreement between the Centrelink organisation and the Department of Social Security, the author discusses their reasons for selecting performance contracting as the appropriate technology for the strategic partnership arrangement. The reasons included:</p> <ul style="list-style-type: none"> • building trust; • maintaining productive relationships; and • legal limitations. <p>Performance contracting was thought to be useful in facilitating complementary corporate cultures and aligning critical values, operating styles and mission targets</p>

in both organisations. Performance contracting was also seen as a useful tool to build on the trust and willingness in both organisations to make the partnerships work.

The Influence of Public Management Systems of Government

The case studies suggest a link between systems operating on a managerialist model and successful implementation of performance contracting.

The case studies suggest that there are links between public management systems operating on a managerialist model (devolution of management authorities, accrual accounting type systems, disaggregation of policy and service delivery, increased customer focus, etc.) and successful implementation of performance contracting (see also, Davis, 1997). This is not surprising given that performance contracting requires enhanced discretion to manage and increased accountability for pre-specified results (outputs or outcomes).

In Australia, Canada, Denmark, Finland, New Zealand, Norway and the United Kingdom, performance contracting is used to increase the clarity of goals and accountability relationships in the context of decentralisation and a devolved management environment. In these countries, the existence of management tools such as accrual accounting, contracting out and other tools which disaggregate programmes and services offer a useful starting point for performance contracting.

In all of these countries, with the exception of New Zealand, performance contracting is used very selectively within the range of program and services undertaken by the government. In Australia, Belgium, Canada, Denmark, Spain, the United Kingdom and the United States, performance contracting is limited primarily to defining relationships linked to policy/service delivery splits, such as between ministries and agencies, between ministries and state-owned enterprises, and in relation to intergovernmental partnerships. However, in New Zealand performance contracting is viewed as a suitable technology in contracting for the provisions of policy advice, just as in contracting for service delivery.

The French case study shows that even in a highly centralised administration, it is possible to find benefits in performance contracting as a tool.

The majority of case studies in this series focus on decentralised systems incorporating performance contracts as a tool to regulate behaviour. However, the case studies on France (see below) and Belgium, and country experience in local governments in Germany, Italy and Switzerland, suggest that it is not necessary to have a highly decentralised system per se, to find benefits in performance contracting. However, where a national government continues to operate with a strong centralised bureaucracy for budgeting and administration, the administration is constrained in its ability to move as far as a United Kingdom or New Zealand type model for performance contracting.

France
<p>The case study on the Directorate General for Taxes describes several factors considered in adopting performance contracting. For example</p> <ul style="list-style-type: none"> • as a management tool, it could be applied uniformly across the organisation, and tailored to each division; • it was flexible enough to be linked to other management processes such as the strategic planning processes and the performance management regime for senior managers; and • it provided a framework for exchanging accountability for results for devolving selected management authorities. <p>In the latter case, the mission of the tax directorate was seen as sufficiently quantifiable and development of performance targets and indicators advanced enough to fit comfortably into to a contracting-type process. The relational aspects of performance contracting were also seen as important to gaining management and staff involvement and support for modernisation and reform.</p>

The influence of different administrative system types

While it is less common in administrative law countries, examples do exist: In general:

- *implementation is on a slower track.*
- *contracting costs may be high, but should not rule it out.*
- *culture should not be an excuse for inaction.*
- *trust between parties may be low at first.*
- *experience will reduce costs and increase success.*

Performance contracting occurs more often in Westminster-type systems than administrative law systems. This does not mean that performance contracting cannot be applied to administrative law systems. Rather, limitations based on the status of contracts under the law mean that development might be slower and require creativity in finding the right management tools and systems to support contracting.

While legal constraints are the most frequently cited barriers to the use of performance contracting, examples from Belgium, France and Switzerland, and local governments in Germany, suggest that performance contracting can be implemented administratively and tools are available to create performance agreements and quasi-contractual relationships.

One key factor for administrative law countries such as France and Belgium is the existence of a well established, formal public sector and professional public service culture. In administrative law countries (or other countries with very centralised managerial structures), in assessing whether performance contracting is a suitable approach, there are a number of factors to consider:

- it may be a slower track, but tools are available to make performance agreements and quasi-contractual arrangements;
- contracting costs may be high, but their use as a tool for management and dialogue of priorities and performance issues;
- the engrained culture should not be an excuse for inaction;
- trust may be low to start with where legal provision rather than trust relationship is basis for management; and
- the maturity process (experience) will reduce the costs and increase the success of this tool over time.

COSTS OF PERFORMANCE CONTRACTING

Sources of costs may include transaction and compliance costs. However, whether costs are too high is more a matter of judgement than rule.

The costs of performance contracting result from transaction and compliance costs. Specifically, key sources of costs include:

- negotiating and monitoring contracts;
- assessing and managing risk; and
- difficulties in enforcing contracts.

An important question for public sector managers and policymakers is: *when are the costs of performance contracting too high?* When the costs of contracting are considered too high, keeping the activity within the traditional bureaucracy may be a more effective form of management or organisational design. Whether the costs are too high is more a matter of judgement than rule. A list of some of the main sources of cost is provided in the table below.

Trust can be an important variable in reducing transaction costs

Trust can be an important variable in reducing transaction costs. Where trust is high, specification and monitoring activities can be lower, reducing these types of transaction costs. Such a system may leave itself vulnerable to abuse, opportunism or accountability problems that may go unchecked until a crisis reveals the flaw. This must be balanced against the risk of contracting for every contingency and imposing high monitoring and reporting requirements, simply recreating a new form of the traditional centralised regulatory control environments that performance contracts are meant to replace.

Sources of Costs in Performance Contracting	
1) Organisational Capacity <ul style="list-style-type: none"> * strategic planning * staff capacity * institutional learning 	3) Information <ul style="list-style-type: none"> * information technology * verification/reporting
2) Incentives <ul style="list-style-type: none"> * hold-up issues * win/win culture * dynamic culture * trust/opportunism 	4) Uncertainty <ul style="list-style-type: none"> * risk management * funding

Sources of costs in performance contracting

Up front costs may be incurred through investment in staff training, organisational re-engineering, and in changing organisational culture.

The demand for new skills and ways of operating in a contractual environment (the capacity to contract) may impose costs on an organisation. Many of the case studies describe demands for significant investment in staff training and organisational re-engineering as linked to a changing organisational culture. This may be the case where the focus is on customer service type contracts, where training for front-line staff and process re-engineering may be required.

Cost may emerge when long-standing performance problems become more visible in the process of change and reorganisation. The Australian case study notes that when splitting an organisation into new and separate purchaser and provider organisations, frustrations and performance problems that were once contained in the unitary organisation are exposed and gain greater visibility.

Information technology (IT) systems may also impose significant real costs where there is a need to share data (as with case management systems or delivery of social services). Both the Canadian and the Australian case studies highlight the added costs in time, staff and financial resources in aligning IT systems across departments and programs. The Australian case study goes so far as to note that the costs of building new IT systems negated expected efficiency savings in the early stages of the programme.

Costs may also occur from a short-term perspective driven by annual contract deadlines, including lack of horizontal co-ordination and lack of investment in ownership issues.

Principal-agent type contracting within government may also result in tangible costs to government through loss of internal capacity to learn from experience and a growing disconnect between the policy and service levels. Costs may result from managers focusing too heavily on a narrow range of performance targets at the expense of the larger policy/service issues at stake. An early criticism of the performance contracting system in New Zealand was the lack of incentives in purchase and performance agreements for chief executives to co-ordinate their policies and programmes, to co-operate across organisational boundaries and to focus on longer-term issues of corporate capacity beyond the term of the contract. New incentives are now being built into Chief Executive performance agreements and other efforts are being made to balance the annual focus on results with the government's broader interests.

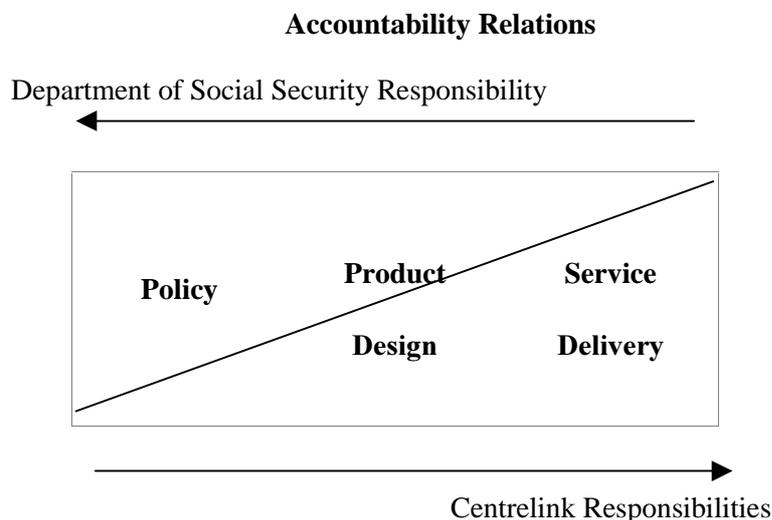
RISK MANAGEMENT FRAMEWORK

Risk management is an important factor in ensuring performance contracting is an effective tool for accountability. A risk management framework is a key element of the performance contracting environment. Although many performance contracting arrangements are characterised by a high degree of input or output specification, they are not predominantly rule-bound or rule-driven. This lack of clear and uniform rules guiding behaviour introduces a different form of uncertainty into the management relationship.

The Australian case study gives particular attention to risk management issues and

One of the risks to accountability is the potential loss of interface between those who deliver services and have key information about clients and service needs, and those who design the policy which drives both products and services.

how risk management strategies were developed for the Centrelink partnership agreement. The case study emphasises the importance of ensuring leaders and managers in both organisations understand the risk management framework within which the agreement will operate. Therefore, it is important that risk frameworks within each partner organisation are aligned and that managers understand the decision making responsibilities that are expected of them. As part of Centrelink’s risk management framework the agreement establishes a balance of policy-service delivery responsibilities between the Australian Department of Social Security (DSS) and the Centrelink agency. To minimise the loss of interface between policy and service delivery, reporting, information sharing and joint task forces are used to facilitate communication between policy/product design and product design/service delivery. As one moves further from policy advice to service delivery, the degree of responsibility of the Department of Social Security reduces, while the responsibility of Centrelink increases. The diagram below illustrates this relationship.



(Source: Ross Worthington, Australian Case Study)

In explaining the dynamic of the risk management framework, the Australian case study author cautions that the importance of the relationship between the contract parties should not be underestimated as a determinant of the quality and relevance of policy performance. In this example, the policy department obtains virtually all information on the effectiveness of outputs from the service provider. Therefore, the design and nature of this relationship is central to the effective functioning of department as the government’s principal policy adviser.

Australia: key factors for risk management

The Australian case study highlights four key factors for risk management and managing the partnership relationship, echoed in the experiences of other OECD countries using performance contracts:

- Balancing between the Department's accountability for policy outputs and outcomes and Centrelink's need for flexibility in delivering products and services effectively and efficiently at a reduced cost;
- Transparency and "reasonableness" in accountability strategies, measures of performance and review mechanisms;
- Providing access to information, policy, product design and service delivery processes as required by each organisation to effectively conduct its business; and

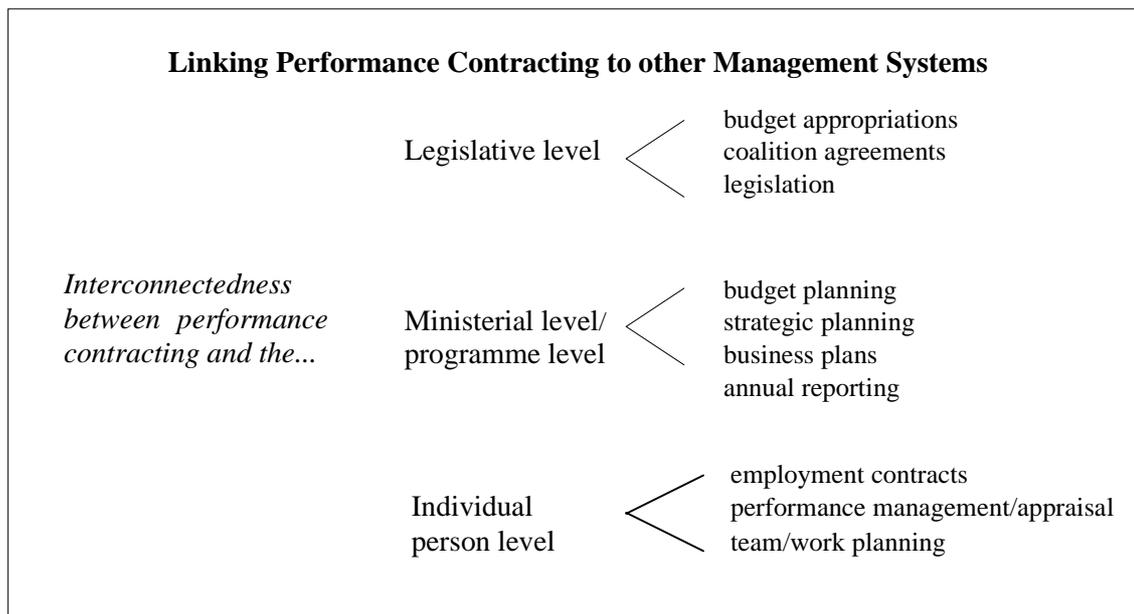
Valuing collaboration and openness in building and maintaining a strategic partnership between the Department and Centrelink in the design and delivery of social security policies to the Australian community.

LINKS TO OTHER MANAGEMENT SYSTEMS

Lack of integration between management systems is a key shortcoming of existing systems, with organisations missing out on potential benefits of performance contracting by better linking resource allocations to results. In nearly all of the cases examined, better integration between management systems was identified as an important area for future development.

A performance-contracting regime is not a substitute for overall performance management. It is merely one element of a performance management framework, which in turn is part of an overall resource allocation system. The case studies showed that linkages with other management systems varied between countries, and even between departments and agencies within a country. Examples of different potential linkages between performance contracting and other management systems are provided in the table below.

In the case studies, lack of integration between performance contracting and other management systems was the often cited as a key shortcoming of an existing system



Case studies highlighted linkages at the programme level, with processes such as strategic and business planning, budgeting, and annual reporting.

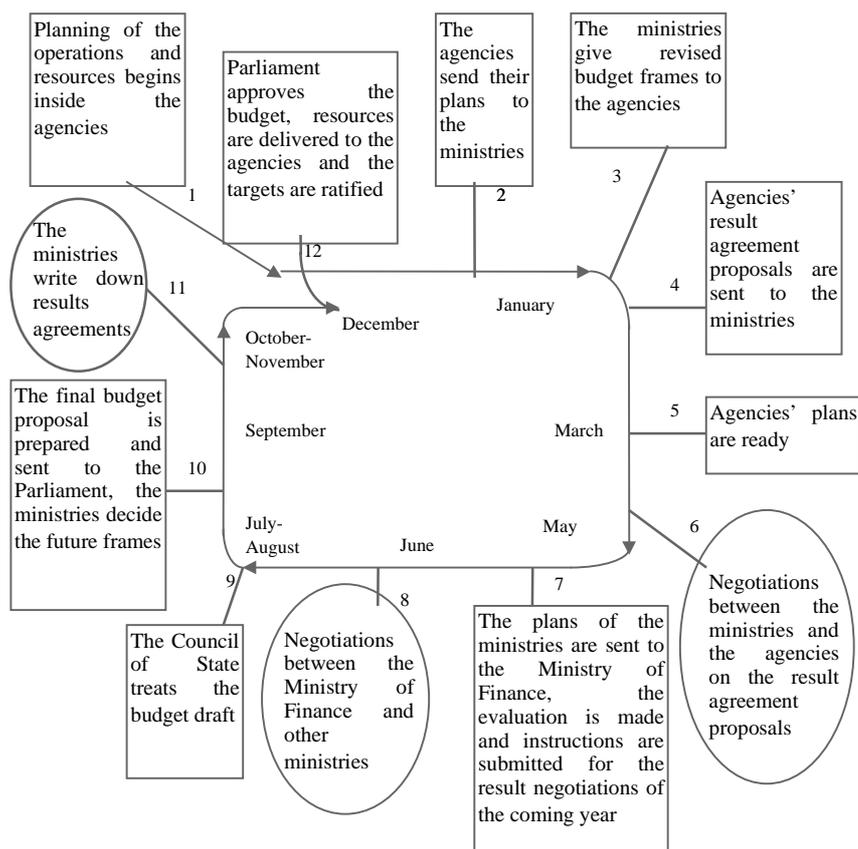
Only Denmark and New Zealand cited links between organisational performance contracts and the individual staff level (below executives).

