

THE CONTRACT MANAGEMENT PROJECT IN DENMARK

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Introduction

This paper discusses the Danish experience with contract management. Contract management has been in operation since 1992 and has been an important instrument for the implementation of performance management in the Danish state. The basic principle of the system lies in the establishment of a contract between a department and an agency defining targets and required results. The paper describes the position of contract management in Danish administrative policy tradition, the background to project implementation, experiences with contract management, and the problems and possibilities associated with the system.

Project Background

The need for increased focus on results

The contract management project has its background in the development of expenditure control policy in Denmark. In common with the other OECD Member countries, Denmark experienced explosive public-sector growth during the 1960s and 1970s. This led at an early juncture to deliberations on the ways in which a control of public expenditure might most effectively be implemented. The method adopted in Denmark consisted mainly of ongoing reforms to the budgetary system based on the concept of "framework budgeting". Under this concept, the budgetary system is structured as a set of top-down budgetary frameworks established on all levels (starting with the ministry as a whole on down to the individual agency). This improves policy prioritisation between principal objectives and ensures tight control on expenditure policy. In the wake of the introduction of framework budgeting, both ministries and agencies were given increased freedom of action, so that over the years a substantial decentralisation of responsibility and competence has taken place.

The weakness of framework budgeting is that it is a solely input-oriented system, not connected to the services that agencies provide. Therefore, in the extreme situation it is possible to imagine an agency that meets the requirements of its budgetary framework, but that is both low on productivity and that does not provide services perceived as relevant by its users. The weaknesses of the framework management concept have meant that the introduction of a supplementary approach providing increased focus on results has been a high-priority task for Denmark's Ministry of Finance in recent years. This supplementary approach is contract management.

The Danish tradition of trial projects

The contract management project should also be seen in the light of Denmark's tradition of using trials in the development of administrative policy.

In Denmark, administrative policy falls within the jurisdiction of the Ministry of Finance. This means that the Ministry of Finance co-ordinates major administrative policy initiatives and also undertakes the development of new administrative policy tools. In the relationship between the Ministry of Finance and the other ministries it is essential to be aware that Danish government ministries traditionally enjoy a high degree of autonomy. Thus, the individual ministers are the supreme policy administration heads in their domain. In practice this means that the decision to implement administrative policy initiatives is largely taken by the individual minister, with assistance and guidance from the Ministry of Finance.

This relationship between the Ministry of Finance and the other ministries has led to the development of a tradition for launching pilot projects or trials. Typically, the Ministry of Finance develops a project concept that is then tested by other relevant ministries to determine whether it functions as intended and to establish the concept's general practicality. The contract management pilot project is a part of this tradition.

The pilot projects typically run over a period of two to five years. This is seen as a sufficient time to evaluate whether or not the trial concept is practicable. The evaluation is done in co-operation between the Ministry of Finance and other involved ministries. It is often considered useful to get an independent evaluator to carry out the initial evaluation, that will be used as a reference in the final evaluation by the ministries. In other cases there is no formal evaluation, i.e. if a project is generally seen as a success there will be a tendency to integrate the trial concept into the practices of the ministries and the concept will become a regular management practice.

The criteria for success may vary between projects, the objectives can be improved efficiency, increased involvement by users or improved service quality. Success is generally seen not only from the viewpoint of the objectives set by the Ministry of Finance; the degree to which other involved ministries accept and value the trial concept is also important.

The Danish ministerial system

The structure of the Danish ministerial system is generally such that each ministry consists of a department and one or more subordinate agencies. The minister is formally both legally and politically responsible for the department and all its subordinate agencies. The department functions as the minister's secretariat and also has a co-ordinating role vis-à-vis the subordinate agencies, that perform a very wide range of functions. These agency functions range from casework and research to the performance of highly specialised functions.

No hard and fast rules have been developed governing the control aspect of the relationship between a department and its agencies. In practice there is a wide variation between the ministries. However, a general characteristic of the relationship has been a tendency for the department to concentrate solely on its function as secretariat for the minister, whereby its control function vis-à-vis the agencies has been reduced. To obtain an increased focus on results, modification of the managerial role of the departments has therefore been a central challenge, both generally and in conjunction with the contract management project.

The Project

Launch of pilot project

In 1991 a decision was taken by the Cabinet to initiate a preliminary study into the potential for improving the efficiency of state agencies via a contract-type control system. The study was performed by the Ministry of Finance in collaboration with a firm of private consultants.

