

Performance Contract: Concept and Rationale

Performance Contract (PC) is attracting a lot of attention in discussions on the reform of public enterprises in developing countries. By its very name, PC is a prelude to the evaluation of performance. In normal circumstances, the evaluation of enterprise performance is made with reference to its Annual Statement of Accounts. If an enterprise gives rise to certain benefits or costs which are not captured in the statement of accounts, they are mentioned in the Annual Reports of the companies. What is the need then for PC?

The concept of a PC and its rationale varies from country to country. PC is a contract between the owner of an enterprise on the one side and the management of the enterprise on the other, setting out certain targets/results to be achieved in a given time frame. It also enumerates the mutual obligations of the two parties in achieving the targets set in the contract. Such contracts have been called by different names, such as, Contract de Performance, Memorandum of Understanding and so on.

The widely accepted rationale for PC is that public enterprises have got multiple objectives and multiple principals. These fussy objectives lead to, or are an alibi for, poor financial performance in many cases. One view is that because public enterprises (PEs) are required to carry out several functions they are unable to do any one of them very well. The other is that while a PE might have done well in achieving many of the objectives, its performance may be judged with reference to one objective in which it has not done well. A PC would remedy the situation of multiple objectives by listing the preferred objectives which the owner (government) would like the PE to achieve. It would remedy the multiplicity of principals by forcing one agency to sign on behalf of all of them.

Other reasons for advocating the PC include:

- a) The strong persuasive influence of the International Financial Agencies (IFAs) and several bilateral agencies who advocate the PC system as an important element of the reforms in the PE sector. IFAs have emphasised this because of routine interference of government in the day-to-day operations of the enterprises, and such interference has not encouraged productivity.

- b) PEs may have to pursue certain social goals and such pursuits may affect the financial results of the operations of the PE. Therefore, a prior understanding of the extent to which financial results can be traded off against social objectives to be achieved by a PE through a PC would help to clarify PE objectives.
- c) Several PEs, on the basis of current operations, could be recording losses but such balance sheet results alone would not indicate the effort put in and the success achieved by the management of the PEs in improving their operations. If a PC target for the year is to reduce loss from the level of previous years, the achievement of such a target should win commendation, boost the morale of the current management and spur them on to better performance.

BOX 1.1: The Role of Performance Contract in Ghana

The performance contract system constitutes a major element in Ghana's public enterprise reform programme. The system incorporates two main elements – the corporate plan and a performance contract, linked in an annual cycle of monitoring and evaluation activity. Each state-owned enterprise (SOE) participating in the system is required to prepare and update regularly a comprehensive corporate plan. The implementation of this plan is disciplined by means of a negotiated contract agreement which sets annual performance targets and is monitored on a quarterly basis.

The Planning, Monitoring and Evaluation (PME) system for updating the corporate plan, negotiating annual performance objectives and targets, followed by quarterly reporting and annual evaluation has come to be accepted as a useful framework for managing the interface between Government and enterprise. An annual cycle of activity now links supervising ministry and enterprise with the State Enterprises Commission and the Ministry of Finance and Economic Planning in the setting of performance objectives for core public enterprises. This contribution is of particular significance in Ghana's case, restoring discipline to a system of SOE governance that had lost both credibility and effectiveness during nearly ten years of enterprise self-management by a committee of its employees.

Source: W.A.Adda, Performance Contracts in Ghana: A Case Study. Prepared for the Commonwealth Secretariat, London 1994, p.1

In the recent PE reform literature, PC is also advocated as a mechanism to smooth the PE-Government interface and increase the autonomy of PEs. The view is that the PC system forces government to set out what it expects from the PE at the beginning of the year and should therefore, discourage the tendency to interfere in its day-to-day operations during the year. Also, PC forces the PE to set out its

requirements of assistance from the government at the beginning of the year. This should discourage the PE from requesting unnecessary assistance during the year.

PC has also been advocated as an alternative to privatisation of PEs – especially in the case of those PEs which are financially viable. The financial benefit expected by divestment of shares could be set out in ‘flow terms’ in the PC as the agreed financial targets. This view has been opposed by some scholars who suggest that developing countries with a large public debt should privatise the profitable PEs without significant public interest and use the cash revenue to reduce the debt. Some have also pointed out that the introduction of the PC system may be a prelude to privatisation, as it might reduce the accumulated losses of the PE and improve its overall image in the market.

BOX 1.2: Performance Contract as a Tool of Commercialisation Programme in Nigeria

As a tool of the commercialisation programme, performance contracts are expected to instil an attitude of accountability within the PEs and govern the relationship between Government and the PE management. The system will:

- (a) help formalise the corporate plan and mutual obligations of the PE and the Government;
- (b) require PEs to strictly adhere to well-defined performance objectives and targets under performance contracts;
- (c) help measure the performance of PEs against these targets in a transparent and systematic manner; and
- (d) provide appropriate monetary rewards and penalties to induce management to achieve the agreed goals, including adjustments in the financial support from the Government.