References to linkages at the legislative level were made only in terms of political priorities and government-wide strategic planning. At the program level, most case studies highlighted linkages between performance contracting and other management systems. For example, there are dynamic and important connections between performance contracting and strategic management. Work on strategic management draws similar conclusions about clear goals and reporting relationships and places emphasis on links to business planning and annual reports. Only Denmark and New Zealand referred to links between organisational performance contracts and the individual level (below the level of chief executive or senior management).

In Finland, the performance contracting cycle was designed to link explicitly to the budget planning, preparation and resource allocation cycle. A diagram of the Finnish budget and contracting cycle is provided below. The Finnish performance contracting system is also closely linked to strategic management processes, although practices vary between ministries. The Ministry of Social Affairs and Health, highlighted in the case study, attempted to link the individual performance contracts for each of its agencies together with the overall strategic plans for the Ministry.

Finland – Integrating Budgeting and Performance Contracting Systems

Links between the budget and performance contracting cycles in Finland (Lumijärvi & Salo 1997, reproduced in the Finnish case study).



As illustrated in the excerpt below, New Zealand provides the most comprehensive series of linkages, with performance contracting as a centrepiece of resource allocation and management systems. A further example is also provided for Norway.

In New Zealand

The performance contracting system is an integral part of the broader resource allocation system. Chief executive performance agreements and departmental purchase agreement are linked to two key decision making processes: Government identified strategic result areas (SRAs), and the annual budget process. A key element in providing a comprehensive framework is to ensure that Government strategic goals are reflected in requirements on chief executives to drive their output delivery and commitment towards achieving those goals. Chief executives work with Ministers to identify contributions their departments can make to the Government's SRAs over a three year period (e.g., the Ministry of Justice and Department for Courts focus on SRAs relating to enterprise and innovation, safer communities, etc.). Their contributions are framed as key result areas (KRAs) in chief executives' performance agreements.

Purchase agreements in New Zealand are negotiated while the budget is being prepared. Parallel discussions are held between the Responsible Minister and chief executive on outputs to be purchased, and between the Responsible Minister and Minister of Finance and Treasury on budget expenditure decisions. Purchase agreements are finalised once Departmental Forecast Reports and the Estimates are tabled in Parliament. At the end of the financial year, departments table their Annual Reports, audited by the Audit Office. These three documents form the public and Parliamentary accountability documents on departmental performance. The performance and purchase agreements are consistent with these external documents.

In Norway

The *letter of allocation* operates as a framework type document that is closely linked to the budget process. Up until the beginning of the 1990s the letter of allocation was the formal notice of the resource allocation for the budget year. When the government budget became increasingly performance oriented at the start of the 1990s, the letter of allocation was regarded as an appropriate tool to use for the management of subordinate agencies. Today the letter of allocation is viewed as the main management document in the relationship between ministries and subordinate agencies. As part of the budget and performance setting process, an estimated 300 different letters of allocation are drawn up and transmitted to a broad range of agencies. The letter contains instructions to agencies regarding what the ministry expects and requires them to implement and achieve within their budget framework.

A main purpose of selecting one central management document is to ensure coherent management of agencies, whereby goals and performance requirements are viewed in conjunction with budgetary limits and other framework conditions faced by the agency. The financial regulations require annual management documents, i.e. the budget, letter of allocation, plan of operations/annual plan and annual report, to be formulated in such a way that

their content forms a coherent whole. The documents are designed to form a basis for the oral management dialogue and to underpin internal management processes in a ministry and its subordinate agencies. However, there is no formalised connection between the letter of allocation and the top management contract scheme. This is an area for future development.

It is possible to over-invest in integration adding unnecessary transaction costs though a desire to design the “perfect system”.

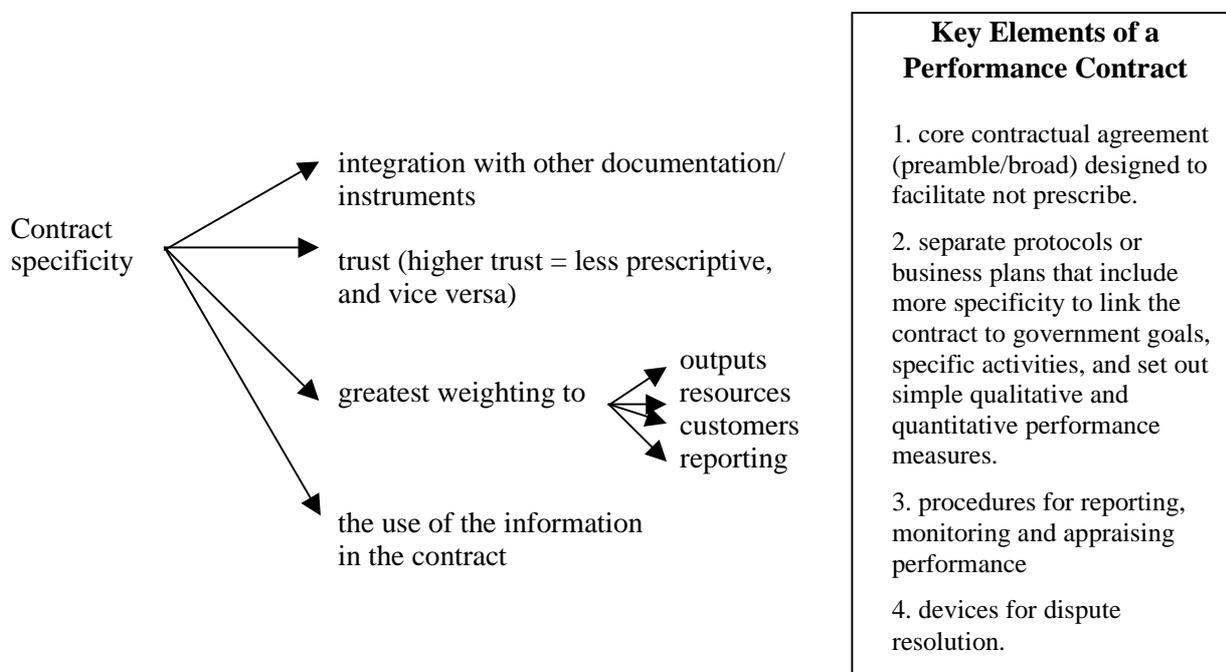
While emphasising the importance of integrating performance contracting in the resource allocation and performance management framework, participants in the OECD expert meeting caution that it is possible to over-invest in integration. Over-investment raises the possibility of creating an overly burdensome and cumbersome contracting system that runs the risk of shifting the focus from results to processes, and increases the transactions costs involved in contracting.

PART III: DESIGNING AND MANAGING PERFORMANCE CONTRACTS

**CONTRACT SPECIFICATION --
HOW DETAILED DO PERFORMANCE CONTRACTS NEED TO BE?**

The basic guideline in setting up a contract should be to facilitate rather than prescribe, to account for both the realities of the situation and expectations.

The basic guideline in setting up a performance contract is to facilitate rather than prescribe, to account for both the realities of the situation and expectations. Specifics and details should be dynamic, with performance contracting being a “learn as you go” process. Enforceable contracts for performance, or even quasi-contractual agreements with a very high level of specificity, can impose significant transaction costs and risks, and may be counterproductive to the long-term relationship between the parties to the agreement. The diagram below outlines the key elements of a contract and factors influencing the degree of contract specificity.



The degree of specification will vary on a case-by-case basis, and, moreover, may change as the contracting process matures. The case studies suggest that specificity in performance contracts is a function of factors such as:

- the level of integration of contracting has with other documentation or instruments for performance management and resource allocation;
- the level of trust (in a political/governmental context) between the contracting parties; and
- how the information in the contract will be used.

These factors reflect the need to assess the objectives for using performance

Without adequate risk management, there can be a tendency to use the contract to address every contingency, creating a vicious circle of increasing complexity and detail.

contracting within the resource management and risk management frameworks. Matheson notes that if specificity is not considered in the context of risk factors, “contracts carry a collective compliance burden (because standardised specification is likely to be designed for the least trusted agency) which is resented by departments and which could precipitate a slide into organisational sclerosis” (Matheson 1997, p. 177).

Country experience varies considerably in the amount of specification included in the contracts. Framework Agreements found in Executive Agencies in the United Kingdom offer very little specification, simply highlighting overall performance objectives and articulating roles, responsibilities and delegations of authority. Such Framework Agreements are complemented by other management planning and reporting tools that carry greater levels of details about performance goals, indicators and methods of evaluation. This level of detail is not included in the contract. In Denmark, performance contracts provide the same overview of roles and delegated authorities, but provide greater detail on agreements for achieving performance and management targets. In contrast, New Zealand purchase agreements provide detailed inventories of outputs, quantity, cost and methods of measuring quality.

TARGET AND INDICATORS SETTING

A central issue in specifying contracts is setting performance targets and indicators. All case study authors reported target setting as a key challenge in developing a successful contracting regime in their country. Many went further to note that the poor quality of target setting was a weak link in designing effective performance contracts and in ensuring that expectations were clear and results were measurable and appropriate to goals.

A well managed process for assessing and reviewing targets contributes to:

- improved co-ordination and co-operation between organisations on performance goals and how to measure them;
- greater commitment to finding appropriate targets and achieving them;
- strengthening the process for developing evaluation methods and indicators; and
- developing links between performance management information and how resources are used.

Types of Performance Targets

There are generally four main kinds of targets used in performance measurement [OECD, 1997]. These can be applied to the performance contracting context. They include:

- Political priorities, long-term outcome oriented priorities (e.g., Strategic Result Areas [SRAs] in NZ).
- Strategic goals, intermediate outcomes or high level outputs (Key Result

Types of performance targets:

- ✓ *political priorities*
- ✓ *strategic goals*
- ✓ *service quality standards*
- ✓ *annual targets*

Areas [KRAs] in NZ; Statements of Aims and Objectives as in Framework Agreements in the UK).

- Service quality standards, often stated as principles or qualitative measures of performance, often as part of organisational performance agreements, or as stand alone performance contracts as in the UK Citizens Charter Program.
- Annual targets, include specification of outputs, processes, management targets (staffing, training, IT), financial targets, efficiency and productivity targets, and may include customer service targets.

Annual targets and service quality standards are, not surprisingly, the main kinds of targets found in performance contracts. However, the way they are used, the balance of different types of targets (e.g., related to process, management, output), and the level of detail used to describe the targets all vary widely between countries, and even between organisations in the same country.

When contracting parties seek more specificity: it may mean a general deterioration in trust.

The consensus in the case studies is that target and indicator settings require ongoing reassessment to ensure that the contracting technology stays leading edge, bringing into play the lessons learned. While in some ways issues of specification and target setting get easier as the contracting process matures, there are also warnings of the tendency to build increasing levels of specificity into the target setting process to deal with compliance, management and accountability problems. While there are times when greater specificity may be sought, it should also serve as a warning sign of potential management issues to be dealt with in the context of the overall relationship and not necessarily the contract itself.

In Denmark, the National Audit Office paid particular attention to the quality of target setting when it evaluated the performance contracting system. They found that establishing performance targets and indicators was the most problematic area of the contracting process. The quality, measurability and appropriateness of targets varied considerably between organisations, with the National Audit Office recommending that the Ministry of Finance play a more active consulting role in the target setting process.

The case studies identified a number of common complaints and cautions in relation to creating performance targets and indicators. They are listed below.

Common complaints and cautions in creating performance targets and indicators

Lack of expertise: development of appropriate performance targets, indicators and measures is still work-in-progress in many OECD countries.

Soft targets: a tendency to focus on things that can be easily specified (outputs, processes, and qualitative measures).

Checklist mentality: setting too many targets, without capturing the heart of the relationship.

Outdated targets: there is a balance between stability and desire to update targets;

Target proliferation: tendency to keep adding new targets and indicators over time. It may reflect lack of strategic focus in the contracting process, or a desire to use a large number of targets as a way to compensate for a poorly functioning incentive system (discussed earlier).

Information overload: lack of measurement tools or capacity to deal with or make use of all the information generated through performance measurement activities;

Relevance: need to ensure adequate follow-up in measuring and evaluating targets; in some cases organisations fail to use the results in decision-making;

Management context: situations arise that cannot be foreseen, target setting alone is insufficient to ensure performance and must be supported by dialogue and ongoing contract management; and

Horizontal co-ordination: while contracts may increase vertical co-ordination on target setting, they may be limited in their capacity to further the collective policy interests of the government (horizontal co-ordination). Similarly a singular focus on targets may discourage staff from contributing to corporate issues (incentives/specification).

France -- Using performance contracting as a vehicle for improving target setting

The French case study of the Directorate General for Taxes describes how performance contracting was used as a vehicle to facilitate better performance target setting and measurement. They found the contracting process useful to:

- (1) provide a framework to allow each region to design a local strategy flexible enough to cover local needs, but consistent with central strategic priorities.
- (2) serve as a source of pressure for performance improvement. In 1992 a working group of central mission offices and regional offices developed a set of pilot indicators that were applied to all sub-organisations. After consultation and revisions they have been accepted and applied to each service-level agreement.

Specification: What is included in the contract?

Statement of objectives covering the short-term, medium-term, and longer-term.

Productivity indicators (14) measure the productivity of services for defined duties and the population being served (individuals, companies, etc.). Productivity indicators are both qualitative (taking into account environment and contextual factors) and quantitative.

Quality indicators (16) including factors such as arrears average, error rates, processing times.

Efficiency indicators (10) including productivity ratios based on staff levels and work load.

Comparative performance rankings, performance is indexed, weighted, ranked and disseminated across the organisation to assess performance (and benchmark progress) for each sector of activity.

Performance evaluation, provision for regular reporting, and a process for evaluating what steps have been taken to achieve the planned improvements -- not just whether or not they have been met.

Regular performance meetings, half day meetings attended by local managers and officials from the head office are used as an incentive (recognition to success and opportunity to showcase good implementation of performance strategies to meet targets) and ensure accountability.

Action plan review, used in discussions as part of bi-annual contract renewals for division directors. Evaluation of performance under the contract is one factor in contract renewal.

Is Performance Contracting Successful in Facilitating Target Setting?

A reported advantage of using the performance contracting as the framework for target setting is its success in making the department's strategy clear to all its operational units and clearly linking resources to performance targets. Targets are put in to the context of near term results, but also emphasise planning for the future in terms of working toward longer-term results and performance improvements. This helps to ensure that performance information is relevant and used. One key area of success is an increase in structured dialogue about performance targets between central government and the various tax directorates, and this is now also taking place between the directorates and their sub-departments.

Denmark

In the Danish case study, performance contracting is used to provide clear definition of objectives and targets to increase ministers' control over policy, while freeing agencies to manage better. There is a fairly high degree of specification on process and output targets, complemented by qualitative targets on management and employee relations. Examples of performance targets include:

State and University Library (Ministry of Cultural Affairs) 1993-96: The contract lists the overall objective as being to extend the library's position as a central distributor of information, the chief means being organisational development and use of information technology. Key targets include:

- improve efficiency through meeting a 10 per cent increase in the number of loans;
- increase revenue by 2.5 per cent per year;
- retroconvert the card catalogue (1 million records);

- formulate a policy on withdrawal of materials and increase withdrawals by 95,000;
- introduce a plan for quality control of services involving different user groups;
- carry out user surveys in 1994 and 1996 comparable to the 1988 survey; and
- continue organisational development through evaluation of management with participation of external consultants.

