

The Development of the Performance Contract System

The PC system has a fairly long history and has been tried out in a number of countries. In each country, the content of the PC, the procedures of finalising it and the institutional arrangements for the PC system have been influenced by the needs of the country and the prevailing environmental conditions in that country.

The PC system originated in France in the late 1960s. It was later developed with a great deal of elaboration in Pakistan and Korea as 'a signalling system' and was introduced in India in 1986/87. With the World Bank's approval of the PC system as one of the principal measures of reform for the PEs, it has been adopted in a number of developing countries in Africa, including Nigeria, The Gambia and Ghana. Attempts to adopt it have also been made in Sri Lanka, Bangladesh and Venezuela among others. Both Pakistan and South Korea have used the system extensively.

BOX 2.1: Evolution of MOU in India

Performance Contracts for Public Sector Units are known as MOUs (Memorandum of Understanding) in India. The MOU is rooted in an evaluation system which not only looks at performance comprehensively, i.e. at both commercial and non-commercial criteria of performance in their static and dynamic aspects, but also ensures and forces improvement of performance of managements and industries by making the autonomy and accountability aspects clearer and more transparent. It is an annual document which is an intrinsic part of a long-term corporate plan in which the government (represented by the Secretary in the line ministry) and the public enterprise (represented by its CEO) lay down their mutual obligations and responsibilities, based on the missions and objectives of public investment, and after mutual negotiations. The idea is to choose appropriate criteria, assign mutually acceptable priorities to them and decide at the beginning of the year how the achievement of targets (and deviations therefrom) are to be evaluated. The crux of the evaluation system is to set the evaluation parameters in advance and before the actual performance is delivered. Further, the process of negotiation is assisted by an objective third body which finally evaluates the performance also importing complete objectivity into the system.

SOURCE: Suresh Kumar, Performance Contracts: An Indian Case Study. Prepared for the Commonwealth Secretariat, London 1994, p.2

France : Contract de Performance

The French experiment in the late 1960s was initiated with the primary objective of reducing the government budgetary support to the public enterprises. It was called 'contract de performance' and was based on a report of a committee headed by Mr Simon Nora. It was intended as a mutually agreed contract between the government and selected public enterprises which had a high level of public purpose, to plan activities jointly and to establish reciprocal commitments on the part of the government and public enterprise.

In the first year, only two contracts were signed, one with the French State Railways, **SNCF** and the other with the French State Electricity Agency, **EDF**. In fixing the targets for price and profitability and other indicators of efficiency, both parties agreed that these were subject to certain factors (e.g. economic variables like GDP, inflation rates, fuel prices, foreign exchange rates etc.). The agreement, therefore, provided that when these assumptions changed, the targets could be re-opened for mutual discussion and further modifications. The contract was for a period of five years. The first contract for five years with EDF was subjected to four changes.¹

The contract provided for certain investments in the growth of the public enterprises and the government budgetary support for that growth was fixed. It was agreed that the prices of the goods or services produced by the PE could be adjusted without prior government approval to cover variable costs and two thirds of the financial needs on the new investments. The indicators of performance were few. The contract fixed the long-term policies and goals, and specified clearly that the company did not need to come to the government for price increases as long as their achieved operational efficiency was in accordance with the terms of agreement. It proceeded well, during the initial years, but with the 1973 oil crisis, most of the macro-economic assumptions were thrown overboard and the government went back on the agreement; the government did not allow companies to increase prices as per the PC. The EDF contract was not renewed, while that of the railways was renewed for only two years.

The second round of contracts was initiated in 1978-79 with four enterprises. The duration was reduced to three years to ensure better appreciation of the economic environment that might affect enterprise operations. But in 1981 when the socialist party came to power, these contracts were subjected to rough weather and only the contract with Air France was operational because it was in a globally competitive

¹J Sridhar Sharma – "The Enterprise Contract System in PE Management: the French Experience " Journal of Institute of Public Enterprise", Hyderabad, December,1982.

environment. These experiences have somehow dampened the French enthusiasm for performance contracts.