An analysis of 15 state agencies and departments revealed 31 barriers and other obstructions to improved efficiency. Significant barriers included absence of targets and result-related controls, planning problems due to budgetary uncertainty, inadequate freedom of action with regard to pay and appointments, investment problems, and difficulties confronting potential private sector collaboration. The large differences that existed between the problems of the individual agencies led to the conclusion that specific solutions should be created for specific problems. Or more precisely, that the problems of the individual agency should be made the point of departure and a unique contract established accordingly. The first contracts entered into force in January 1992, followed by a second wave in January 1993. A total of 13 agencies under seven ministries took part in the project.

The contract management concept - and contract contents

The principal aim of the contract management project was two-fold: to improve operational efficiency and to increase policy control potential.

Overall, the problems identified by the preliminary study pointed to the need for:

- increased freedom of action in the performance of tasks;
- budget guarantees based on multi-year agreements;
- establishment of clearer target- and result-related requirements.

Against this background the idea was that a result-based contract should be negotiated defining both the rights and the obligations of the agency. In other words, the contracts would be based on a something-for-something principle: the agency would promise to meet certain increased efficiency requirements formulated in terms of specific results, in return for which it would receive a certain freedom of action with regard to task performance plus a budget guarantee for a number of years.

All the project contracts had a four-year term. The contract consisted of a description of the tasks, rights and obligations that were to form the basis for task performance. In addition to the more specific performance targets, the obligations could include more process measures (i.e. measures of activities and initiatives within an agency) and service quality oriented measures, e.g. new initiatives in respect of services or groups of users, requirements relating to personnel matters, or requirements for increased information provision to users and the public. The contract was also to contain a measurable operationalisation of the established targets and obligations, and a statement of the agency's required reporting frequency. The reporting frequency for all the contracts covered by the project was set at once per year. The contract was not legally binding in the normal sense as it could, in principle, be revoked by the minister.

The idea was that the subsequent reporting by the agency should both pressure the agency to make efficiency improvements and open the way for increased insight by the department into the agency's work. No sanctions for failure to reach performance targets were specified. However there has not been a

need for sanctions as all agencies have achieved the targets defined in the contracts. One of the main objectives of the project was also to improve co-ordination and connect together the department's specialist and financial management functions.

Examples of performance targets and special conditions provided in performance contracts are shown in the Annex.

Selection of project participants

The agencies suitable for project participation were mainly chosen by the responsible ministries. The main selection criteria were that:

- an agency reorganisation process was already under way;
- an agency was already functioning effectively;
- an agency was motivated for change;
- there was a clear need for efficiency improvements;
- there already existed studies or action plans that could be used as a starting point for contract negotiations.

Project findings

Results

In December 1995 the Ministry of Finance published a report containing the provisional findings of the contract management project.

The findings showed, *firstly*, that a substantial number of the barriers to efficient agency working had fallen away. In general, the participating agencies were seen to have fulfilled the targets and result-related requirements established in the contracts. Thus, the result-based contracts did lead to increased agency performance in terms of improved efficiency and service quality. To a large extent the contracts acted as a hub for agency reorganisation processes and efficiency activities, such as development of internal management and control tools and targeted developmental activities in the personnel domain. In addition, contract establishment often served to increase personnel awareness of work place objectives. In many cases agency performance was found to be better than the contract specifications. This might suggest that in some cases the requirements were set too low.

Secondly, the findings showed that provision of information to the public and users was strengthened. The contracts generally focused strongly on level of service, case handling times, information, and so on. The views and satisfaction of the public and users were directly incorporated in the contracts, partly in conjunction with the need analyses on which the required results were based, and partly in conjunction with requirements for user surveys.

Thirdly, the contract management project generally resulted in an improved dialogue between agencies and departments. The intensive contract negotiations led to the creation of a network of contacts between the parties at all levels. The departments gained improved insight into the workings of the agencies, that led to a more holistic, all-round dialogue rather than the traditional ad-hoc dialogue focusing on detailed issues. In addition, the reporting provided improved documentation of agency activities, something that in turn improved the quality of communication.

Fourthly, contract management proved to be a useful tool for changing agency priorities in line with changed external demands -- not least new policy requirements. The potential for policy control was improved as a result of the improved information platform. At the same time better integration of programme management and financial management was achieved, something that was very largely lacking in the normal one-year budget negotiations. However, there was criticism in the evaluation that the excellent strategic control potential of contract management was not adequately used by ministers and departments. Nevertheless, positive results were achieved, even with the limited departmental strategy participation to date.

Finally, the project showed that it was possible to develop the necessary methodology for measuring and documenting even highly complex activities. As well as the conventional quantitative measures (efficiency, savings), success was achieved in developing systems for measuring the quality of case handling. In addition, two agencies succeeded in establishing operationalised requirements for quality improvements. Examples of "soft" measuring tools contained in the contracts include user surveys and image analyses. This was one of the most important results in the project.