Court of Taxation Appeals (Ministry of Taxation) 1993-1996: The court processes appeals of tax assessments and real estate valuations from the local tax authorities. Targets and special conditions:

- reduce the average case processing time from 14 months in 1992 to 9 months in 1995;
- deal with all complaints related to the 19th general valuation of real estate by end-1996;
- increase productivity 20 per cent by 1996;
- long term budget arrangement to be provided;
- additional manpower to be provided;
- introduce performance-related pay scheme.

DURATION

WHAT IS AN APPROPRIATE PERIOD FOR PERFORMANCE CONTRACTS?

There is no a priori ideal time frame for a performance contract. The period of performance contracts are linked to annual cycles for resource planning and allocation. From the case studies it might be concluded that Framework Agreements tend to run on a multi-year time frame, while organisational performance agreements tend to run on an annual basis. The duration of the contract should be considered after taking an assessment of the balance of risks, costs and benefits involved in assuming different contract periods.

Contract duration: factors to consider

- budget / planning / resource allocation cycles
- transaction costs of negotiation, re-negotiation, and compliance
- business dynamic, e.g., risk profile of the contract parties
- maturity of the performance contracting regime
- number of funding sources

Other factors to consider in determining the duration of a contract include, for example, the time sensitivity of performance objectives (medium-term objectives versus more specific targets), how quickly the policy/service delivery environment changes, political sensitivity of programmes being delivered by contract, and whether the contract is with a relatively new agency (more likely to need frequent reassessment) or with a more well established agency.

Contract periods tend to be a function of:

- *resource allocation cycles;*
- *risks for each party; and*
- *an assessment of the costs and benefits for contract renegotiations.*

Evidence from the case studies suggests that assessing the appropriate contract period tends to be a function of:

- resource allocation cycles;
- risks assumed on both sides of the contract relationship; and
- the cost-benefit ratio for the processes of re-negotiation. The costs of re-negotiation should be compared to the benefits associated with a reduced likelihood of having the organisation doing the wrong thing, or doing the right thing, poorly.

In terms of taking account of risk, it is also important to understand clearly:

- the risks taken by ministries or departments in delegating service provision;
- the financial and managerial risks taken by agencies (as in health care organisations); and
- the risks others may incur as part of the trust relationships (e.g., where provider are dependent on one funder).

SETTING THE INCENTIVE SYSTEM

WHAT TYPES OF INCENTIVES ARE IMPORTANT IN PERFORMANCE CONTRACTING?

A key difference between performance contracting and other contracting regimes, such as contracting out, is that direct market incentives may not apply and appropriate incentives and sanctions are less clear. There are three key arguments qualifying the use of incentive systems for performance contracting, these include:

- the difficulty in linking the effort of individuals (e.g., chief executives) to actual results;
- sanctions that might be used in a market setting may be difficult or impossible in a public sector setting. For example, the need for contract parties to continue doing business over the long run means that the threat of finding a new service provider in the event of non-performance is often not possible; and
- rewards that might be used in a more market-type setting may also be difficult to apply to many public sector organisations. For example, financial or material rewards, such as financial bonuses or perquisites that might be found in the private sector for meeting or exceeding performance can be difficult to implement in the public sector due to limitations on the use of public monies. In many OECD countries, public employees, even at senior levels, do not have the opportunity to negotiate their salary or compensation package in a way that might improve links between compensation and contracting for results.

Incentives can be derived from the power of politicians and executives, linking organisational and individual performance, and establishing a competitive environment.

A comparative assessment of the cases suggests that incentives and sanctions can be derived from a number of internal sources. These include:

- the power of politicians and executives to reorganise an organisation or to dismiss a chief executive where performance over time is consistently unable to achieve results;
- ensuring a clear link between individual and organisational performance.

For example, an emphasis on shared interests, recognising the value of reputation and recognition factor. Many of the factors that drive organisational performance come from leadership and the desire of individuals to achieve and move their careers forward; and

- establishing a competitive business environment.

Usually, the more the contract relies on high powered incentives to reward or sanction performance, the more comprehensive and detailed the contract specifications need to be.

Participants in the OECD expert meeting on performance contracting stressed that it is important to be aware of the negative and unintended consequences of different incentive schemes and their potential to bias behaviour. For example, the more the contract relies on high powered incentives to reward or sanction performance, the more comprehensive and detailed the contract specifications need to be to ensure the focus of the debate remains on performance elements rather than interpreting (or disputing) eligibility for rewards and sanctions.

Strategies to deal with poor performance should accompany contract sanctions.

Where sanctions are included in the performance contract, it is important that they are complemented by mechanisms for assessing and developing strategies to overcome poor performance. This is another key area where the performance contracting approach tends to differ from more legalistic or contracting-out type contracts. Many of the performance contracts discussed in the case studies do not make explicit use of rewards or sanctions in the contract or the performance management system.

Following are excerpts from the case studies discussing the use of performance sanctions and rewards.

In Norway

Virtually no incentives or sanctions are attached to the actual letter of allocation. Agencies normally do not receive rewards from the ministry if performance and reporting requirements are met or exceeded. Although the ministries themselves rarely use sanctions in a punitive way, a shift in the direction of closer and more detailed management by the ministry may be interpreted as a sanction. In very exceptional cases, a ministry may put a subordinate agency into "administration" (that is, the ministry takes over the management). Also, agencies with a *high* degree of goal achievement may have their financial allocation reduced to account for increased productivity and may perceive may see such an action as a sanction.

Spain -- State Railways

In the State Railways in Spain, emphasis is given to holding managers accountable for meeting performance-contracting goals with the level of resources and subsidy provided by the State. However, in contracts between levels of government, holding executives accountable may become more difficult, and indeed distribution of responsibilities may be more ambiguous, making it hard to use personal incentives for executive and managerial behaviour.

Australia's Three-step Framework for Evaluating Poor Performance

The Australian case study on the partnership agreement between the Centrelink organisation and the Department of Social Security describes the three-step framework for evaluating poor performance that is used in managing the partnership:

- The first response to poor performance is for both parties to analyse together the reasons for the failure.
- The second response is not to assign blame but to ask why performance is bad and not assume that it is automatically the fault of the provider or an individual. Fault could lie in policy or product design, or the difficulty of implementing a legislative requirement.
- The third response is to impose a sanction that is an incentive to change and improve, *not to punish*. This does not always mean reduction of funding to the provider organisation. For example, it may require the provider or the purchaser to allocate resources to develop a particular capability to improve performance. Punitive corporate sanctions may be considered but only as a last resort after incentive sanctions fail to work for no good reason.

If both organisations are aligned in the value they place on the strategic partnership, it is expected that punitive sanctions need not be imposed. This does not mean that consistently poorly performing staff or teams will not have punitive sanctions imposed on them in terms of requirements to improve individual performance, but such management strategies operate below the partnership agreement level.

In New Zealand

Personal incentives for executive and managerial behaviour are well integrated into the performance management system. The case study describes how individual performance agreements and employment contracts seek to clearly link individual and team effort to organisational goals, and individual achievement to rewards such as contract renewal, pay-for-performance and promotion opportunities. For chief executives, performance appraisal is based on information drawn from the central management agencies, the responsible Minister, and other referees, to gain a broad view and making the most of reputational factors to drive performance. Moreover, with the State Services Commission using information from chief executives' assessments to plot the position of individual departments compared to others in relation to particular competencies, departments have increasingly good comparative information, which may also serve as an incentive to improve performance. Another incentive is the use of performance bonuses. Sanctions include non-renewal of contracts for chief executives whose performance does not meet expectations, or in extreme cases, removal from office.

HOW (AND BETWEEN WHOM) DO PERFORMANCE CONTRACTS GET NEGOTIATED?

The first attempt at negotiating a contract will require a considerable investment of time, advance planning, and goodwill and co-operation from all parties.

Capacity issues for “how and who” negotiates and signs contracts featured strongly in the case studies and in the OECD expert meeting. The ad hoc use of performance contracting in many OECD countries means that staff on one or both sides of the table lacked experience in contract negotiation.

Information imbalances, particularly lack of information with the “principal” in setting performance goals and indicators for services, may result in poor quality contracting or force significant adjustments in the contract terms over time. In the case study examples, goals for performance contracting and specific procedural and content guidance were sometimes lacking in the early stages and only gained clarity with time and experience. A majority of the case study authors noted specifically that the initial attempt at negotiating a performance contract required a considerable investment of time, resources, advance strategic planning, experimentation and, perhaps most importantly, goodwill and co-operation on all sides of the contracting relationship.

The negotiating process is often more important in promoting strategic and results oriented management than the contract.

To determine how performance contracts are negotiated, it is important to first step back and see the value of the process as a learning and strategic planning exercise. As a management tool, the case studies suggest that the process of determining the contents of the contract is an extremely useful planning and information sharing exercise. Often in negotiating a performance contract, the process is more important than the final contract for promoting strategic and results-oriented management.

In most of the case studies, it was the “principal” who initiated and provided the first draft of the performance contract at the start of a new contracting regime. This was done to establish clear principles for the contractual relationship, the aims of

the contract and the accountability relationships. Thereafter, “agents” tended to initiate the process and provide draft contracts. The shift in who writes the draft contract appears to take place once the overall framework has become sufficiently established.

In reality, who initiates and who writes the contract matters less if the contract is part of an ongoing management relationship and a clear framework.

Once the contract cycle is in place, agents are often well placed to start the contract discussion as they often have the most information about programme needs and results. They also often have the larger available resources. Who initiates and who writes the contract matters less where the contract is part of an ongoing management relationship and part of a framework with clear principles and guidelines.

Following are excerpts from the case studies discussing processes for negotiating and writing contracts.

Denmark - National Board of Industrial Injuries

The contract is formally made between the Ministry of Social Affairs and the Board’s Director General. The specific requirements of the contract are negotiated between civil servants from the Board and the department respectively. The Board provides the first draft of the contract, which provides the basis for negotiation with the Ministry.

An internal management team made up of workers from different areas of the Board and representatives from the Ministry initially develops performance targets and management goals, and these are then negotiated with the Ministry. A smaller management team monitors progress against the contract over the year via reports made by each of the divisions. The contract process is linked to other performance management processes such as strategic planning, service quality management, and benchmarking.

In Finland ...

Performance contracts are linked to the budget process and the Ministry of Finance initiates negotiations. At the start of the budget process, the Ministry of Finance provides brief guidelines on the process (timetable, structure for the contracts and information on the parties who sign the contracts), as well as content (strategic targets for next three years; annual performance targets; resource levels; and monitoring of the contracts).

Performance areas and units are set during the budget negotiations, with performance targets set in the final contract. Targets usually include both quantitative and qualitative measures, and are set so that the monitoring, follow-up and evaluation of results can be done in a way that is acceptable to both the ministry and the agency.

In principle, the highest level civil servants and the minister sign performance contracts. However, it is not specified in the budget decree and actual practices

vary among the ministries. Even where the minister signs the contract, his or her role is often rather distant from contract negotiations. Promoting a more active role for the minister in result management has been one of the key issues in developing the system. The State Audit Office has paid attention to this question in recent years.

The relational nature of performance contracting means that special attention must be given to ensuring that the relationship between the contract parties remains co-operative rather than adversarial.

DISPUTE RESOLUTION

The case studies highlight the need for explicit mechanisms for dispute resolution to be built into the contract, or the overall governance framework for the contracting regime. The relational nature of performance contracts means that special attention should be given to ensuring that the relationship between the contract parties remains co-operative rather than adversarial, particularly when dealing with problems or disputes in managing or interpreting the contract.

Resorting to adversarial means of solving disputes is generally a clear sign that the relationship between the contracting parties has broken down to the point that the relationship should be dissolved or substantially rethought. The Australian case study gives particular attention to the issue of dispute resolution, noting that when problems do arise in carrying out or managing the contract, resolution should be relatively simple.

It is important to assess the limits of dispute resolution for solving problems in the contracting process. Fundamental or recurring problems in interpreting the contract or assessing performance against targets set out in the contract may be a sign of problems elsewhere in the contracting process. Country experience suggests there are limits to the ability of governments to resolve disputes between the contracting parties through legal action.

GOVERNANCE ARRANGEMENTS

Governance arrangements are not generally highlighted in the case studies with more work needed to better understand the costs and benefits of different types of arrangements. In several of the case studies, ad hoc management boards were used to manage the contract over the course of the year (e.g., in selected agencies in Denmark). In partnership arrangements, as with the Australian and Canadian case studies, management boards were used in the design and set up of the partnership and in managing the contract over time. Only in the Australian case study did governance arrangements factor highly in the set-up, organisation and implementation of the partnership arrangement.

There is some concern that formalised

Formalised governance structures that sit outside the everyday management of the organisation may have an unintended effect of diluting individual responsibility for relationship management. However, separate governing boards may play an important function where there is:

governance structures may have an unintended effect of diluting individual responsibility for relationship management.

- significant risk in implementing new forms of service delivery;
- a need for substantial distance in policy and operational decision making and/or
- distance is sought between a ministry and a contract organisation (as is the case in the Australian Centrelink example).

Similarly, ad hoc staff or management boards are of value where there is a desire to use performance contracting to build management and staff participation in organisational planning and decision-making.

EVALUATION

MEASURING SUCCESS -- WHO EVALUATES THE CONTRACT? HOW SHOULD PERFORMANCE INFORMATION BE REPORTED?

A key part of the contracting framework is to evaluate whether the players are fulfilling the contract both as the contract progresses and at the end of the contract period. While performance reporting is a common feature of performance contracting, the quality of the reporting and evaluations, and the use of the information vary considerably among countries.

Evaluation can take several forms, including:

- Evaluation can take several forms:*
- *ongoing dialogue;*
 - *annual reporting;*
 - *periodic reviews by the "principal" or "agent"; and*
 - *external reviews.*

- ongoing dialogue between the parties about performance relative to the targets;
- annual reporting of results, as part of major evaluations of programmes or services;
- periodic reviews by the principal; and
- external verification (i.e., Audit offices, Parliamentary committees, academics) serving external audiences.

A meaningful and ongoing dialogue between the contract parties about performance is a key element of contract management. In a daily context, regular performance monitoring and reporting ensures there are no surprises at the end of the contract period and allows for assessment and correction of priorities and targets if changes or contingencies occur.

Ongoing dialogue between contract parties is a key element to successful contract management.

All case studies examined included provisions for the regular reporting and evaluation of progress throughout the contract period. Most of the case studies had provisions for generating annual financial and performance reports from individual departments and agencies built into their contracting arrangements or their overall performance management framework. On a broader scale, Denmark and Sweden have carried out targeted evaluations of their administration wide performance contracting activities, and New Zealand commissioned an extensive evaluation of its public sector reforms, including an assessment of the contracting regime.

Generally speaking, performance information does not directly affect the resource allocations in most countries, (OECD, 1997). However, the case studies suggest that performance, cost and productivity information generated from performance

contracting is a useful management tool in building the bridge between available resources and achieving priority goals and objectives. Moreover, the management of resources to achieve results is generally an important aspect of agreed performance.

Following are excerpts from the case studies discussing how performance information is evaluated, used and reported in the context of performance contracting.

In Canada

In the labour market partnership agreement discussed in the case study, a Joint Evaluation Committee was established to:

- prepare an evaluation framework;
- implement an evaluation plan;
- approve third party evaluation contracts and reports; and
- approve the design and operation of research and innovation projects.

A two-phased evaluation process will be used initially with the first phase (formative) evaluation to be conducted towards the end of the first year of the agreement and the second phase (summary) evaluation to be conducted in the latter part of the third year. Further evaluations will take place every three to five years as long as the labour market agreement is in effect.

In Denmark

According to the case study of the Danish National Board of Industrial Injuries, new and more targeted performance information generated through the contract management process has improved communication and information sharing between the Board and ministry. The contract requires progress reports (see below) and a user and stakeholder survey to be conducted every two years (by external consultants).

During the period 1993-1996, the Board reported quarterly to its parent ministry and gave an account of its initiatives and current status in relation to specific targets. These reports were discussed in group management meetings attended by all directors in the Ministry of Social Affairs, as well as by the permanent secretary. Since 1996, the Board prepares "company accounts" consolidating performance and financial reporting, giving a detailed report of the Board's progress in relation to targets and "normal" financial accounts. The report is submitted to the ministry and to the public auditors. Reporting now consists of company accounts and one mid-year summary progress report .