Source: Technical Committee for Privatisation and Commercialisation (TCPC) "Framework for Commercialisation", The Presidency, Lagos, 1993, p.3

Types of Performance Contracts

Performance Contracts are referred to by various names in different countries. The most popular terms include: Performance Contracts, Contract Plan, Contract De Programme, Letter of Agreement, Performance Agreement and Memorandum of Understanding.

There is a general consensus that there are only *two* main types of contract and all other arrangements fall under one or the other. These two systems are commonly known as:

- a) The French-Based System; and
- b) The Signalling System – which originated in Pakistan and Korea.

The main difference between the two is that the typical French Contract Plans do not allocate weights (and point calibrations) to targets. Thus there is no distinction between targets in terms of emphasis (by weighing them differently) and as such, performance evaluation is affected by a high degree of subjectivity. This system is practised in France, Africa (e.g. Senegal, Benin and Morocco) and Latin America.

The Signalling System is popular in Asia (e.g. Pakistan, South Korea and Bangladesh), Africa (e.g. Ghana, Nigeria and The Gambia) and Latin America. It should be noted that both systems may be practised concurrently in the same country such as the case in India where the initial Memoranda of Understanding (MOUs) were based on the French System, while those signed more recently follow the Signalling System.

Pakistan's signalling system is based on the principle that given the capital stock in hand, how best can the management make use of it. The system aims at motivating management to maximise return on the sunk capital. To attain this objective, attempt is made to evolve a primary criterion of evaluation which reflects the improvement in real productivity which in turn leads to an increase in socially relevant profit (as against privately relevant profit). A PC is signed at the beginning of the year in which management is committed to improvement in real profitability. At the end of the year, and based on a comprehensive evaluation system, the management is awarded a performance bonus which is determined by the improvement in real performance. Thus Pakistan's signalling system is based on the principle that public enterprise management should be appropriately guided to aim at improving real productivity and its efforts should be acknowledged and rewarded by an incentive system.

The parties involved in the contract system do vary, both in number and role, from country to country. In Senegal for instance, the contract is signed by the Prime Minister in the Presidency, the Sectoral Minister, the Minister of Economy and Finance, and the Managing Director. In Nigeria, contracts are signed by a representative of the Federal Government with the Board of Directors *and* management; in Ghana contracts are signed by management and board with the State Enterprises Commission (SEC) also signing as witness to the agreement. In India MOUs are signed by Managing Directors and Line Ministries (represented by

Secretaries of States). In The Gambia, the contracts are signed rather uniquely by H. E. The President and management. In Pakistan, the Experts' Advisory Cell – an independent technical agency with the Ministry of Industries and Production negotiates targets on behalf of the Government with the Chief Executives of Enterprises.

BOX 1.3: The Concept of PC

During the past few decades, improving efficiency in the Public Sector Enterprises has been a challenge confronted by various countries. In order to attain this objective, a number of organisational devices and management systems were tailored conforming to the specific requirement of public enterprise management. The concept of the performance contract system was originated in the late 1960s by Simon Nora to improve the public sector enterprises in France. This system was generally known as "**CONTRA PLAN**" though adopted by several enterprises outside France suffered from a number of difficulties. The development of the signalling system in the early 1980s was a major step forward in evolving the performance contract system. The system addressed some of the complex technical issues of evaluating real performance of public enterprise managers. The system was pioneered in the early 1980s almost simultaneously in Pakistan and South Korea. Since then it has been adopted in various modified forms by a number of countries.

Source: Istaqbal Mehdi, Signalling Systems for PEs: A Case Study of Pakistan. Prepared for the Commonwealth Secretariat, London 1994, p 1.

The few number of signatories to the Contract in the Gambia, and more importantly, the involvement of the head of government, is generally accepted to have increased accountability and improved credibility which have helped to streamline communication between PEs and government. Furthermore, there is a high level of political commitment where the Head of State personally signs the contracts. However, another school of thought has argued that line ministries and the Board of Directors, as interested parties, are likely to be more committed to their crucial roles where they are signatories to the contract.

The introduction of a PC in any country requires the preparation of a document and the signing of such a document which will constitute a contract between the parties to the agreement. Contract documents, while they have many contents in common, differ greatly in details. The contractual document can vary considerably in length (from a short "letter of mission" to an extensive "programme contract" incorporating multi-year plans and budgets), depending on the availability of data on past performance, operating norms, future investment/rehabilitation needs and the specificity of objectives. A performance contract differs from a Memorandum of

Understanding in that the PC is a precise document which specifies objectives and targets, and secures the commitment of enterprise management and government.

It has been suggested that the Gambian and Senegalese documents are the most voluminous, while India's MOUs and the Pakistan's Signalling Systems use forms that are considered relatively simple. It is believed that detailed documents run counter to the autonomy objectives which is implicit in the PC system. In the next chapter, we shall examine in greater detail, the development of the PC system in selected countries.