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A Framework for Public Sector Performance Contracting

by

Murray Petrie*

1. Introduction

OECD Member 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."[1]

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;
- a move from centralised bureaucratic structures, to more decentralised managerial environments.

Public sector reform has not taken an identical approach across OECD Member countries. Different institutional arrangements, histories, and political circumstances have resulted in differences in reform programmes 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.[2] 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

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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.

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;
- 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

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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 2 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 3 applies the framework developed in Section 2 to different funding relationships and activities within the public sector.
- Section 4 presents some concluding remarks.

2. An economic and legal framework

2.1. *The governance approach to contract*

The fundamental economic function of contracts is to facilitate voluntary exchanges, thereby increasing social welfare.[3] 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.[4]

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.

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2.1.1. *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.[5]

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.[6]

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.[7] 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.[8]

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

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"spirit" in which adjustments for unforeseen events will be negotiated.[9] 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.[10]

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).[11]

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.[12] 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.[13] For example, complex interdependencies between different units or functions can make it impossible to determine respective contributions to output.

2.1.2. *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.[14] Specifically, ownership may economise on transaction costs where:

- each party is highly dependent on the other in a long-term relationship;

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- 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.[15]

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.[16]

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.*[17]

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. Ouichi (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.[18]

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).[19] 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.

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These rewards and sanctions include the subtle use of employment, promotion, remuneration, and internal resource allocation processes.[20]

2.1.3. *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.[21]

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.

2.2. *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.[22] 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 3.

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

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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.[23]

The existence of separate legal entities within the public sector makes it theoretically possible to implement performance contracting with these entities through enforceable contracts.[24] The remainder of this section will consider the legal implications of enforceable contracts within the public sector.

2.2.1. A *legal perspective on enforceable contracts in the public sector*[25]

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.[26] Typically, if the terms of the contract are breached, a party can be sued for specific performance or damages.[27] 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. 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

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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.[28] 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 3.

2.3. *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

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owner is funding the supply of outputs from entities it owns it should be concerned with *ex ante* incentive alignment.[29] 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. T*he 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,[30] 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). 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.[31] Principals face costs in trying to obtain information

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required to monitor the agent's performance, and try to economise on these through designing efficient monitoring and incentive structures.

2.3.1. *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;[32]
- delegating authority over the use of inputs to agents, and holding them accountable for outputs, or outcomes where feasible,[33] and monitoring of performance.

2.3.2. *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);[34]

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- 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.[35]

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;
- 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 Member countries, from unitary states through to various forms of federalism. In many countries, it is

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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.[36] The issue arises as to what conditions should be attached to these transfers.

The two main types of intergovernmental transfer in use in OECD Member countries are untied block grants, and various types of specific grants, with the former becoming more common.[37] 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.

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.

2.3.4. *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.

3. 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 specifica-

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tion 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.

3.1. *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 2).

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".[38]

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 estab-

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lishing 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.[39] From a somewhat different perspective, Mintzberg has advocated greater reliance on a "normative-control model", especially in areas like education and health.[40]

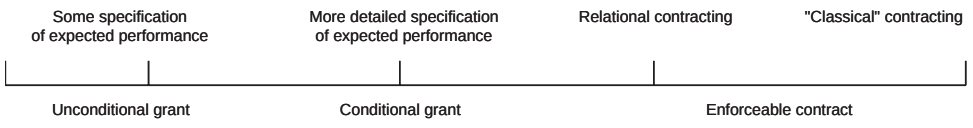
The political culture and the history of public sector institutional development will impact on efforts to introduce a greater performance orientation, that is, starting points and initial conditions matter. North (1990) stresses that those with the power in any society to implement changes are usually 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.[41] Premfors (1998), in a detailed study of Swedish public sector management reforms during the last 20 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 Member countries.

3.2. *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.[42] As one moves along the spectrum, additional conditions are imposed on the grant recipient. These conditions create obligations

Figure 1. **A stylised performance contracting continuum**



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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.[43]

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 by 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.[44] 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;[45] 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.

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3.3. *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.[46] 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;
- 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

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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 agreements). 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. 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.[47] 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.

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- 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.[48]
- 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.

3.4. K*ey 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:[49]

- 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.[50] Wilson suggests that from a managerial

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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 Table 1 below.