Negotiations and participant attitudes

The agencies themselves had a major influence on the establishment of the result-related requirements and target setting. The Ministry of Finance played an important part in the negotiations with the agencies on the elaboration of the first contracts, so important that the Ministry of Finance - rather than the individual responsible department - was often regarded as the opposite party in the negotiations. The role played by the Ministry of Finance was necessary to set the project in motion and to arrive at a form of standard model for the contracts. In the future it is intended that the Ministry's role in the negotiations will be taken over by the individual responsible departments as a means of increasing their feeling of responsibility towards the contract. The sole role of the Ministry of Finance will be to advise and ensure continued development of the concept. This will also increase the departments' strategic action potential and their ability to reflect their relevant policy goals in the contracts.

At the time the first contracts were established, the departments were sceptical about the project. This was partly because the budget guarantee given to the agencies could be seen as a limitation on departmental freedom of action. For this reason, the departments left the negotiations largely to the Ministry of Finance. However, by the time of the second wave of contracts, the departments had become more alert to the potential of contract management, and the selection of agencies for new contracts was based on a deliberate choice of control methodology.

Most of the agencies saw the contract management project as a means of setting the agenda for their future development, and thus often acted as initiative takers and formulators in the framing of contracts. However, the agencies showed strikingly little interest in additional autonomy, which is surprising in view of the barriers to efficiency that emerged in the preliminary study. This can partially be explained by the barriers being more formal than real, and some barriers were removed more generally for all agencies during the contract period. By contrast, substantial weight was placed on the budget guarantee, principally with regard to the possibilities opened up for long-term planning. Thus, one or two agencies commented in the evaluation that if the budget guarantee were removed there would be nothing left to negotiate about. Within the ranks of the management, there was particular satisfaction at being able to point to external pressure when called upon to implement changes and efficiency measures. The agencies were generally satisfied with the improved dialogue with the department.

Problems

The crucial factor in contract formulation is to establish operationalised result-related requirements that at the same time cover the full range of agency functions. Already from this it is clear that contract management should principally be applied to agencies for which targets can be established for all major tasks. An agency will focus on the targets stated in the contract, and if there are components in an agency's functions that cannot be measured, and that are therefore not included within one of the performance criteria in the contract, the function concerned will probably be assigned reduced priority by the agency. In conjunction with the contract management project, particular attention was drawn to the danger of excessive weight being placed on quantitative result-related targets at the expense of process and service quality targets related to, for example, internal backup functions, public and user information, and personnel policy goals. For the same reason, the selection of agencies for the project was often based on the pre-existence of a reasonable overall picture -- and ideally an overall action plan -- for the agency. Without this pre-preparation it would be difficult to identify all the key factors and thus enable a balanced list of result-related requirements to be established.

As mentioned, one of the most significant results of the project was the successful development of tools for measuring complex activities. However, there still exist activities that are not directly measurable, something that can lead to distortion of the incentive structure. Similarly there are cases where it is difficult to form a reasonable picture of the agency's task profile. Generally, however, the study found very few tendencies towards distortion in agency development. This was due partly to the success in the development of measuring tools, and partly to the fact that Danish agencies normally have a very strong specialist profile in which specialist competence and identity prevent reduced priority from being given to areas difficult to measure. However, the avoidance of distortion in the incentive structure was also due to the fact that agency selection for the project was specifically based on the pre-existence of an overall picture and documentation for the agency's task profile.

The process of contract establishment is extremely resource-intensive. Contract formulation takes a long time, but the subsequent resource burden is reduced by the fact that ongoing control is simplified. However, some areas of public-sector activity are characterised by the presence of many agencies with uniform tasks. In such cases the project showed that negotiating a customised contract for each individual agency is too costly a solution.

Future Use of Contract Management -- Deliberations and Problems

Today, result-based contracts are operational in 20 agencies and more are on the way. Most of the agencies in the pilot project wish to continue with contract management. However, what will happen when the individual departments take over negotiations is an open question. In the light of the evaluation and experiences with the contract management project, various changes have been introduced into the concept and new changes are on the way.

Changes currently being considered or already introduced include the following:

Firstly, consideration is being given to whether the budget guarantee should necessarily form part of future contracts. The Ministry of Finance has clearly stated that it will not in future provide a guarantee and that any such budget guarantee must be provided by the department within its funding allocation. The practice hitherto has obscured the departments' control responsibility. Therefore, the question is whether the departments wish to provide their own guarantee.