PART IV: CONCLUDING COMMENTS

A good contract therefore is one that strikes, at a level which will be robust over time, a balance between specification and trust which is appropriate to the risks of non-performance but does not either impose unnecessary transaction costs or inhibit the capacity or motivation of the agency to contribute anonymously and creatively to the enterprise in question. While it takes a very bad contract to be less efficient than centralised regulation, creating a good contracting regime is difficult. (Matheson 1997, p. 176)

While a common definition of performance contracting can be found, there is a considerable variety of uses and forms for quasi-contractual arrangements

Performance contracting is used as a performance management tool in OECD countries to help public sector executives and policy makers to define responsibilities and expectations between contracting parties to achieve common, mutually agreed goals. While it is possible to find a common definition for the practice that has become known, somewhat deceptively, as performance contracting, there is no single or unified approach to making these arrangements. There is considerable variety in the use and form of quasi-contractual arrangements and implementation of these contracting arrangements is often ad hoc.

Practices in the national administrations of OECD countries suggest that quasi-contractual arrangements in the form of performance contracting can be tailored to fit a wide range of administrative, legal and institutional settings. In most cases, these arrangements exist as administrative or management tools or service delivery strategies which are not formalised in law. Regardless of institutional and legal arrangements, the case studies suggest that performance contracting is as valuable a management tool for enhancing dialogue and ensuring clarity of roles, purpose and expectations, as it is a regulatory tool for control and monitoring behaviour.

Adopting a contractual model in a rigid and legalistic way is likely to result in significant transaction costs as a new internal bureaucracy of detailed contract management and interpretation begins to crowd out the spirit of the partnership and big picture goal of achieving outputs and outcomes. In many cases it is the relational aspects of contracting, such as trust, dialogue, clarity of purpose and expectations, and commonly agreed frameworks for performance review and improvement, rather than the legal or administrative underpinnings that foster the necessary environment for achieving the aims of performance contracting. Petrie's paper goes further, finding a legally enforceable contract, or even quasi-contractual agreements with a very high level of specificity may be counterproductive to the long-term relationship between the parties to the agreement.

Despite difficulties in design and implementation, performance contracts are effective for managing relationships in a devolved management environment.

The conclusions reported in the country case studies on performance contracting suggest that despite difficulties in design and implementation, performance contracting is effective for managing relationships in a devolved management environment. Almost all of the case studies report organisational benefits from performance contracting such as:

- improved co-operation, co-ordination and dialogue between contracting partners such as Ministries and their subordinate agencies;
- improved commitment to achieving the overall strategic goals set by a Ministry or more broadly for the public sector; and

- better links between organisational performance and the budget process.

Performance contracting can support a variety of public sector management priorities.

The key objectives driving the implementation of performance contracting included the desire for greater efficiency, savings and responsiveness. In this context, the case studies suggest that performance contracting can promote or enhance public sector management priorities such as:

- an increased focus on outputs and outcomes (over process);
- greater transparency in carrying out the business of government;
- use of purchaser-provider splits such as through the creation of performance-based organisations;
- a renewed focus on performance management to foster value for money, efficiency gains and achieving results;
- risk management rather than rule-driven management;
- an emphasis on performance reporting (to government and the public) and accountability for results; and
- better access to data on performance to strengthening government's capacity for policy development and service delivery.

A number of areas in the performance contracting process were identified as requiring further development. Specifically, identifying and measuring performance targets, measuring and evaluating results, and setting meaningful incentives for individuals and organisations against contract goals were highlighted consistently across case studies as weaknesses of performance contracting.

Weaknesses were identified in the areas of performance targets, evaluation and incentives.

In addressing the limits of performance contracting, McGuire (1997, p 115) notes that "if the current problems are [due to] inefficient management of service delivery, the transparency of contracting will reveal this. Where the problem is the effectiveness of policy choices, contracting will not reveal the problem." While the case studies would support that conclusion, it is important to note that examples such as those provided by the case studies from Canada and Australia suggest that improved and focused communication about performance measurement and results that can be facilitated by a performance contracting regime may also be used to improve the quality of the policy dialogue and, ultimately, policy making.

Despite the wide variety of forms, performance contracting takes in the national administrations of OECD member countries and the different circumstances and approaches under which performance contracting is carried out, the long-term success of a performance contracting regime appears to rest on three key underpinnings:

- an *environment* that maintains and supports a trust-based business relationship which includes a balance between the formal and informal, on-going dialogue, information sharing, negotiation, clarity of purpose, and mutual respect. Performance contracting requires good faith efforts from all sides of the contractual relationship. It must have strong support at the highest political and managerial levels on both sides of the agreement. It is also suggested that performance contracting requires a mature and well established public service culture and a stable political and policy environment;⁴
- a *commitment* to mutual purpose and accountability for results activated through one or more performance contracts or agreements. Such contracts

A successful long term performance contracting regime depends on :

- *an environment of trust;*
- *a commitment to a mutual purpose and accountability of results; and*
- *a big picture focus.*

provide for goals, objectives and targets, incentive systems to achieve in the current period and also for the future, and agreed processes for managing the contract and assessing results. Moreover, the staff involved with the delivery of the programs and services under a performance agreement need to have (or be supported in gaining) the appropriate skills, attitudes and experience to ensure the agreement delivers the results expected.

- a **“big picture” focus** that does not expect performance contracting to address the whole spectrum of factors related to performance management, culture, politics and administration that make up a business relationship.

Performance contracting is being used increasingly in the national and sub-national governments of OECD countries. It is an increasingly important performance management tool within the context of resource allocation and strategic management processes. In countries such as Denmark, Finland, New Zealand, Norway and the United Kingdom quasi-contractual arrangements in the form of performance contracts and agreements have become widely accepted and integrated features of the public management and accountability system. Its inroads into public sector management in countries such as Australia, Belgium, Canada, France, Spain and the United States suggest it is a practice that is here to stay.

APPENDIX

COUNTRY CASE STUDIES

An OECD expert network was created drawing from the Public Management Service's Performance Management Working Party. A list of the experts is provided in the appendix; however, the contents of this paper are published on the responsibility of the OECD Public Management Service and any errors or omissions are the responsibility of the authors and not the experts. Nine case studies have been prepared on country experiences with performance contracting, , plus an additional paper on service quality standards. The case studies are published under separate cover and are available on-line on the OECD internet site (<http://www.oecd.org/puma>).

Country-based Case Studies on Performance Contracting	
Australia	Centrelink and the Department of Social Security
Belgium	Emergence of public service performance contracting in Belgium and Flanders
Canada	The Canada-Alberta Agreement on Labour Market Development
Denmark	Contract Management in Denmark, featuring a case study of the Danish National Board of Industrial Injuries
Finland	Finnish performance contracting system: a case study of the Ministry for Social Affairs and Health
France	Contracting and Management of Local Service in the Directorate General for Taxes
New Zealand	Contracting for results: case studies from the Ministry of Justice and the Department for Courts
Norway	Use of Performance Contracting in Norway
Spain	Performance contracting and inter-government agreements in Spain: three examples

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A FRAMEWORK FOR PUBLIC SECTOR PERFORMANCE CONTRACTING

EXECUTIVE SUMMARY

The widespread interest in performance contracting across the OECD has resulted from its potential to contribute to a more effective and efficient public sector. The term performance contracting covers a variety of arrangements, however, and the desirability of contract-type arrangements depends to an important extent on the nature of the activities concerned, and on the broader environment in which they take place. Performance contracting can establish greater clarity over what public agencies will achieve in a more decentralised management environment, while retaining the necessary accountability. There are however significant risks from the inappropriate use of performance contracting.

Economic and Legal Framework for Contracts: A transaction cost perspective suggests that performance contracting as a governance mechanism both influences and in turn is influenced by the broader governance arrangements within which the contract is embedded. Performance contracting must be viewed within this broader context. Indeed, the role of and limits to contracting are themselves critically important in determining whether transactions in the public sector can be more effectively undertaken across quasi-markets or controlled within a more direct hierarchical relationship.

Transaction cost theory suggests that “classical” contract law is more suitable for situations where the parties are in an arms length relationship and do not expect to deal with each other on an on-going basis. In this case, disputes are typically settled in court. In settings where the parties have a mutual interest in an on-going relationship, “relational contracts” are more common. Relational contracts are still enforceable, but in contrast to “classical” contract law, disputes that cannot be mutually resolved as they arise are likely to be referred to arbitration rather than court. The relationship is based as much on trust and co-operation as on reliance on legal rules.

There are limits however to the types of exchanges relational contracting can handle effectively. In situations where each party is highly dependent on the other, where transactions are frequent and or complex, and measuring performance is difficult, common ownership can reduce co-ordination and control costs, in comparison to arms length contracting.

In general, transaction cost analysis suggests that contracting between public sector entities in the form of enforceable contracts would be inefficient. Allowing recourse to an independent third party to resolve disputes is likely to involve high transaction costs, and to reduce the effectiveness of the co-ordination and control possibilities of joint ownership.

The analysis also suggests that many funding relationships in the public sector should be considered as forms of informal long term relational contracting, rather than more strictly legalistic and enforceable contractual relationships.

These conclusions are reinforced from a practical legal perspective. First, many public sector agencies are not separate legal entities. They are in a hierarchical relationship with a Minister or ministry, and are not able at law to enter legally enforceable contracts with them. Secondly, even between separate legal entities, there are problems with the concepts of contractual intention, offer and acceptance in applying the private law instrument of contract to the public sector.

Guidelines for Performance Contracting: A key element in the design of performance contracting arrangements is the choice of the appropriate degree and form of ex ante performance specification, along a stylised spectrum from unconditional grant to enforceable contract. There is no simple template for deciding the optimal degree and form of specification. The optimal form will be very country-specific,

reflecting the important role of social, legal and political culture, trust and the history of institutional development.

The nature of the transactions themselves also impacts on the design of the contracting arrangements. In particular, the presence of specific assets, the complexity of the activities, the ability to specify and measure the outputs and/or outcomes, and the frequency with which the contract will need to be adapted all impact on the efficient design of the funding relationship.

In general, an enforceable contract is desirable where government is funding the supply of outputs by a non-government owned entity. In the absence of any ownership relationship, the government is entirely dependent on the funding relationship to provide the necessary clarity, certainty and accountability. However, there are exceptions to this conclusion (for example, where central government is funding the supply of outputs by a lower level government, this should not necessarily be through enforceable contract).

Legally enforceable contracts are not efficient or effective for funding relationships between public sector entities, except in relatively limited circumstances. Exceptions might include:

- a funding relationship with a fully commercial state enterprise for the delivery of non-commercial outputs to the government, where an arms length contractual relationship may be appropriate;
- arrangements for the supply of commercial services between different state-owned enterprises, and between enterprises and government ministries or departments; and
- in some circumstances, arrangements between different levels of government for the supply of services.

At the other end of the spectrum, a completely unconditional grant would not seem to provide the necessary assurance of accountability for the use of public funds.

The bulk of public sector activity occurs in situations where enforceable contracts are undesirable, infeasible or both. The key issue that needs to be considered in designing such funding relationships is: *what are the marginal costs and benefits (financial and non-financial) of more detailed and prescriptive specification of performance, as one moves along a continuum from unconditional grants to highly detailed conditional grants.*

Two factors that impact on the degree of performance specification in a particular case are the ability the government has to influence performance through the power of the purse, and through any ownership relationship it has with the agency. Any owner funding the supply of outputs from an entity has a vital interest in ex ante incentive alignment, rather than sole reliance on the instruments available to owners to enforce accountability. The government's objective should be to maximise the advantages of delegation of control, net of agency costs, through a combination of ex ante incentive alignment and ex post governance. Therefore, design criteria should address the following question: *what is the best mix of ex ante performance specification and use of ex post instruments for a particular institutional setting, and for a specific type of activity or output?*

Principal/agent theory provides a number of principles for efficient ex ante design of the funding relationship. These include clarity of roles and responsibilities, clear specification of the outputs and/or outcomes to be delivered, delegation of authority over inputs, and effective monitoring of performance. Significant gains are achievable through the careful application of these principles. In their absence there is a serious risk of poor performance.

However, there are important constraints on the use of a simple principal/agent framework in the public sector. Designing the funding relationship in a pure principal/agent framework can cut across the statutory

independence of some state agencies, and can infringe on important principles, often enshrined in constitutions, of the separation of powers, of the duties of public servants, and of the roles and responsibilities of sub-national governments.

There are also a number of costs and risks in designing appropriate performance measures. These are in addition to negotiating costs and the need to establish systems to capture and report the physical and financial information required for monitoring. Additional costs and risks include inappropriately restricting the freedom to manage, damage to trust and the quality of the relationship, and the inducement of dysfunctional behaviour. Strategic decisions over the type of performance contracting regime must take into account possible interactions with other, non-contractual approaches to reducing agency costs, such as socialisation and professional leadership.

The choice of the precise degree and form of performance specification therefore requires particular care. There are risks both from having too detailed or too simple a specification. There is no escaping the need for careful case by case analysis in every instance. This analysis should focus on:

- the nature of the goods or services being supplied;
- the type of institution and its relationship with the executive and other branches of government; and
- the broader cultural and legal environment in which the relationship takes place.

Used with care, performance contracting should be seen as a very important lever for improving the performance of the public sector. It is by no means, however, a silver bullet.

A FRAMEWORK FOR PUBLIC SECTOR PERFORMANCE CONTRACTING

I. INTRODUCTION

OECD countries have grown increasingly interested in the use of contract type arrangements in the 1990s as a means of improving public sector performance. This interest reflects a number of broad challenges to traditional governance structures. These challenges include the demand for greater efficiency through highly adaptive and flexible public sectors and the increasing pressure of accumulated public debt and fiscal deficits. “Governments must strive to do things better, with fewer resources, and, above all, differently.”⁵

Many countries have pursued a strategy of developing a more performance-oriented culture in the public sector. This has generally involved two closely related elements:

- an increased focus on results, in terms of efficiency, effectiveness and quality of service; and
- a move from centralised bureaucratic structures, to more decentralised managerial environments.

Public sector reform has not taken an identical approach across OECD countries. Different institutional arrangements, histories, and political circumstances have resulted in differences in reform programs across countries (see Premfors, 1998). While the types and emphases of reform vary across countries, in many countries there has been a general shift to more decentralised management of resources to achieve specified government objectives. This new approach has been characterised as both letting managers manage, and making them manage.

Performance contracting has emerged as a tool of public sector reform.⁶ It can provide greater clarity over what public agencies will achieve, while at the same time provide agency managers with greater flexibility to deploy resources to better achieve those goals. In this way, performance contracting has the potential to improve the effectiveness and efficiency of the public sector, while ensuring appropriate accountability is maintained for the use of public money.

The term performance contracting covers a variety of arrangements. The desirability of contracting arrangements depends to an important extent on the nature of the activities concerned, and on the broader environment in which they take place. There are significant risks from the inappropriate use of performance contracting.

The purpose of this paper is to set out an analytical framework for performance contracting in the public sector. It assesses why and how different approaches to performance contracting are appropriate in different circumstances. This framework combines insights from institutional economics, public sector management, and public law. It is designed to supplement, and provide a context for the accompanying case studies of performance contracting in individual OECD member countries.

The framework highlights key factors for public sector advisors and practitioners that are important in determining the precise specification of performance contracting in any particular case. Due to the broad scope of funding relationships and the diversity of circumstances across the OECD, the framework is

indicative. There is no substitute for careful case by case analysis of the appropriate design of performance contracting arrangements.

In this paper, the terms performance contracting, and contracting, are used to describe the application of the language of contracting to a wide variety of arrangements in the public sector. These include:

- organisational performance agreements between a Minister and an agency head;
- resource or budget agreements between a central agency and a budget-funded agency;
- individual performance agreements for agency heads;
- performance agreements between an agency head and a lower level line manager within the same organisation;
- a partnership-style arrangement between two independent agencies, and arrangements for the supply of goods and services between different agencies;
- an agreement or understanding between central government and a sub-national government; and
- a contract between a public agency and a private or not-for-profit organisation for the supply of goods and services.