Table 1. **Wilson's managerial matrix of public sector activities**

		Outcome Observable: Yes	Outcome Observable: No
Outputs Observable: Yes		Production (*e.g.* payment of welfare benefits)	Procedural (*e.g.* policy advice)
Outputs Observable: 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.[51] 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.[52]

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.

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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.

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3.5. 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.[53] 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.[54] 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

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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 sub-national 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."[55]

4. 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.

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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;

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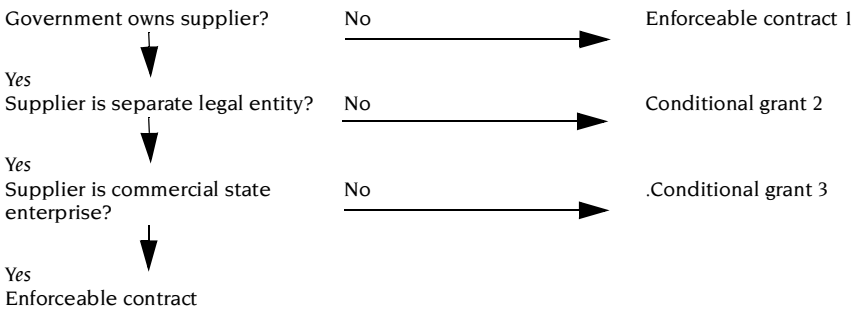
- arrangements for the supply of commercial services between different state-owned enterprises; and
- between enterprises and government ministries or departments, and in some circumstances, arrangements between different levels of government for the supply of goods or service.

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.

Table 2 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.

Table 2. **Conditional grant or enforceable contract?**



The bulk of public sector activity occurs at nodes two and three in Table 2. 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

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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.

Table 3 summarises the general factors driving the appropriate degree of specification of expected performance for conditional grants.

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;

Table 3. **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

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- 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.

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Notes

1. *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.
2. 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, (1997*a*).
3. 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.
4. See Williamson, (1985).
5. Macneil, I.R., "The Many Futures of Contracts", *Southern California Law Review*, 47, May 1974, pp. 691-816, cited in Williamson, (1985).
6. 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.
7. 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.
8. 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.
9. 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 even-

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tualities out of the contract, and to re-negotiate once it is known what specific circumstances have in fact materialised. Through this economising 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).

10. 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.

11. Quoted in Boston (1994), p. 17.

12. 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.

13. 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.

14. 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).

15. 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 Gorringe).

16. 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.

17. Williamson, (1993), p. 15.

18. See Oichi, (1980), p. 132.

19. See Ouichi, (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. Ouichi defines a clan organisation as one where socialisation is the principal mechanism of control.

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20. These points are taken from Williamson, (1986), p. 87.
21. See Williamson, (1985), p. 41.
22. 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),.
23. 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).
24. 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".
25. This section is based on collaborative work between the author and Mai Chen, Partner, Chen and Palmer, public law specialists.
26. In some legal systems consideration is also a requirement.
27. See "An Introduction to Comparative Law", by K. Zweigert and H. Kotz, Third Edition, Clarendon Press, Oxford, 1998, Section C, Contract, pp. 323-526.
28. In some countries their statutory duty may be subject to judicial enforcement.
29. 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.
30. 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…".
31. 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

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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.

32. 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.

33. 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).

34. See Alchian and Demsetz, (1972) for a discussion of the role of residual claims in creating incentives for performance monitoring in the private sector.

35. 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.

36. 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.

37. See OECD, (1997*b*), p. 53.

38. See Ouichi, (1980), p. 137.

39. See Wallis and Dollery, (1997).

40. See Mintzberg, (1995), p. 81. Mintzberg identifies five key elements of a normative model: selection by values and attitudes, rather than just credentials; socialisation 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.

41. 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.

42. 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 recip-

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ient 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.

43. 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.

44. 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.

45. 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.

46. See Wilson, (1989), p. 370.

47. 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.

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

49. These are based on Milgrom and Roberts, (1992), pp. 219-228.

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

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51. 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."
52. Of course any one organisation may conduct more than one of these types of activities.
53. 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.
54. 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.
55. OECD, (1997*b*), p. 64.

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