The guarantee is a useful bargaining tool vis-à-vis the agencies, and experience has shown that they accord it considerable value. The problem is that the budget guarantee reduces the number of action alternatives for departments and ministers. The budget guarantee may therefore become an encumbrance on the future use of contract management. In addition to this, it can be argued that result-related requirements are a wholly natural imposition, and that agencies should not, therefore, be given something "extra" for taking on such obligations. Whether the budget guarantee should be included in future contracts will be up to the individual responsible ministry to decide. Consideration could be given to use of a more dynamic, rolling form of contract within which the budget guarantee is not an indispensable component and within which new guarantee periods could be introduced as existing periods expire. With this system, renegotiation will arise at regular intervals, providing ongoing recourse to sanctions on the agencies. Another possibility is to make the budget framework dependent on the result targets. However, this would require a substantial knowledge of the relationship between activity and cost, and this information may be difficult for the department to obtain.

Secondly, consideration should be given to a possible widening of the policy dimension in the contracts. The objective of using contract management as a means of strategic control has not been adequately fulfilled. The rather unobtrusive role played by the departments during the project should be changed, and the minister should adopt a more active role. The departments are now alive to the strategic control potential offered by contract management. At the same time it is important that the departments should involve themselves actively if a qualified counterbalance to the agencies is to be established at the negotiating table.

Thirdly, consideration must be given to improving the agency annual reporting. This procedure was in several cases not satisfactory. In future, increased weight should be placed on the reporting function as good reporting is crucial to the agency's continued implementation of the result-related requirements in the contract, and can also serve as a continuous reservoir of experience and a learning process. The work surrounding the reporting system will in future be integrated with another Danish project focusing on annual reporting. The purpose is to ensure that all state agencies with operations-related and outward-oriented functions submit annual reports in a form capable of providing increased information on results.

Fourthly, consideration should be given to the contexts in which contract management is well suited. Experience has shown that contract management is useful for supporting operations- and reorganisation-related tasks and can usefully supplement other control methods. However, it should in future primarily be used by ministries that administer large numbers of agencies with different types of tasks. Contract management is less suited for agencies where it is not possible to give a relatively precise and comprehensive description of relevant work tasks and development needs. In order to expand existing knowledge of where contract management can be suitably applied, it is planned to establish a contract management experience network where guidance can be obtained when new contracts are to be established.

ANNEX

Examples of Targets and Special Conditions of the Danish Free Agencies

The following mentions the most important elements in the listed free agency contracts:

Risø National Laboratory (Ministry of Research) 1994-97

The Ministry of Research seeks in this contract to pioneer the application of performance management and results-based contracts to research institutions. Risø, a research institute that seeks to support industrial and commercial development, is described as a good pilot candidate because of its considerable size, and its ability to adapt to changing conditions. Risø proposes to be evaluated by a series of objectives and targets established by its Board of Governors, known as "RISØ 2000."

Risø's overall objective is to create new opportunities for development in energy technology and energy planning; environmental aspects of energy, and industrial production; and on materials and measuring techniques for industry. Research on these three areas and nuclear matters is distributed over 11 programme areas, for which targets have been established for the next 5-10 years. The 11 programme areas are in turn subdivided into 30 subprograms with 3-5 year plans.

Results are evaluated at the end of each year, partly on the basis of achievement of milestones defined in Risø's research programme and partly based on performance on three sets of quantitative indicators: activity indicators concerning personnel resources; communication indicators; and network indicators concerning relations with Danish and international research. Risø will provide annual reports on its results and a final report upon completion of the project.

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;
- Increasing 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.

The National Museum (Ministry of Cultural Affairs) 1992-95

The contract includes a declaration of aims, and then a series of measurable targets, including museum attendance increases, a change from a financial deficit to a profit, and an increase in the number

of articles published in internationally recognised periodicals. Each year, until completion of the contract at the end of 1995, the Museum will submit a report on progress towards meeting the agreed targets.

Court of Taxation Appeals (Ministry of Taxation) 1993-96

The court processes appeals of tax assessments and real estate valuations from the local tax authorities.

Targets

- reduce the average time a case is processed from 14 months in 1992, to 9 months in 1995;
- deal with all complaints related to the 19th general valuation of real estate before end 1996;
- increase productivity 20 per cent by 1996.

Special conditions

- long term budget arrangement to be provided;
- additional manpower to be provided;
- performance-related pay schemes to be introduced.

National Board of Industrial Injuries (Ministry of Social Affairs) 1993-96

The Board of Industrial Injuries processes applications for compensation for industrial injuries.

Target:

- reduce the proportion of cases where the processing time target is exceeded from 23 per cent in 1992 to 19 per cent in 1996;
- increase productivity from approx. 156 standard cases per employee in 1993 to approx. 162 per employee in 1996;
- reduce the number of appeals from 18 per cent to 14 per cent by 1996.

Special conditions

- long term budget guarantee to be provided;
- possibility of working at home to be introduced;
- special days off in case of children's illness to be provided;
- performance-related pay schemes to be introduced.

Medicine division of the National Board of Health (Ministry of Health) 1993-96

The Medicine division is responsible for licensing drugs prior to their marketing, for inspecting products on the market and for inspecting chemists.