These arrangements may involve legally enforceable contracts (for example, with private suppliers of goods and services). However, where the arrangements are between different public sector entities, they generally involve quasi-contractual arrangements, agreements or undertakings. These arrangements feature some of the elements and language of legal contracts, but there is no intention, and in many instances no possibility, of creating legally enforceable contracts.

The structure of this paper is as follows:

- Section II outlines an economic and legal framework for contracts. The economic functions and legality of contracts in the private sector are analysed, with insights of this analysis applied to performance contracting in the public sector.

First the governance approach to contract is considered. This approach outlines the need to consider the interactions between the nature of performance contracting arrangements and the broader institutional environment in which they take place. Secondly, public sector contracting is analysed from a legal perspective, and problems with using the private law instrument of enforceable contract in the public sector are identified. Finally, the principal/agent approach to the design of efficient performance contracting relationships is considered.

- Section III applies the framework developed in Section II to different funding relationships and activities within the public sector.
- Section IV presents some concluding remarks.

II. AN ECONOMIC AND LEGAL FRAMEWORK

The Governance Approach to Contract

The fundamental economic function of contracts is to facilitate voluntary exchanges, thereby increasing social welfare.⁷ Contracts take a variety of forms. The economic function they play needs to be considered in the context of the institutional settings in which they take place. There are significant risks from the inappropriate use of performance contracting.

Economists have paid increasing attention to these issues in recent years. Transaction cost economics or the new institutional economics views contracts as both influencing and in turn being influenced by the governance arrangements within which they take place. This approach has been described as the governance approach to contract.⁸

In this section, a transaction cost approach is used to consider the different types of contract and the role they play in influencing whether transactions are organised across markets or within hierarchies. Transaction costs arise basically when it is difficult to determine the value of goods or services.

Different forms of exchange

The simplest form of exchange is a spot transaction. This is a favoured means of exchange where the identity of the other party to the exchange is not important, and the exchange is completed “on the spot.” Specific arrangements to govern the terms of the transaction do not need to be negotiated beyond “on the spot” agreements over the price and quantity, with quality apparent at point of sale. As noted by Macneil, this is a world of “sharp in by clear agreement; sharp out by clear performance”, and corresponds to economists’ idealised world of perfect competition.⁹

Most exchanges are not of the classic spot market variety. Many exchanges involve a time delay before completion of the exchange. Other exchanges involve a stream of services over time. Exchanges may also require one party to invest in assets that have a greater value in the contracted-for use than in other uses (in Williamson’s (1985) terminology these are known as “specific assets”). These elements introduce uncertainty over the performance of the initial terms of the exchange and the possibility of opportunistic behaviour by one of the parties.

In the absence of the ability to enforce compliance with agreements, many exchanges would not take place. Others may take place, but only with costly efforts by the parties to protect themselves from loss or exploitation.¹⁰

The use of contracts that are enforceable by an independent third party is one solution to these problems. Contracts strengthen the credibility of and commitments of parties to perform. Therefore, they facilitate the achievement of co-operative outcomes.

Contracting can have substantial costs. There are costs involved in negotiating, monitoring and enforcing contracts - termed transaction costs.¹¹ From a national welfare perspective, a contractual arrangement should only be used where it delivers net benefits to the parties, that is, where it is expected to minimise production and transaction costs.¹²

Different forms of contracting are suited to different institutional settings, and involve different costs and benefits. For example:

- “classical” contract law, is a strict legal rules regime. This form of contracting is suitable for situations where the parties do not have an on-going relationship, and have little interest in reaching agreement on mutual adjustment to contract terms, should the need arise. The focus is on formal documents, and the range of remedies is fairly narrow and predictable. Disputes are typically settled in the courts; and
- where the parties to a contract have a mutual interest in an on-going relationship, contracts tend to be more of the “relational” variety. They are less specific detailing the contingencies that might arise, providing more the “spirit” in which adjustments for unforeseen events will be negotiated.¹³ Reputation, trust and custom can play an important role in “completing” a contract, especially longer term and repeated contracts where parties have an incentive to develop a reputation for fair dealing.¹⁴

Sen (1987, pp. 83-88) has noted the instrumental role of general social norms of behaviour in achieving co-operative outcomes. More specifically, Sako (1991), in an article on the role of trust in Japanese buyer-supplier relationships, argues that trust “economises on the costs of bargaining, monitoring, insurance, and dispute settlement.” Sako identifies three forms of trust:

- contractual trust (adhering to agreements);
- competence trust (belief in the competence of the other party); and
- goodwill trust (the willingness to go beyond minimum contract fulfilment in the interests of the other party).¹⁵

In relational contracting, disputes that cannot be mutually resolved as they arise are likely to be referred to arbitration rather than court, with the intention of reaching a resolution more conducive to continued relations. Relational contracts are however enforceable, and enforceability is an important part of the context in which the less formal approach to dispute resolution occurs.¹⁶ However, there are limits to the kinds of situations relational contracting can handle effectively. For example:

- a party may gain more from defecting from a contract than co-operating and continuing the contractual relationship. This may be the case in the presence of highly specific assets, where each party is dependent on the other;
- uncertainty over contingencies that might occur, and information imbalances between parties can make contracting problematic; and
- there are frequent difficulties in specifying precisely what is to be performed, and verifying whether it was delivered, which can make it extremely difficult to write a satisfactory contract.¹⁷ For example, complex interdependencies between different units or functions can make it impossible to determine respective contributions to output.

Vertical integration of transactions within a hierarchy

The costs of frequent re-negotiation or dispute will, at some level, suggest the need for alternative governance arrangements. In these situations, vertical integration within a hierarchy (e.g. a conglomerate) can be a transaction cost economising solution. Common ownership can reduce co-ordination and control costs, in comparison to arms length contracting.¹⁸ Specifically, ownership may economise on transaction costs where:

- each party is highly dependent on the other in a long term relationship;
- transactions are frequent and/or complex;

- measuring performance is difficult, or
- contracts need frequent changes.

Internalising a transaction reduces uncertainty and opportunism through internal command and organisational culture, rather than negotiation between different organisations.¹⁹

Internalising co-ordination and control of a transaction within a hierarchy generally imposes costs, chiefly the loss of high-powered incentives and innovative behaviour in the bureaucratic setting. Therefore, common ownership is a choice where arms length contracting relationships prove to be especially problematic.²⁰

Contracting within hierarchies takes the form chiefly of employment relation, which is an incomplete contract. However, Williamson (1993) argues that, from a transaction cost perspective, the implicit contract law of hierarchies is that of “forbearance”. He goes on to say:

“The underlying rationale for forbearance law is twofold: (1) parties to an internal dispute have deep knowledge - both about the circumstances surrounding a dispute as well as the efficiency properties of alternative solutions - that can be communicated to the court only at great cost; and (2) permitting internal disputes to be appealed to the court would reduce the efficacy and integrity of hierarchy. If fiat were merely advisory, in that internal disputes over net receipts could be pursued in the courts, the firm would be little more than an “inside contracting” system. The application of forbearance doctrine to internal organisation means that parties to an internal exchange can work out their differences themselves or appeal unresolved disputes to the hierarchy for a decision. But this exhausts their alternatives. Since “legalistic” arguments fail, greater reliance on instrumental reasoning results.”²¹

In addition to internalising dispute resolution, there are a wide variety of control mechanisms available within a vertically integrated hierarchy. One of these is the role of organisational culture in developing a climate of trust, and limiting the more aggressive and opportunistic bargaining associated with arms length contracting. Ouchi (1980) has noted that employee socialisation in Japanese firms is associated with the use of non-performance related criteria (such as length of service) that are relatively inexpensive to determine. The degree of employee identification with the company’s goals reduces the need to verify employees’ performance explicitly through the use of performance measures.²²

Organisational culture can be a particularly important means of influencing performance where performance is very hard to measure (for example in many public sector activities).²³ Compared to a purchaser under a contract, a hierarchy has easy access to the information required to monitor and evaluate performance. Further, there is a wide range of rewards and sanctions that can be imposed within a hierarchy once a transaction is internalised that are not accessible to a purchaser. These rewards and sanctions include the subtle use of employment, promotion, remuneration, and internal resource allocation processes.²⁴

Conclusions

A transaction cost perspective of contract suggests that different forms of contracting have different attributes and costs, and are suited to different institutional settings. Indeed, the role of and limits to contracting is a critical determinant of whether transactions are performed in an arms length contracting arrangement or internally within hierarchies. Transaction costs can be minimised by assigning transactions (which differ in their attributes) to governance structures (which differ in their incentive and adaptive attributes) in a discriminating way.²⁵

In terms of contracting arrangements in the public sector, the analysis suggests two key points:

- contracting between public sector entities in the form of enforceable contracts would generally be inefficient. Allowing recourse to an independent third party to resolve disputes is likely to involve high transaction costs, and to reduce the effectiveness of the co-ordination and control possibilities of joint ownership; and
- to the extent private sector contracting provides an appropriate analogy for the public sector, it is relational contracting, rather than a strict legal rules approach, that should be used as the model. Relational contracting is a feature where relationships are long term. There are fewer attempts to set out in advance all the contingencies that might arise, and the relationship is based as much on trust and co-operation as on reliance on legal rules.

Public Sector Contracting from a Legal Perspective

The conclusion from a transaction cost analysis, that enforceable contracts will in general be undesirable in the public sector, is reinforced from a practical legal perspective. Many public sector agencies are not separate legal entities distinct from a Minister or ministry, and therefore cannot enter into enforceable contracts with these parties. In some instances, public sector agencies are unable to enter into legally enforceable contracts with a government ministry or department, even though the agency may be a separate legal entity.²⁶ Therefore, in most situations the relevant question is purely one of what form of quasi-contractual arrangement is most suitable in any particular case – a question that is explored in detail in Section III.

An important general feature of public sector design, however, is the organisation of agencies into different institutional types, depending on their nature and purpose. Some agencies, such as core government ministries or departments, are in a direct hierarchical relationship with a Minister. Others, such as specialised or executive agencies, subordinate bodies or public enterprises, have varying degrees of independence from Ministers and departments, and may be separate legal entities. Some of these are accountable in the first instance to their own Boards, rather than directly to a Minister.²⁷

The existence of separate legal entities within the public sector makes it theoretically possible to implement performance contracting with these entities through enforceable contracts.²⁸ The remainder of this section will consider the legal implications of enforceable contracts within the public sector.

A legal perspective on enforceable contracts in the public sector²⁹

The private law instrument of contract creates specific rights and obligations on the parties to the contract. They generally take place in circumstances where the parties are in an arms length relationship, enjoy freedom over whether or not to contract, and are able to choose between alternative contracting parties in a market. While the specific approach adopted by different legal systems varies greatly, there are generally three preconditions to a legally enforceable contract. These are contractual intention, offer, and acceptance.³⁰ Typically, if the terms of the contract are breached, a party can be sued for specific performance or damages.³¹ A breach of contract could also result in the relationship being terminated.

As noted earlier, legally enforceable contracts between a purchaser and a supplier are often an efficient means of facilitating exchange. They strengthen the credibility of promises to supply, and to pay on delivery. They also tend to result in greater clarity over what is to be supplied, over the accountability of the respective parties, and over the consequences of non-performance.

However, in considering the potential application of contract law to the relationship between different entities within the public sector a number of issues are immediately apparent.

First, contractual intention refers to the desire of the parties to create binding obligations, which if breached can be the subject of legal action. The political reality is that governments generally do not intend that public sector agencies should be able to legally challenge them in court should a contractual dispute arise.³² Litigation between the government and an entity it owns would be a highly visible breakdown. There is also a difficulty in applying the private law instrument of contract to a situation where one contracting party, the government, has the ready ability to change the law through securing the agreement of the legislature.

For the government's part, the fact that it owns the other party means it is highly unlikely to sue for specific performance or damages, or to terminate the relationship and select an alternative provider. This is particularly the case where there is no other provider, and the outputs are necessary to fulfil the government's obligations, such as providing compulsory education or access to justice. This illustrates the bilateral dependence between the government and some public sector entities, with ownership being the existing (although not necessarily the best) solution. More generally, because the government as owner has access to other forms of control, and the ability to vary the level of funding from year to year, it is highly unlikely to utilise the remedies available under enforceable contracts.

Secondly, the requirement for contractual agreement is problematic when applied to the public sector. It is generally difficult to characterise the funding the government determines appropriate for an agency as "an offer." Sometimes there is only one provider of those outputs. In other areas the government may have created an agency as a monopoly funder or purchaser. While there will often be negotiation and haggling over the funding levels and terms, there is no real sense in which the government expects at the end of the day that its "offer" will be turned down outright.

The concept of contractual acceptance is even more difficult. Public agencies may be created under their own statute, and have a statutory duty to provide the particular services sought.³³ Further, there may be no way an agency has the ability to decline an offer or make a counter-offer. They must accept the funds provided, or find themselves unable to provide the services for which they were established.

An enforceable contract also requires sufficient certainty and completeness, which may raise the following difficulties:

- contractual certainty may be hard to achieve without encroaching on the independence of some agencies, for example those exercising quasi-judicial functions; and
- a contract prescriptive enough to ensure contractual certainty may result in breaching the principle in common law countries that the exercise of statutory discretion cannot be hindered by contract. For example, a public agency could face a legal challenge if a contract with the government failed to provide adequate funding for it to carry out its statutory duties.

As stated, legal considerations reinforce the conclusion from transaction cost analysis that a legalistic approach to contracting in the public sector would generally not be effective or efficient. However, enforceable contracts may be appropriate for some circumstances in the public sector. These circumstances are considered in Section III.

The Principal/Agent Approach to Contract

While enforceable contracts are generally undesirable where government owns the supplier, there is clearly still scope for the government as funder to use other instruments to align incentives between parties. In any situation where an owner is funding the supply of outputs from entities it owns it should be concerned with ex ante incentive alignment.³⁴ That is, it will want to ensure beforehand that the funding arrangements are such that it can expect to receive the services it wants, rather than just relying on its ability to order

compliance with its requirements after the contract is in place. *The owner's objective should be to maximise the advantages of delegation of control, net of agency costs, through a combination of ex ante incentive alignment and ex post governance.* More specifically, for a given institutional setting, the efficient solution is to apply the form of contracting most appropriate to the attributes of the institution and the nature of the transactions in question. It is to the ex ante specification of performance that we now turn.

For a given institutional setting, the economic approach to the design of contracts focuses on the importance of ex ante incentive alignment between the principal and an agent employed by the principal to complete a particular task. Some agents are assumed to act opportunistically on occasions, and principals are unable to determine ex ante whether they will or not. Opportunism ranges from simply lacking motivation to pursue the interests of the principal, through various forms of actively promoting the agent's interests at the expense of the principal's, and at the limit potentially including dishonesty and fraud.

It should be repeated that the concept of contract here is much broader than contracts enforceable at law. It includes all types of relationships where agreement is reached between two parties for the provision of a good or service.

Principal/agent theory applied to the public sector generally views the government as a series of agency relationships,³⁵ namely:

- between electors and the legislature
- between the legislature and the executive
- within the executive, between the Prime Minister or President and the members of cabinet
- between Ministers and ministries or departments, state-owned commercial enterprises and semi-independent public agencies, and
- between the chief executive officer and his or her subordinate staff within individual agencies.

Agency theory analyses the "contracts" between these parties, both explicit and implied. The behavioural assumptions are those of public choice theory, where politicians are primarily interested in maximising their prospects of re-election, and bureaucrats are primarily interested in maximising the enjoyment of the benefits of public office (for example, prestige and influence).³⁶ The focus is on information asymmetry: agents have much more information on their actual performance, and their real objectives and motivation, which create potential moral hazard and adverse selection problems.³⁷ Principals face costs in trying to obtain information required to monitor the agent's performance, and try to economise on these through designing efficient monitoring and incentive structures.