Targets

- increase yearly inspections of producers by 20 per cent and increase in yearly inspections of chemists by 75 per cent before the end of the contract period;
- increase from 50 per cent in 1992 to 80 per cent in 1996 of the amount of applications for parallel importation that are processed in less than four months;
- ISO-9000 certification.

COMMENTARY

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The Contract Management Project in Denmark

Planning or “management” contracts¹ traditionally aim to improve the performance of public enterprises or bodies. The idea of contractual autonomy, formalised at a very early stage in France², has developed through different experiments, all of which originated in the dissatisfaction with traditional budgetary control mechanisms and the need to establish performance control of efficiency (for example productivity) and effectiveness (quantity and quality of services). Of particular note, in relation to the OECD Member countries³, are the US Government Performance and Results Acts, the contracts in Germany and the Netherlands between regional authorities and railway undertakings, France’s planning and objectives contracts for the railways, electricity and some commercial and industrial public bodies (EPICs), and Belgium’s management contracts for the railways, telecommunications and low-cost housing. In the United Kingdom, the use of contracts is part of the broader initiative to introduce market mechanisms into public services (contracting out, contracting in)⁴. It is clearly the failure of traditional methods of regulation, whether of public bodies or private operators, that lies behind the development of contractualism⁵. In this sense, the Danish experience fits in with the tradition of reforms aimed at contractualism. The needs identified are the same as in contracting experiments, that is, to:

- increase freedom of action in order to improve performance;
- establish budget guarantees on a multi-year basis so as to remove the constraints imposed by the principle of yearly budgeting;

¹ The different terms used here synonymously sometimes arise from somewhat different traditions which cannot be discussed here in detail. It is also relevant to mention the specific terminology of the World Bank which uses the term performance contracts for contracts between public enterprises and their responsible authorities, keeping the term management contract for contracts between a public authority and a private operator. See World Bank (1994), *Infrastructure for Development*, New York, Oxford University Press.

² Nora Report (1967), *Rapport sur les entreprises publiques*, Report to the Prime Minister, Paris.

³ Projects have also been implemented in India and Latin America, see World Bank Report (1994).

⁴ See Walsh K. (1995), *Public Services and Market Mechanisms - Competition, Contracting and the New Public Management*, London, MacMillan.

⁵ Drumaux A. (1994), “Management Contracts and the Regulation of Public Enterprises”, *International Review of Administrative Sciences*, London, Sage, Vol. 60, No. 1, March, pp. 103-115.

- define objectives as clear targets, measured in terms of expected results, so as to be able to move from the control of compliance and legality to a full assessment of performance.

Having said that, the Danish experiment is totally original in a number of respects:

- the role played by the Ministry of Finance in elaborating the contracts is altogether quite unusual: project promoter at the first stage of experimentation with contracting, advisor or consultant at the development stage. This change of role is interesting and it will be addressed below when the incentive aspects of contracting are discussed;
- the project seems to have covered a very wide range of activities in different ministries (research, cultural affairs, taxation, social affairs, health, etc.) and to have involved administrative agencies, that is a rarer occurrence in other countries. As a result, the experiment led naturally to discussion about measuring the performance of complex activities. It is acknowledged that administrative activities are generally intangible services whose characteristics need to be detailed very carefully to understand what constitutes their quality. The complexity of the activity sometimes makes it difficult to define administrative output and identify the direct or indirect beneficiaries;
- the concern with assessing the reform (over and above the Ministry of Finance's role already mentioned) as it developed is indicative of an exemplary administrative process.

The conceptual framework for analysing contractualism practices

Before commenting on the Danish reform, the contract analysis framework needs to be explained. Different theoretical tools are available: the contract model with the agency theory, the transaction model with the transaction cost theory, the convention model with the convention theory. The perspectives of these three approaches differ and will be described very briefly below.

Put most simply, agency theory⁶ attempts to resolve co-ordination between a principal and an agent, and is focused on resolving information imbalances through the use of incentive mechanisms in contracting. By focusing on the incentive aspect, the motivating factors in actual contracts can be analysed, for example, as can the quality of the control exercised by a responsible authority.

The aim behind transaction cost theory⁷ is to explain the organisational structure and control procedures that co-ordinate agents at the lowest transaction cost. This is a tool that can be used, for example, to compare contracting-out and contracting-in procedures (i.e. “buy” or “make”).

Conventions theory⁸ looks at the co-ordination problem from the point of view that motivations are based not on the pursuit of agents' personal interests, but on socially internalised mechanisms. A convention is a collective agreement, tacit or explicit, that specifies how to behave in a recurring situation and so allows agents, once the convention has been established, to co-ordinate their actions merely by

⁶ For a non-formalised presentation, see Milgrom P, Roberts P. (1992), *Economics, Organisation and Management*, New Jersey, Prentice Hall.

⁷ See Williamson O. (1975) *Markets and Hierarchies: Analysis and Antitrust Implications*, New York, The Free Press, Williamson O. (1985), *The Economic Institutions of Capitalism*, New York, the Free Press.

⁸ See La Revue Economique, No. 2, 1989, devoted entirely to the theory of conventions, Orléans A. (dir) (1994), *Analyse économiques des conventions*, Puf, Paris.

foresight. Organisations thus establish conventions that distinguish between what belongs to individuals or operational units and to their independent action, and what is in the domain of the hierarchy and line control.

Which of these three paradigms to use (contract, transaction, convention) depends on what is being analysed: the contract model for effectiveness of control, the transaction model for contracting out decisions and the convention model for work relations.

The contract model will be used in this analysis to illustrate the information and control problems facing the responsible authority. Since the contracts analysed are geared towards the production of outputs, this approach is totally justified inasmuch as, to manage these contracts, the responsible authority has to evaluate and measure outputs. Therefore, the quality of information on these outputs is a key issue.

A contract between a responsible authority (the Ministry of Finance in this case, at least during the first stage in the reform) and a public enterprise or agency can therefore be presented as a relationship between a principal and an agent, binding them and committing them to doing or not doing a number of things.

Each of the parties can pursue different objectives. There would, in fact, be little point in negotiating a contract if the interests of the parties were exactly the same. What is more, the principal and the agent are not necessarily in possession of the same information when the contract is negotiated.

This information imbalance stems primarily from the fact that the principal cannot possibly know the agent's productivity level or quality standards. This situation is called *adverse selection* as it is the agent who has the best information on the production conditions (productivity, quality), while the principal in fact knows only what the "other side" divulges.

The information imbalance also stems from the fact that the principal is not necessarily in a position effectively to check the agent's level of effort (a situation referred to as *moral hazard*) and cannot therefore reward the agent according to the intensity of the effort.

The theory of the principal-agent relationship should be borne in mind when discussing the quality of contractualism reforms in government.

Comments on the Danish reform

The contract philosophy in the Danish experiment is relatively typical compared with previous experiments. For the reasons stated above, the comments will discuss the contract as an instrument of information and control for oversight within the framework of an agency theory approach.

The comments will chiefly focus on the following issues:

- the idea of commitment in contractualism procedures;
- budget guarantees;
- incentives;
- transfer of experience; and
- standardisation of procedures.

Commitment

The absence of sanctions in contracts is a key element of discussion. While the information imbalance between agency and principal is a reality, widely confirmed by research into administrative behaviour, it should be acknowledged that the absence of sanctions may be seen as standing in the way of fully effective reform. Target setting and the budget guarantee will be discussed below. The point to note at this juncture is that sanctions (positive or negative) are a way to reinforce the agency's commitment to achieve a target, particularly when the context shifts from a stimulating pilot project to a reform establishing a recurring practice.

To make the agency's budget framework dependent on results is one possible stimulus, but it is not the only solution. Generally, the sanction can be positive (to obtain a benefit or not, as the case may be) or negative (to incur a penalty in the event of certain dysfunctions). The use of one or another of these solutions depends upon the seriousness attached to failure to meet a target. Penalties should clearly be reserved for flagrant and proven cases of, for instance, non-compliance with quality standards.

The fact that the contract can be revoked by the minister makes the contracting procedure shaky if there is no appeals procedure. The possibility that the contract can be revoked may be interpreted by the agency as a sign of minimum commitment by the principal, that would inevitably have an adverse effect on the agency's own commitment in return.

The use of a third party is a conventional method of offering some security. The question arises as to why the Ministry of Finance might not play this role in the subsequent stage in the reform, considering its culture of experimentation and hence expertise in this field, as well as the structure of the Danish ministerial system.

The budget guarantee

The budget guarantee is a key issue. To what extent is achieving results a natural obligation that need not be "rewarded"? The problem touches again on the information imbalance. The agency is the best observer of its actions. It may be pursuing its own particular goals that are not necessarily in step with the principal's objectives, that are to achieve a particular result. Moreover, all organisational theories highlight these strategic behaviour patterns that are not specific to the public sector. The information imbalance provides a built-in information advantage when there is overconsumption of resources in relation to results, or a deterioration in quality when cost constraints are tight. The fact that public organisations operate in the public interest does not protect them from these strategic behaviour patterns⁹.

Therefore, the conclusion is that, if the consequences of this are to be avoided, mechanisms are needed that will prompt the agency to behave in the desired way of its own accord and not to rely solely on instructions, whether in the form of a mere reminder of mission statement obligations or a performance standard imposed from above.