Principles for design of principal/agent relationships

Agency theory suggests a number of general principles for designing efficient and effective principal/agent relationships. The theory can accommodate very different political philosophies and priorities; it is a tool for achieving varying ends, independent of the ends themselves. Efficient design principles include:

- clear definition of the roles and accountability of the parties;
- the avoidance of conflicts between different roles, as for example when a single agency acts both as a regulator and a supplier of outputs;
- the avoidance of multiple principals, where it is unclear whose interests the agent should be pursuing, and therefore where it can be very difficult to hold an agent accountable for results;
- clear ex ante specification of the goods or services to be delivered, including the performance standards expected, to provide the basis for ex post accountability;

- methods of specifically aligning the incentives of the agent ex ante with those of the principal, through prior agreement to, or understanding of, the consequences that will flow from superior or inferior performance;³⁸
- delegating authority over the use of inputs to agents, and holding them accountable for outputs, or outcomes where feasible,³⁹ and monitoring of performance.

Limitations of principal/agent framework in the public sector

There are limitations on the use of principal/agent solutions as means of reducing agency costs in the public sector. For example:

- the absence of profit as a measure of performance can mean that measuring performance is difficult and there is less ability to tie compensation closely to performance;
- for many public sector activities there is a complex relationship between outputs and outcomes. Neither the outputs nor the outcomes may be readily observable. Many of the factors influencing outcomes are beyond an agency's control and/or are not well understood. The difficulties in specifying and measuring performance are precisely why many of these activities are conducted in the public sector;
- there are weaker incentives on principals to monitor performance because of the absence of residual claims (i.e. profits);⁴⁰
- when individual politicians are the principal they may focus their monitoring of an agency on aspects of performance that impact most on their own interests (for example, re-election); and
- there are often problems of multiple principals in the public sector, and multiple and conflicting objectives for a single agency. This can result in an agency being potentially pulled in different directions by competing stakeholders, or having different principals for different aspects of its operations.⁴¹

Further, viewing the relationship between a Minister and a public sector agency as a simple principal/agent relationship is not always appropriate, and in some instances may be highly inappropriate. There are a number of reasons for this:

- as noted earlier, the legislation establishing a public agency may set out some of its functions and the manner in which should be carried out. In this sense the legislature has chosen to place limitations on the decision rights allocated to Ministers, and to make some public sector agencies accountable directly to the legislature for the conduct of some of their functions. Agencies have more than one principal, and this may be a deliberate attempt to build checks and balances into the system, restricting the ability of the government of the day to direct or "contract" for the performance it desires;
- where a public sector agency is involved in the exercise of judicial functions, performance contracts may in some instances cut across the doctrine, often enshrined at the Constitutional level, of the separation of powers between the executive, Legislative and Judicial branches of government;⁴²
- there may be important conventions covering the manner in which department heads carry out their functions – for example a duty to provide the government with free and frank advice – that override or constrain the ability of an individual Minister to contract for performance. One effect of such a convention might be to limit the politicisation of the public service, or the arbitrary intrusion of political considerations into particular decisions, that might otherwise occur; and
- aside from the ultimate principal and the ultimate agent, each person in the hierarchy acts as both a principal and an agent. This creates the possibility, for example, that the Prime Minister or President

may intervene in the relationship between a Minister and a department in the collective interests of the government.

A further problem in a simple principal/agent approach arises in agreements between the central government and subnational governments. There are a variety and complexity of intergovernmental relations in OECD countries, from unitary states through to various forms of federalism. In many countries, it is highly inappropriate to view the intergovernmental relationship as a principal/agent relationship. Subnational governments are often vested with certain independent powers and responsibilities, and in some countries these are set down in the constitution. Nevertheless, the typical existence of a vertical imbalance between revenue capacities and expenditure responsibilities means that significant transfers from the central government are a feature of inter-governmental fiscal relations in most countries.⁴³ The issue arises as to what conditions should be attached to these transfers.

The two main types of intergovernmental transfer in use in OECD countries are untied block grants, and various types of specific grants, with the former becoming more common.⁴⁴ Specific grants include matching grants, designed to influence behaviour by sub-national governments, and arrangements with lower levels of government for the delivery of services for which the central government has responsibility, or where responsibility is shared.⁴⁵

The economic rationale for untied block grants is the comparative advantage subnational governments have in information about local needs. There is by definition no setting of detailed ex ante performance expectations by central government (although there may be a need for agreed guidelines or minimum standards). Matching grants similarly rest on a framework in which there is no clear principal/agent relationship between central and sub-national governments.

Arrangements or understandings between central and subnational governments for the delivery of services raise somewhat different issues. In these circumstances it is desirable for clear expectations of performance to be set out. For activities clearly the formal responsibility of central government, the relationship is more like a principal/agent relationship. However, in the case where formal responsibility is shared, both sides may set performance expectations, and the relationship is far more in the nature of a partnership or arms length relationship than a principal/agent relationship.

Conclusions

The use of performance measures within a contract-type approach in the public sector should be approached with care. A simple principal/agent framework may be highly inappropriate in certain situations, and there can be severe difficulties in specifying and measuring desired performance. Care should be taken in the use of some of the theoretically efficient contracting principles described earlier in the design of funding relationships within the public sector.

III. THE APPROPRIATE SPECIFICATION OF PERFORMANCE CONTRACTING ARRANGEMENTS

This section uses the legal and economic framework developed in the previous section to address the question: what is the appropriate degree of specification of public sector performance contracting arrangements under different circumstances?

It is clearly not possible to devise standard contract templates. The set of variables that can impact critically on the appropriate form of contracting arrangement is simply too extensive. There is no escaping the need for careful case by case analysis in every instance. Such analysis must focus on:

- the nature of the goods or services being supplied;
- the type of institution and its relationship with the executive and other branches of government; and
- the broader environment in which the relationship takes place.

The Influence of the Broader Environment for Performance Contracting

The broad cultural, social and legal environments are important determinants of the need for, and usefulness of, more formal contract-like approaches. Trust and social conventions also play an important role in securing commitment and performance in long-term relationships, especially where output is hard to specify and measure. The importance of these factors varies across countries and cultures, and can be expected to result in considerable variation in the optimal form of performance contracting across public sectors, just as it results in variation across countries in the types of business and governance relationships found in the private sector (as noted in Section II).

One public sector illustration of the different influences in countries is the divergent approach to the institution of a career civil service. Countries such as France, Germany and Japan focus on instilling loyalty and motivation, and enhancing competence amongst civil servants in an effort to align their interests with those of the State. Hood (1991) has suggested there can be tensions between an approach to administrative reform based on instilling values of honesty and fairness, and one of pursuing values of economy and frugality. He sees the former approach as suggesting multiple rather than single objective organisations, and a control framework focusing on inputs or processes rather than outputs. This is very different to the prescriptions of the contractual approach to administrative design. Ouichi suggests that, in situations where employees identify highly with the goals of their organisation, but where individual performance measurement is not possible, “performance evaluation takes place instead through the kind of subtle reading of signals that is possible among intimate co-workers but which...cannot withstand the scrutiny of contractual relations.”⁴⁶

Leadership can be used as an alternative to a contractual approach to reducing agency costs. Casson (1991) suggests that principals can reduce agency costs through either intensive monitoring or the use of “moral rhetoric” aimed at establishing a group norm of behaviour. Wallis and Dollery develop this idea with the suggestion that agency problems can be reduced if leaders forgo a contractual approach and exercise leadership by developing a distinctive culture which transforms agents into followers who can be trusted to carry out tasks delegated to them.⁴⁷ From a somewhat different perspective, Mintzberg has advocated greater reliance on a “normative-control model”, especially in areas like education and health.⁴⁸

The political culture and the history of public sector institutional development will impact on efforts to introduce a greater performance orientation, that is, starting points and initial conditions matter. North (1990) stresses that those with the power in any society to implement changes are usually those who

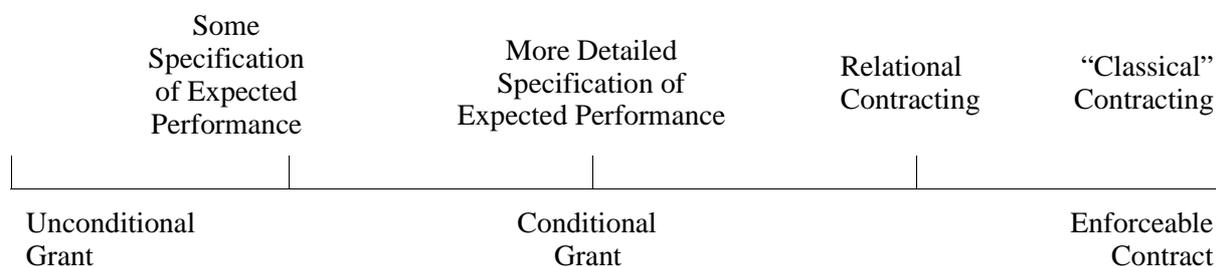
benefit from the status quo, and this greatly limits the set of feasible changes. Further, when formal “rules of the game” change significantly, actual behaviour may change much less so. The informal rules, such as social values and customs, change much more slowly. This suggests that caution should be taken in attempts to introduce new approaches to public sector management, and in particular attempts to transplant reforms from one country to another.⁴⁹ Premfors (1998), in a detailed study of Swedish public sector management reforms during the last twenty years, concludes that they can be explained in terms of some basic features of Sweden’s institutional and policy heritage, rather than any general “more market” approach permeating across OECD countries.

Guidelines for Performance Contracting

With these important caveats in mind, it is nevertheless possible to provide some broad guidelines on the appropriate degree of specification of performance contracting arrangements.

In order to do so it may be useful to think in terms of a highly stylised continuum of possible performance contracting arrangements in which the government is funding the supply of goods or services – see Figure 1 below. Completely unconditional grants are at one end of the spectrum, and fully enforceable “classical” contracts at the other.⁵⁰ As one moves along the spectrum, additional conditions are imposed on the grant recipient. These conditions create obligations on the recipient, and reciprocal obligations on the funder to provide the funding should the recipient meet the conditions. At some point it may be difficult to distinguish a highly detailed and prescriptive conditional grant from an enforceable purchase contract.⁵¹

Figure 1: A Stylised Performance Contracting Continuum



The “continuum” is not meant to imply any kind of simple linear relationship between degree of specification and enforceability. Some conditional grants may be quite detailed, while some contracts may be relatively simple. The intuition, however, is that, in general, the possibility of enforceability creates incentives to be very clear about just what the parties are committing themselves to. In addition, the terms must be sufficiently clear and certain for the agreement to be enforceable at law.

In general, it is inappropriate for governments to make completely unconditional grants, that is, a delegation of resources or authority with no conditions attached to their use.⁵² It would fail to meet the usual requirement for the executive to account to the legislature for the use of tax payer’s money.

At the other end of the spectrum, where government is funding the supply of goods or services from a supplier it does not own, for example, a private firm supplying IT services, an enforceable contract would seem desirable. In the absence of any ownership relationship, the government is entirely dependent on the funding relationship to ensure value for money and demonstrate accountability to the legislature for the use of public money. A full arms length relationship would seem to be the most appropriate default funding mechanism in this situation.

However, given the wide variety of activities and types of supplier, an enforceable contract may not be desirable in every situation. For example:

- in funding the supply of social services by Non Government Organisations (NGOs), there may be difficulties in specifying the services with sufficient certainty, and possible concerns over the impact of enforceable contracts on the motivation of those in the voluntary sector;⁵³ and
- an enforceable contract is not necessarily desirable where one level of government is funding the supply of goods or services by a lower level of government (see below).

For the majority of activity within the public sector, the issue is not whether to use enforceable contracts between public sector entities. Rather, the relevant issue in designing funding relationships is: *what are the marginal costs and benefits (both financial and non-financial) of more detailed and prescriptive specification of performance, as one moves along the continuum from unconditional grants to highly detailed conditional grants.*

Costs and Benefits of More Detailed Performance Specification

Drawing on the principles for efficient contract design suggested by agency theory, there are a number of potential benefits from a greater degree of performance specification. These include:

- avoiding ambiguity or uncertainty over roles, and clarifying agency accountability for the conduct of those roles. This is of benefit to both the principal and the agent. There is a risk that a high degree of delegation, in combination with poorly specified objectives or goals, could result in what James Q Wilson has termed “mission madness”, that is, a manager charging off to implement his or her private version of some ambiguous public goal.⁵⁴ From the agent’s perspective, possible effects on their reputation in the labour market can be a powerful motivation for agency heads, creating an incentive for them to seek clarity;
- highlighting the presence of conflicting roles, and suggesting the need to reallocate roles among existing or new agencies;
- avoiding ambiguity or uncertainty over the precise nature of the services to be supplied. More precise performance measurement can create stronger incentives to perform;
- highlighting a need to assess the continuing relevance or priority of some services, for example whether they should be contracted out to the private sector, or whether they should continue to be funded at all. Similarly, specification can help to clearly signal a new or changing strategic priority;
- making it more likely performance will be effectively monitored, and pressure brought to bear where appropriate for greater effectiveness and efficiency;⁵⁵
- creating the confidence that resources and authority can be delegated without compromising accountability or risking ministerial responsibility;
- avoiding uncertainty over the circumstances that would justify intervention by the contract principal in the management and operation of the agency. Clear specification can reduce the scope for opportunistic or mistaken intervention by a Minister, thereby strengthening Ministers’ accountability to the legislature and the credibility of any commitment to operational independence. More generally, performance contracting can enable agencies to receive formal validation of their strategic initiatives by the centre. It can also result in better feedback to the centre about agency performance.

There are costs and risks in a greater degree of performance specification. These include:

- costs involved for both parties in negotiating a more formal agreement, and in establishing systems to capture and report the information needed to assess performance. These costs are both direct and indirect. Direct costs include the cost of specifying outputs or outcomes, costing outputs and devising performance measures, and assessing whether the outputs or outcomes have been delivered to the required quality and cost (costs may be minimised through some standardisation of performance agreements⁵⁶). Indirect costs include the opportunity costs of the time of Ministers and the civil service;
- loss of flexibility and adaptability in the face of unforeseen developments, due to the costs of renegotiating formal arrangements during the contract period. One important consequence may be an unwillingness of a Minister to abide by the degree of delegated authority granted to an agency under a performance contract in the face of political challenge or stress. It is important that the degree of delegation and level of performance specification is politically robust;
- the risk of inappropriately restricting the freedom to manage. From an efficiency perspective, one of the main reasons for delegating decision rights is to take advantage of information advantages and specialist expertise not available to the centre. Highly detailed conditional grants may inappropriately restrict the ability of the supplier to manage his or her business;
- the possible loss of or damage to trust, and a general lowering of the quality of the relationship. Trust and a spirit of co-operation can have the effect of reducing transaction costs, and making co-ordination between the parties more effective.⁵⁷ Trust is particularly important in long term relationships and where output is hard to measure;
- the use of performance targets may induce counter-productive behaviour on the part of agencies, where outputs or outcomes are hard to specify ex ante and to measure ex post and where there are significant information asymmetries. For example, specifying targets for less critical but more easily measurable performance dimensions can result in dysfunctional behaviour. Agency managers can create the appearance of an improvement in performance by manipulating some indicators. Holding managers accountable for outcomes that are not sufficiently within their control is unlikely to have the desired incentive effects. Therefore, particular care is required in assessing the incentives created for agency managers by choosing a particular set of performance measures.⁵⁸ This is particularly the case where high powered financial incentives are introduced, such as the ability to retain surpluses, or performance bonuses for management tied to achievement of pre-specified objectives. The stronger the incentives on the agency to meet performance targets, the more the contract principle will need to monitor agency performance;
- too many performance indicators may be developed, and information not used. A contract should have a carefully designed and meaningful set of performance indicators that generates timely information useful both for internal managers and external users. In some instances (for example funding the outputs of a hospital) this may mean contracting broadly over the delivery of a capability to supply a range of outputs rather than specifying individual outputs in detail.⁵⁹
- the more formal the accountability mechanisms, the more managers will seek to define the performance expected of them in a narrow manner. This could lead to the compartmentalising of government, and a loss of focus on cross-cutting issues. Management may focus disproportionately on the efficient short term funding level at the expense of longer term organisational capability and effectiveness issues;
- specification of expected performance could in some instances cut across the statutory independence of some agencies, or cut across the separation of powers between the different branches or levels of government;
- a highly detailed conditional grant could be deemed by the courts in some common law countries to be, in effect, an enforceable contract.