If the budget guarantee becomes a departmental responsibility, budgets for other departmental activities could be reduced. If departments and the minister responsible are to make optimum use of the strategic control tool of contracting, there necessarily has to be a commitment, not just symbolic in the spirit of reform but also budgetary, failing that the reform could lose part of its purpose. By granting a certain budget guarantee to agencies pursuing objectives considered to be priorities, the department

⁹ The issue has been well documented by the Public Choice School.

becomes directly involved in achieving results. It can be argued that the objectives in current contracts are in fact connected with existing functions rather than new ones: improving the quality of library services or reducing the time taken by the tax authorities to process cases, are not new functions.

At the preliminary stage of the transfer to departments, there could be negotiations between the Ministry of Finance and departments to encourage them to select contractual forms that offer more incentives. Neither is it sure that the Ministry of Finance has to be the only consultant: the use of outside consultants could help departments to see the benefits of reform objectively.

The relative lack of interest shown by agencies in greater freedom of action, and their concern for a budget guarantee from a long-term standpoint, are factors to be taken into consideration for the future of the reform. It is possible that freedom of action is not the priority goal for agencies, either as stated in the report because the actual barriers have fallen away, or because independence is not a sufficient incentive for some agencies. Whereas, that does not seem to be the case for the multi-year budget guarantee.

It must be recognised that the search for a budget guarantee is consistent with the idea of contractualism in that it reduces the constraints inherent in the principle of yearly budgeting. The budget guarantee acts as a sign of the principal's commitment and is therefore vital, but there is nothing to say that it should not be adjusted if necessary. The agencies' commitment in return also needs to be ensured. The solution probably lies in finding mechanisms that offer more incentives.

Incentives

While contracting has clearly facilitated the reorganisation of agencies by promoting efficiency and effectiveness (intrinsic quality of services, starting with a more precise definition of complex administrative activities and culminating in concrete indicators of delivery and quality, managerial reform at personnel management and financial levels, user information, quality of communication between the agency and the Ministry of Finance, etc.), the incentive aspect of contracts is still open to question. The absence of sanctions comes down to the fundamental problem of the information imbalance between principal and agent. As the report notes, the fact that there was no need for sanctions because the targets were achieved suggests that these targets may have been set too low. This is at the heart of what the theory terms information imbalance: "The agencies themselves have had a major influence on the establishment of the result-related requirements and target setting"¹⁰. The dynamics were positive, but there is nothing to suggest that the process could not have been taken further: productivity and efficiency could inevitably have been improved.

It would be useful to make the contract more motivating, encouraging the agency to exceed the targets. One possible way to do this is to abandon the single contract and introduce a menu of contracts. The idea is simple: when the agency is confronted with a choice between several contracts, it will be required to make a choice that will reveal some of the hidden information. To put it more simply, imagine, on the one hand, a contract offering a minimum objective combined with an unattractive cost repayment system or the prospect of a minimum budget guarantee and, on the other hand, a contract setting a maximum objective combined with a higher payment (better cost repayment, but also longer

¹⁰ This finding, highlighted by the report, is common to many analyses of contractualism practices, see Haut Conseil du Secteur Public (1992), *Les entreprises de service public*, rapport 1990, Paris, La Documentation française. The finding was similar for Belgacom, the Belgian telephone enterprise, documented in Debande O, Drumaux A. (1994), *Regulating Infrastructure in Europe: contractual approaches*, Background Paper for the 1994 World Development Report, Washington, The World Bank.

budget guarantee, or even greater freedom of action, etc.). The menu can be supplemented by intermediate contracts introducing gradation. Through its choice, the agency will indicate with greater certainty the target that it believes it is capable of achieving, being in possession of information that the principal does not possess in the same detail: it will in fact be opting for the effort-remuneration ratio that it prefers. Some of the hidden information will thus be revealed.

Another possibility is the subsequent development of the reform, particularly where several comparable agencies might be engaged in parallel contracting. This would involve multilateral contracts with agencies made interdependent: agency x would be rewarded (by whatever means) both in terms of the degree of achievement of its objective, and also according to its success compared with other agencies.¹¹

The proposal for “rolling contracts” introducing new guarantee periods when the contract expires, seems to be a strictly technical issue about how to transfer existing contracts to departments. By way of contrast, the budget guarantee is a policy issue as it concerns the department’s commitment to the reform. The possibility of making the budget framework dependent on results is one possible way to strengthen the agency’s commitment. The objection regarding the information unavailable on the link between activity and cost-generated is not totally justified: it is true that there is an information imbalance against the principal on this point; using an appropriate technique of incentive-based contracting, such as contract menus or multilateral contracts, it is possible to overcome the barrier and obtain some of the hidden information. But is there a danger of budget overruns with a system of “rewards”?

In practice, it is possible to establish a link, in some cases a partial link not covering the entire budgetary framework, between inputs and results if a system of positive sanctions is adopted. Contract menus and multilateral contracts can normally smooth out cost overruns: the improvement in service efficiency and effectiveness should not be measured solely in relation to the cost of more motivating contracts, but should also be measured in terms of the gains deriving from the achievement of targets. Examples might include the increase in library revenue, museum attendance and productivity.

Transfer of experience

The little amount of interest shown by ministerial departments in using management contracts as a strategic control tool is due to the fact that the pilot stage was managed by another principal, the Ministry of Finance. In this sense, the proposal to transfer the role of principal to ministerial departments is likely to strengthen their commitment. However, there is still a risk that the departments’ sceptical attitude toward the reform, as a limitation on their freedom of action, could water down that commitment. It is therefore sensible for the Ministry of Finance to retain the role of advisor and promoter of the spirit of reform.

The forms of the Ministry of Finance’s involvement need to be clarified. As mentioned, negotiating contracts is very time-consuming and hence resource-intensive. Therefore, the Ministry of Finance has developed an “engineering” approach: preconditions for contracting (suitable types of activities, types of indicators), negotiation programme, forms of contracts, etc. What remains now is to organise the effective transfer of its administrative management capabilities to departments. As stated above, another possibility is to give the Ministry of Finance the additional role of arbitrating in the event

¹¹ A reform based on the idea of multilateral contracts has been developed in the low-cost housing sector in the Brussels-Capital Region in Belgium. For the general philosophy, see Drumaux A. (1995), “Contrats et incitants pour l’amélioration de la performance des entreprises publiques” in *Les Facteurs de performance de l’entreprise*, Paris, Aupelf-Uref, John Libbey, pp. 167-179.

of conflict over a contract: all the experiences with contracting have shown that the commitment of parties to the contract needs to be sustained.

The first experimental contracts have made it possible to define the types of agency that could operate under a form of contracting (ability to define measurable targets for all the agency's functions and tasks, precautions so as not to give excessive weight to quantitative targets, identification of the agency's action plan).

This lends extra weight to the proposal that the Ministry of Finance should retain an advisory function. Moreover, while the quality targets, whether concerning service quality, internal backup functions, user information or personnel policy, are naturally qualitative, they are not necessarily unquantifiable: frequency of breaks in service, dysfunctions, case handling time, percentage of complaints, internal and external satisfaction surveys, etc.

Standardisation of procedures

Contractualism is costly in terms of time and, therefore, resources. The possibility of standardising contracts is a solution in the case of agencies performing the same kinds of tasks. It may be more difficult to persuade agencies to agree to negotiate standard contracts. It should also be said that the benefits of better communications and mutual information during the negotiation process, highlighted in the report, could be diminished by contract standardisation.

A possible compromise solution would be to define a "common core" for contracts containing the objectives common to the agencies, with the possibility of adding a limited number of "made-to-measure" targets¹². The advantage of this solution is that it reduces costs while leaving room for negotiations -- without which a contract is not a contract. As mentioned above, multilateral contracts are a variant of this solution: these are contracts that are partly the same and contain payment mechanisms that bind agencies to each other. Not only does this save on the transaction costs of negotiations, but it also limits the built-in information advantage.

Some Key Elements for Contracting Practices

First and foremost, to be aware of the conflict between objectives aimed at improving productivity or achieving a quality target, and the aim of minimising the built-in advantage to the agent. The built-in advantage arises from a non-optimal commitment by the agent to achieve the objective, that allows the agent to derive a real surplus through a resource allocation that is too high for efficiency or effectiveness. Harsh treatment pays no dividends. Even when the contract includes a mechanism that rewards increased productivity, for example, an incentive mechanisms needs to be included based on the difference between predicted and achieved productivity gains.

¹² This solution was adopted for low-cost housing companies in the Brussels-Capital Region project mentioned above.

A good contract should reveal hidden information. Instead of a single contract, the principal may propose a menu of contracts involving different levels of coverage of costs and commitments. By choosing one of these contracts, the agent in fact reveals the level of commitment that the agent actually can and wants to envisage. The multilateral contract is another solution through which information is revealed by comparing between different agencies performing similar tasks.

Adverse selection and moral hazard inevitably lead to a loss of control by the principal. To reduce the information imbalance, the principal may supplement the control system with external audit procedures. Likewise, parallel contracting with different agents can be an appreciable source of information (yardstick competition).

In order to strengthen the level of commitment, it is preferable to limit the possibility of renegotiating active contracts. To provide contractual security, a third-party authority should be nominated beforehand to intervene in the event of conflict.