Key General Principles Influencing the Appropriate Degree of Specification

There are some general principles that can be used in determining the optimal degree of performance specification and delegation in any particular case. These include: ⁶⁰

- optimal incentive-intensity in performance contracting depends on the incremental gains from additional effort by the agent, the precision with which performance can be measured, the agent's appetite for risk, and the agent's responsiveness to incentives;
- optimal risk sharing between the principal and the agent involves balancing the costs of risk sharing against the incentive gains that result;
- optimal degree of ex ante allocation of risks depends on the cost of allocating a risk, in comparison to the cost of allocating a loss should the risk materialise multiplied by the probability of the risk materialising; and
- optimal monitoring intensity depends on the strength of the link between performance and reward.

One crucial element is the ability to specify and measure desired performance. As noted earlier, many outputs of government are very hard to measure, which is precisely why many of them remain in the public sector. James Q Wilson has developed a matrix for assessing the appropriate approach to managing different types of public sector activities.⁶¹ Wilson suggests that from a managerial perspective public agencies differ from each other in two main respects, the ability of management to observe operational activities (are the outputs observable?), and the ability to observe the results of their activities (are the outcomes observable?). This gives a two by two matrix, shown in Figure 2 below.

Figure 2: Wilson's Managerial Matrix of Public Sector Activities

		Outcomes Observable	
		Yes	No
Outputs Observable	Yes	Production (e.g. payment of welfare benefits)	Procedural (e.g. policy advice)
	No	Craft (e.g. police)	Coping (e.g. education)

Where outputs and outcomes are both observable (for example in the processing of welfare applications or income tax returns, which Wilson labels "production organisations"), Wilson sees scope for designing a prescriptive performance management regime which will generate efficiency gains (although he warns of the danger of inducing dysfunctional behaviour). Where neither outputs nor outcomes are readily observable (for example, in education, which Wilson labels "coping organisations") management is forced to focus efforts on recruitment and training, and the development of a culture which values performance rather than the use of formal performance indicators.⁶² Where either outputs or outcomes are observable, but not both, Wilson labels the organisations as procedural or craft organisations respectively. In procedural organisations the management focus is on instilling a sense of professionalism and quality

processes. In craft organisations performance measurement in terms of outcomes is feasible, but management must also rely on the sense of duty and ethos of its operating staff.⁶³

Three further general factors impact on the desired level of performance specification for a particular case:

- the ability of government to influence performance through the power of the purse;
- the ability of government to influence performance through its ownership of the supplier; and
- the degree of contestability of the outputs being supplied.

In practice, a key lever government has in dealings with public agencies is the power of the purse. Non-commercial entities are generally highly dependent on the government for funding. An issue that arises is how the power of the purse should be exercised. For example, to what extent should financial penalties be a possible consequence for poor performance under a performance agreement?

There are a number of constraints on the ability of Ministers and their advisers in deciding, within a funding period, that performance could warrant a financial penalty. The information demands may be severe (particularly given the complexity of the functions carried out by many public agencies) and it may be difficult to determine the quality of output. Better information about quality is available over a longer time period (just as it is, for example, in employment relationships, or for that matter, with respect to the quality of service provided directly to a Minister by a government ministry or department).

In general, it may be desirable to view the annual (or the periodic) funding cycle as providing the natural opportunity for the government to decide on the funding level for outputs, and whether to vary the funding level (or the outputs). Varying funding levels from year to year is less informationally demanding of the centre and less damaging to the relationship, than within-year variations in funding.

However, there may be occasions when it is appropriate to respond to clearly identifiable non-performance of the terms of a conditional grant, by delaying funding during the financial year. For example, if an agency fails to report certain information, or uses resources for purposes outside the funding agreement, it may be appropriate to withhold further funding within the year until the failure has been remedied (or even to recover monies improperly spent).

Furthermore, the government will often own the supplier. Even where its ownership rights are constrained by an agency's statutory independence, a Minister will often have the ability to exert pressure on a governing board through a variety of means. For example, the Minister may have the power to issue a directive to a Board, or to withhold approval of a strategic business plan. Ultimately the Minister has the ability to exercise effective influence through replacing the chairperson and other board members during or on expiry of their term.

A third factor influencing the degree of performance specification is the level of contestability of the outputs being supplied, both at the contract letting and contract renewal stages. Where there are a number of feasible suppliers, more detailed specification can assist in finding the appropriate supplier, with potential gains in productive efficiency. Where there is likely to be one feasible supplier only, for example, for the supply of a number of core government services such as foreign relations or the provision of justice, the potential efficiency gains from contestability are not available to offset the costs of establishing a more complex performance contracting system.

Use of Enforceable Contracts

The question remains as to whether there are circumstances where an enforceable contract between two public sector entities may be desirable. In comparison to a well-specified conditional grant, what additional benefits might be achieved by adopting an enforceable contract, assuming a contract is legally feasible?

An enforceable contract has the potential to result in:

- greater “buy in” from the agent, and therefore stronger accountability;
- less scope for ambiguity or uncertainty over exactly what is required to be delivered by each party;
- a greater likelihood that performance under the contract will be monitored; and
- a greater likelihood that conflicting roles will be highlighted, and fully contractible functions identified and contracted out to competing suppliers.

Implementing an enforceable contract, on the other hand, could impose significant additional transaction costs and risks, and may be counterproductive to the relationship. This is due to:

- substantial direct costs of lawyers and other negotiators on both sides of the contract. Legal advice is required initially to ensure all of the prerequisites are met; and, from time to time, as potential or actual disputes arise;
- risk of damage to trust and motivation, and to the quality of the relationship, as a result of adopting a legalistic, more adversarial approach to the relationship; and
- risk that formal contracts may undesirably restrict the flexibility of agencies to manage (although, as noted, this risk is also present with a highly detailed conditional grant).

An enforceable contract may be desirable where the government is funding the supply of non-commercial outputs from a state-owned commercial enterprise. This arrangement may be appropriate where the enterprise operates on a purely commercial basis, and the governance arrangements are such that the entity is directed to behave in a purely commercial manner.⁶⁴ The added transparency and formality of an enforceable contract might strengthen the credibility of a commitment by government not to direct public enterprises to provide non-commercial services without funding their supply.⁶⁵ This arrangement would be consistent with the manner in which the enterprise concerned conducts its business generally.

Similar reasoning suggests that state enterprises should use the arms length commercial instrument of contract when supplying each other with commercial services. Further, where a government department is buying commercial services from a state-owned enterprise (e.g. electricity) there may be advantages in using the same type of contractual basis applying to the enterprise’s non-government customers.

Alternatively, an enforceable contract is undesirable for the supply of services between different government ministries or departments. The direct hierarchical relationship government generally has with ministries and departments provides relatively easy co-ordination and control possibilities compared to state-owned enterprises established under Boards of Directors. This suggests enforceable contracts would be less desirable than more informal arrangements. In any event, it may not be possible to use enforceable contracts in this situation if the ministries are not separate legal entities.

Whether a performance arrangement between a central government and a subnational government for the delivery of a service entirely the responsibility of central government should be in the form of an enforceable contract is less obvious. The nature of the legal environment and political culture will be a crucial determinant of the appropriate approach to performance specification. In general, there is less of a problem of acceptance and agreement on the part of a sub-national government in this situation than is the

case with a subordinate agency of central government. In a more arms length relationship an enforceable contract is likely to result in some additional clarity of roles and expectations, and greater certainty of performance. However, this advantage should be balanced, against the additional transactions costs, and a potential loss of trust and co-operation (although a low level of trust at the outset may itself indicate the desirability of enforceable contract). “The challenge is to develop co-ordination and consultation mechanisms for a more comprehensive and coherent approach to target-based governance and which fit the cultural context and the “style of relationship” in each country and sector.”⁶⁶

IV. CONCLUDING REMARKS

The widespread interest in performance contracting has resulted from its potential to contribute to a more effective and efficient public sector. Performance contracting can establish greater clarity over what public agencies will achieve in a more decentralised management environment, while retaining the necessary accountability.

A transaction cost perspective suggests that performance contracting as a governance mechanism both influences and in turn is influenced by the broader governance arrangements within which the contract is embedded. Performance contracting must be viewed within this broader context. Indeed, the role of and limits to contracting are themselves critically important in determining whether transactions in the public sector can be more effectively undertaken across quasi-markets or controlled within a more direct hierarchical relationship.

In general, transaction cost analysis suggests that contracting between public sector entities in the form of enforceable contracts would be inefficient. Allowing recourse to an independent third party to resolve disputes is likely to involve high transaction costs, and to reduce the effectiveness of the co-ordination and control possibilities of joint ownership.

The analysis suggests that many funding relationships in the public sector should be considered as forms of informal long term relational contracting, rather than more strictly legalistic and enforceable contractual relationships.

These conclusions are reinforced from a practical legal perspective. First, many public sector agencies are not separate legal entities. They are in a hierarchical relationship with a Minister or ministry, and are not able at law to enter legally enforceable contracts with them. Secondly, even between separate legal entities, there are problems with the concepts of contractual intention, offer and acceptance in applying the private law instrument of contract to the public sector.

A key element in the design of performance contracting arrangements is the choice of the appropriate degree and form of ex ante performance specification, along a stylised spectrum from unconditional grant to enforceable contract. There is no simple template for deciding the optimal degree and form of specification. In particular, the optimal form will be very country-specific, reflecting the important role of social, legal and political culture, trust and the particular history of institutional development.

The nature of the transactions themselves impacts on the design of the contracting arrangements. In particular, the presence of specific assets, the complexity of the activities, the ability to specify and measure the outputs and/or outcomes, and the frequency with which the contract will need to be adapted all impact on the efficient design of the funding relationship.

In general, an enforceable contract is desirable where government is funding the supply of outputs by a non-government owned entity. In the absence of any ownership relationship, the government is entirely dependent on the funding relationship to provide the necessary clarity, certainty and accountability. However, there are exceptions to this conclusion (for example, where central government is funding the supply of outputs by a lower level government, this should not necessarily be through enforceable contract).

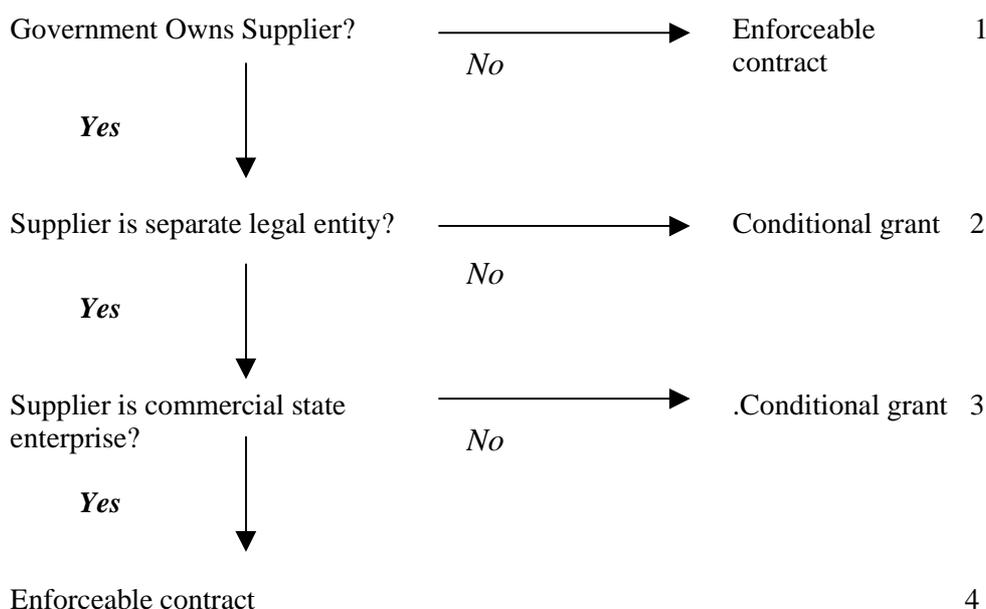
Legally enforceable contracts are not efficient, effective or robust for funding relationships between public sector entities except in relatively limited circumstances. Exceptions might include:

- a funding relationship with a fully commercial state enterprise for the delivery of non-commercial outputs to the government, where an arms length contractual relationship may be appropriate;
- arrangements for the supply of commercial services between different state-owned enterprises, and
- between enterprises and government ministries or departments, and in some circumstances, arrangements between different levels of government for the supply of goods or service.

At the other end of the spectrum, a completely unconditional grant would not seem to provide the necessary assurance of accountability for the use of public funds.

Figure 3 provides a stylised decision tree for choosing between a conditional grant and enforceable contract. It is meant to be suggestive rather than definitive, providing the starting point for a more detailed analysis in any particular case.

Figure 3: Conditional Grant or Enforceable Contract?



The bulk of public sector activity occurs at nodes two and three in Figure 3. At these nodes the key issue that needs to be considered in designing funding relationships is: *what are the marginal costs and benefits (financial and non-financial) of more detailed and prescriptive specification of performance, as one moves along the continuum from unconditional grants to highly detailed conditional grants.*

Two factors that impact on the degree of performance specification in a particular case are the ability the government has to influence performance through the power of the purse, and through any ownership relationship it has with the agency. However, any owner funding the supply of outputs from an entity has a vital interest in ex ante incentive alignment, rather than sole reliance on the instruments available to owners to enforce accountability. The government’s objective is to maximise the advantages of delegation of

control, net of agency costs, through a combination of ex ante incentive alignment and ex post governance. Therefore, design criteria should address the following question: *what is the best mix of ex ante performance specification and use of ex post instruments for a particular institutional setting, and for a specific type of activity or output?*

Principal/agent theory provides a number of principles for efficient ex ante design of the funding relationship. These include clarity of roles and responsibilities, clear specification of the outputs and/or outcomes to be delivered, delegation of authority over inputs, and effective monitoring of performance. Significant gains are achievable through the careful application of these principles. In their absence there is a serious risk of poor performance.

However, there are important constraints on the use of a simple principal/agent framework in the public sector. Designing the funding relationship in a pure principal/agent framework can cut across the statutory independence of some state agencies, and can infringe on important principles, often enshrined in constitutions, of the separation of powers, of the duties of public servants, and of the roles and responsibilities of sub-national governments.

There are also a number of costs and risks in designing appropriate performance measures. These are in addition to negotiating costs and the need to establish systems to capture and report the physical and financial information required for monitoring. Additional costs and risks include inappropriately restricting the freedom to manage, damage to trust and the quality of the relationship, and the inducement of dysfunctional behaviour. Strategic decisions over the type of performance contracting regime must take into account possible interactions with other, non-contractual approaches to reducing agency costs, such as socialisation and professional leadership.

Figure 4 summarises the general factors driving the appropriate degree of specification of expected performance for conditional grants.

Figure 4: Factors Driving the Degree of Performance Specification

	Less Prescriptive	More Prescriptive
Difficulty of performance measurement	High	Low
Degree of statutory or constitutional independence	High	Low
Need for adaptability	High	Low
Reliance on culture/professionalism	High	Medium
Contestability	Low	Medium

The choice of the precise degree and form of performance specification requires particular care. There are risks both from having too detailed or too simple a specification. There is no escaping the need for careful case by case analysis in every instance. This analysis should focus on:

- the nature of the goods or services being supplied;
- the type of institution and its relationship with the executive and other branches of government; and
- the broader cultural and legal environment in which the relationship takes place.

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Used with care, performance contracting should be seen as a very important lever for improving the performance of the public sector. It is by no means, however, a silver bullet.

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Notes

- ¹ *Governance in Transition: Public Management Reforms in OECD Countries*, OECD 1995, p. 7.
- ² A pilot project for the creation of Performance-Based Organisations, limited to activities heavily focused on service delivery (e.g., provision of retirement benefits), was included in the Government Performance and Results Act (GPRA). To date, however, no agencies have been established.
- ³ Customer service standards as a form of performance contracting is not dealt with in detail in this paper. Previous research by the OECD Public Management Service on the use of customer service standards has been published in *Responsive Government*, OECD, 1996.
- ⁴ See also, Jonathan Boston, “The New Contractualism in New Zealand: Chief Executive Performance Agreements”, in Davis, Glyn, Barbara Sullivan and Anna Yeatman (1997), editors, *The New Contractualism*, Macmillan Education Australia. Boston highlights the importance of a relatively stable political and policy environment with infrequent changes of government and ministers to provide the contract parties with the opportunity to work together over time to achieve goals and minimise the transaction costs of building new contracts and relationships.
- ⁵ *Governance in Transition: Public Management Reforms in OECD Countries*, OECD, 1995. The quotation is from the “Conclusions of the OECD Public Management Committee”, p. 7.
- ⁶ Apart from performance contracting, there is a broader range of approaches aimed at improving performance management, including benchmarking, contestability, contracting out, and mechanisms for increasing consumer voice. See OECD, (1997a).
- ⁷ This utilitarian view of contract can be contrasted with a view that sees upholding the freedom of contract as a primary task of a legal system, as part of a broader function of protecting the freedom of the individual and safeguarding his/her power. See Zweigert and Kotz, (1998), pp. 325-327.
- ⁸ See Williamson, (1985).
- ⁹ Macneil, I.R., *The many futures of contracts*, Southern California Law Review, 47, May 1974, pp. 691-816, cited in Williamson, (1985).
- ¹⁰ Such efforts, or safeguards, might include severance or penalty payments for early termination; the creation of specialised contract governance structures such as independent arbitration; or the creation of reciprocal business transactions so that each party is reliant to some degree on a continuing good relationship with the other (in the language of transaction cost economics, the creation of mutual hostages). More generally, Williamson describes contracts as involving choices over the three elements of technology (that is the extent of use of specific assets), safeguards/governance structures, and price. These three elements are fully interactive and determined simultaneously. “It is important to study contracting in its entirety. Both the ex ante terms and the manner in which the contracts are thereafter executed vary with the investment characteristics and the associated governance structures within which transactions are embedded.” See Williamson, *ibid.*, pp. 34-35.
- ¹¹ Ouichi (1980, p. 130) has defined transactions costs as “any activity which is engaged in to satisfy each party to an exchange that the value given and received is in accord with his or her expectations.” In considering issues of the design of contracting and institutional choice in the public sector, transaction costs should include all the costs incurred by the political system in negotiating, monitoring and enforcing the arrangements concerned. See Dixit, (1996), for a discussion of transaction-costs politics, and see also footnote 22.
- ¹² Although from the perspective of each individual contracting party, it is only the costs they bear, and the gains they can appropriate that determine their actions.
- ¹³ The transaction costs of long term contracting are seen as (a) the cost of anticipating all possible eventualities; (b) the cost of agreeing how to deal with them; (c) the cost of specifying the contract in a way that can be enforced; and (d) the cost of enforcement (where this occurs). Because of these costs it is efficient to leave many possible eventualities out of the contract, and to re-negotiate once it is known what specific circumstances have

in fact materialized. Through this economizing on transactions costs, many contracts will be incomplete in important respects. See Hart and Moore, (1998). Alternative or additional explanations for incomplete contracts are the potential for performance specification to distort behaviour through an undesirable focus on the measurable but not necessarily the most important dimensions of performance [see Holmstrom and Milgrom, 1992)]; and through the possibility that, where it is not possible to specify all aspects of performance, it may be optimal to leave out some elements even where they are capable of specification (see Bernheim and Whinston, 1998).

¹⁴ Reputation effects are seen in the transaction cost literature as creating pressures for self-enforcement of contracts by the two parties to the contract, as opposed to resorting to third party enforcement.

¹⁵ Quoted in Boston (1994), p. 17.

¹⁶ In an arbitration situation it is easier for the arbitrator to obtain all the relevant information from both parties, than in an adversarial court setting where the parties use information more strategically.

¹⁷ The literature on incomplete contracts makes an important distinction between performance that is observable only by the parties to the contract, and performance that can also be verified by a third party. The parties to the contract may both know whether either has shirked, but unless that can be verified by a third party it will be difficult to contract over this dimension of performance.

¹⁸ Grossman and Hart see the contracting versus integration decision as involving a comparison of the costs of contracting for all the specific rights desired over the assets concerned, compared with purchasing the residual decision rights (that is, ownership). See Grossman and Hart, (1986).

¹⁹ Where specific assets are significant, vertical integration may be even more of an advantage in the public sector than in the private sector. This is because, in the private sector the specific assets may be in the context of the supply of an intermediate product to a producer who is selling in a competitive market. Competition in the final goods market can impose discipline on the intermediate goods supply relationship, as both parties “sink or swim together”. (This point is due to Peter Gorringer).

²⁰ Between the “pure forms” of market exchange and hierarchy the transaction cost literature also identifies hybrid forms that exhibit some of the features of both, for example franchising. In a public sector setting, networks between individual organisations are an important feature – for example, horizontal networks between agencies involved in policy analysis and advice on specific areas of government policy.

²¹ Williamson, (1993), p. 15.

²² See Ouchi, (1980), p. 132.

²³ See Ouchi, (1980), who suggests two factors determine the desirable basis of organisational control: the degree of goal congruence, and the degree of performance ambiguity. Where goal congruence and performance ambiguity are moderately high, bureaucracy is the preferred institution (rather than market relations). When goal congruence is high and performance ambiguity high, a “clan” is the efficient form of organisation. Ouchi defines a clan organisation as one where socialisation is the principal mechanism of control.

²⁴ These points are taken from Williamson, (1986), p. 87.

²⁵ See Williamson, (1985), p. 41.

²⁶ Under Australian law, the national government and its component parts -- the legislature, executive and judiciary, cannot enter into legal arrangements other than those arrangements permitted by the national constitution or constitutional convention and cannot litigate against each other. It is therefore not possible for agencies of the executive government, such as departments of state and certain unincorporated statutory authorities (e.g. Centrelink) to litigate against each other; although they may litigate against other legal entities either on behalf of the national government or in the case of statutory authorities, in their own right. See Worthington, (1999),.

²⁷ This may or may not significantly distance the Minister from their operations. In many countries the delegation of service delivery functions to devolved institutions is part of an attempt to place ministerial control at greater arms length. A distinction is often made between strategic objectives, for which the minister remains responsible, and operational matters which are the responsibility of the institution itself. This association of greater delegated authority and a reduction in ministerial responsibility may represent a political equilibrium,

making the commitment to non-interference in day to day operational matters more credible. On the other hand, there have been concerns about a reduction in ministerial accountability through the transference of activities from departments to agencies more removed from ministers. Ministerial involvement in the UK prison service in recent years illustrates the tension between the desire to delegate authority and the ability of the political system to commit to the delegation over time. This is an example of the need to take a broader view of transaction costs in institutional design in the public sector, to ensure institutional arrangements are politically robust (see footnote 7).

²⁸ Enforceable contracts are sometimes implicitly advocated even where they are not legally possible. For example, Hood (1991, p. 9) has noted that implicit in some criticisms of the new public management is the argument that it lacks substance, and that what is needed are some real teeth - “for example, in making contracts between Ministers and chief executives legally binding.”

²⁹ This section is based on collaborative work between the author and Mai Chen, Partner, Chen and Palmer, public law specialists.

³⁰ In some legal systems consideration is also a requirement.

³¹ See “An Introduction to Comparative Law”, by K. Zweigert and H. Kotz, Third Edition, Clarendon Press, Oxford, 1998, Section C, Contract, pp. 323-526

³² In Denmark, for example, performance contracts are not legally binding, as they could in principle be revoked by the Minister. See *Public Sector Performance Contracting In Denmark*, by Pedersen, Sorensen and Vestergaard, OECD, May 1998.

³³ In some countries their statutory duty may be subject to judicial enforcement.

³⁴ There may also be instances where it is unclear whether the government is in fact the owner of an entity from which it is purchasing services, which makes clarity at the outset over what is being purchased even more important.

³⁵ See for instance Moe, (1984, pp. 765-766): “Democratic politics is easily viewed in principal/agent terms...[as] a chain of principal-agent relationships, from citizen to politician to bureaucratic superior to bureaucratic subordinate and on down the hierarchy of government to the lowest level of bureaucrats who actually deliver services directly to citizens...”

³⁶ See Buchanan and Tullock, (1962).

³⁷ Moral hazard refers to the tendency of an agent, after the contract is entered into, to shirk or otherwise not fully seek to promote the principal’s interests. Adverse selection refers to the inability of a principal to determine, before the contract is entered into, which among several possible agents is most likely to promote the principal’s interests; and, given this imperfect information, the tendency for candidates with less than average motivation or qualifications to apply.

³⁸ Consequences may, for example, be in the form of the performance assessment of the agency head; the withholding of payment or budget transfers, the loss of some decisions rights or the imposition of financial penalties, if certain specified conditions are not met; or the use of performance information as an input in the budget process to assess the agency’s budget for the following year.

³⁹ Accountability will usually be in terms of the specification of certain inputs and the delivery of specified outputs (expressed in both physical and financial terms), and, where appropriate, the achievement of certain outcomes - together with various ratios of inputs, outputs and outcomes aimed at assessing efficiency and effectiveness. For some outputs where quality is hard to assess (for example policy advice) performance standards may be based on specification of the processes to be used in producing the outputs, as a proxy for output quality. Use of consumer satisfaction indicators based on client surveys can also be useful as an indicator of output quality, taking advantage of the information widely dispersed amongst actual recipients of the services. This can be done in a centralised manner (for example the French *Charte des Services publics*, the *US National Performance Review*, and the UK *Citizens’ Charter*) or in a decentralised manner (for example on the initiative of individual service delivery agencies).

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- ⁴⁰ See Alchian and Demsetz, (1972) for a discussion of the role of residual claims in creating incentives for performance monitoring in the private sector.
- ⁴¹ As Moe, (1984, p. 769) has noted, this can mean that politicians in general have a more difficult time controlling the bureaucracy. It can also mean that, rather than acting solely in the interests of their nominal principal, bureaucrats have an interest in ensuring broad-based political support for their agency to head off potential threats to its survival.
- ⁴² For example, in New Zealand the purchase agreement between the Minister of Justice and the Department for Courts treats judicial salaries and related expenses as demand driven expenses which are not supported by understandings over performance. See Easterbrook-Smith, S. (1999), *Public Sector Performance Contracting in New Zealand: Case Studies of the Ministry of Justice and Department for Courts*, OECD, p. 16. More generally, enforceable contracts between different branches of government would seem to breach the principle of the separation of powers.
- ⁴³ Vertical imbalance is typical because efficiency in expenditure is generally seen as requiring a high degree of decentralisation, whereas efficiency in taxation is generally seen as requiring a relatively high degree of centralisation.
- ⁴⁴ See OECD, (1997b), p. 53.
- ⁴⁵ For example, the Canada-Alberta Agreement on Labour Market Development. See Advanced Education and Career Development, Alberta (1999), *Public Sector Performance Contracting in Canada: A Case Study of the Canada-Alberta Agreement on Labour Market Development*, OECD.
- ⁴⁶ See Ouichi, (1980), p. 137.
- ⁴⁷ See Wallis and Dollery, (1997).
- ⁴⁸ See Mintzberg, (1995), p. 81. Mintzberg identifies five key elements of a normative model: selection by values and attitudes, rather than just credentials; socialization in public service ethics; guidance by principles and visions, rather than plans and targets; responsibility and inspiration rather than empowerment; and performance judged by experienced people.
- ⁴⁹ See World Bank, (1997, Chapter 5) for a discussion of the challenge for developing countries of developing the state's capacity to implement a contractual approach to public sector management.
- ⁵⁰ There are a variety of terms used to describe different funding relationships. In this paper, the word "funding" will be used as a catch-all, covering all types of relationship. "Grant" covers both an unconditional grant (or, the same thing, a gift), and a conditional grant, which is a funding relationship involving the specification of conditions the recipient is expected to meet, but which does not have contractual force. "Subsidy" is a type of funding where the funder is making only a partial contribution towards the costs of an activity. The funder is not necessarily determining who will supply the goods or services, or even exactly what the goods or services to be supplied are, as these are being determined by the purchase choices of others. For example a subsidy to private schools is driven by the choice of parents over where to send their children.
- ⁵¹ This insight is due to Mai Chen. The comment might be made that a grant is qualitatively different from a contract, from a legal perspective, because there is no legal obligation to fulfil the conditions of the grant in order to receive or retain the funds. In practice however, where the government owns the supplier, there is an effective obligation to meet the conditions, especially but not only where these conditions are set down as part of the Statutory duties of the agency.
- ⁵² One possible exception is a transfer to a lower level of government, where accountability for the use of the monies is effected through reporting by the recipient government to the governance institutions at that level. Government transfer payments – such as social welfare benefits - are generally unconditional, in the sense of not limiting what the recipients can spend the money on. However, such benefits are transfer payments, and are not used to fund the supply of goods or services, and so fall outside the scope of this discussion.
- ⁵³ There may also be situations where the government has quasi-ownership rights and/or obligations because of the degree of dependence of an NGO on government funding, and/or the degree of dependence of government on a monopoly NGO supplier of a politically sensitive service. These issues are worthy of in-depth exploration in

their own right, but are beyond the scope of this paper. A related issue is that, where the government funding is more in the nature of a partial subsidy, and the rights of a purchaser are being exercised by another entity, it may be difficult to specify just what outputs the government is funding. Even in these situations, however, it may be possible to contract around a more limited set of conditions. For example, a government subsidy to private schools might be conditional on the schools meeting minimum requirements with respect to the curriculum they teach.

⁵⁴ See Wilson, (1989), p. 370.

⁵⁵ For example, performance contracting in the French Directorate General for Taxes is used as the basis for internal benchmarking between the different geographic regions, and the dissemination of best practice. See *Public Sector Performance Contracting in France*, by Grapinet, OECD1999.

⁵⁶ As suggested, for example by Pedersen, Sorensen and Vestergaard in *Public Sector Performance Contracting in Denmark*, OECD,1999.

⁵⁷ This aspect is stressed by Worthington as the reason a legalistic, contractual relationship was rejected as the model for the relationship between the Department of Social Security and Centrelink in Australia. See *Public Service Performance Contracting in the Australian Public Service: A Case Study of Strategic Partnering*, by R. Worthington, OECD, 1999.

⁵⁸ There is also an important time dimension to this. The appropriate performance specification is likely to change over time as circumstances change. For example, focusing on a simple performance measure can be a powerful way to bring about radical organisational change, even where that measure is acknowledged to be too narrow a measure of performance in steady state – see Petrie, (1998). More generally, Carter, (1991, pp. 98-99) has described common regularities in the pattern of use of performance indicators in organisations: first, perfunctory compliance in response to outside pressure to introduce performance measurement; then organisational resistance and attempts to discredit; then refinements, and acceptance of the view that performance indicators are useful.

⁵⁹ See Carter, (1991), for a discussion of the design of performance measures.

⁶⁰ These are based on Milgrom and Roberts, 1992, pp. 219-228.

⁶¹ See Wilson, (1989), Chapter 9, pp. 154-175.

⁶² Mintzberg, (1996, p. 79) has noted: “How many times do we have to come back to this one until we finally give up? Many activities are in the public sector precisely because of measurement problems: If everything was so crystal clear and every benefit so easily attributable, these activities would have been in the private sector long ago.”

⁶³ Of course any one organisation may conduct more than one of these types of activities.

⁶⁴ An example is the State Owned Enterprises Act in New Zealand, Section 7 of which provides that, where a State Owned Enterprise is asked by the government to supply services on a non-commercial basis, this is to be on the basis of a legally enforceable contract. The one instance where this currently occurs is the funding through Vote Justice of the purchase of the services of NZ Post in maintaining the electoral rolls for Parliamentary elections.

⁶⁵ The credibility effect could come from the fact that government would be giving the enterprise the ability to enforce the agreement in court against the government, while government would be highly unlikely itself to enforce the agreement given its ownership rights.

⁶⁶ OECD, (1997b), p. 64.