In the French experiment, the institutional arrangement was quite simple. The administrative machinery monitoring the public enterprise formed a committee which included all other ministries involved in the activities of the public enterprise. The public enterprise also formed a Committee of the Board of Directors who would constantly monitor negotiations, with the CEO as the chief negotiating agent. There was a constant flow of information on the negotiations to the board of directors, the executives and workers. Due to the information asymmetry between the government and enterprise, there were long delays in negotiations and some of the contracts took two years to negotiate and finalise.²

In addition, the French system did not introduce any special rewards for achieving the targets nor penalties for non-fulfilment of the terms of the contract.

Korea : The Signalling System

The next major experiment in the PC system was in Korea. In the early Eighties, Korea had few public enterprises but they were very important for the development of the national economy. There were four departmental enterprises called Government Enterprise (**GE**), namely rail, road, postal services and grain management departments. There were also 24 Government Investment Enterprises (**GIE**) in which government had more than 50% equity. Important among these are: Korean Equity Corporation, KEMPCO and Korean Telecommunication Authority. These GIEs also had 67 subsidiaries. The GIEs and their subsidiaries were yielding a much lower return than similar companies in the private sector. This problem was examined in detail by the Korean Development Institute which proposed a package of enterprise reforms, including suggestions for a complete realignment of the Government-PE interface. The Institute proposed special legislation setting out the relationship between the PEs and government, and spelt out the details of the PC system to be organised in the Act itself.

The PC system was to consist of three parts:

- (i) Performance Information System
- (ii) Performance Evaluation System

² Nellis, John (1988), Contract Plans and Public Enterprise Performance, Working Papers Country Economics Department, Washington, DC, The World Bank.

(iii) Performance Incentive System

The Government accepted all the recommendations and implemented them as detailed hereunder.

Public Enterprise – Government relations were defined under an Act of Parliament, called ‘Government Invested Enterprise (GIE) Management Act of 1984’. The Act sets out clearly the provisions which guarantee autonomy to GIEs. The Act defined in general terms what the Government would do for all public enterprises in Korea, leaving the negotiated PCs to define only what is expected from each of the public enterprises by Government and the people.

The centrepiece of the Korean PC system is the Management Evaluation Council (MEC). The new Act (G.I.E. Management Act of 1984) defines the functions of the MEC as follows:

- i) formulation of general guidelines for the draft preparation of management objectives of GIEs;
- ii) establishment and co-ordination of management objectives of GIEs;
- iii) formulation of common guidelines for the budget preparation of GIEs;
- iv) evaluation of the managerial performance of GIEs;
- v) other matters concerning the management of GIEs as determined by Presidential Decree.

With regard to the evaluation of management performance, the MEC, with the help of the Ad Hoc Task Force and other agencies, formulates the performance evaluation criteria and target values, decides the incentive bonus rates for GIEs based on performance evaluation results, and may suggest the dismissal of officers of GIEs for poor management.

MEC is assisted by the performance information system which collects the broad data and historical working of the company as well as information relating to similar industries elsewhere.

The incentives for the GIEs are based on the score gained by the GIE. The Korean PC system is based on the firm belief that unless performance evaluation leads to some rewards and penalties, the incentive system will have no teeth.

Analysis

The Korean Performance Contract System has several merits. It was introduced as part of a total reform package in which several elements of operational autonomy were given to PEs. It was introduced through an Act of Parliament and the Act confers several powers on PEs and clarifies what PEs can expect from government.

It gets the commitment of the political executive by having the Minister of Economic Planning on the Management Evaluation Council, and by involving ten other concerned ministers within this Council. The presence of the ministers makes it possible to attract the highest level of academic and industrial talent to serve on the Council. The Korean Development Institute, which has been deeply involved in academic studies on the functioning of the Korean economy as a whole and public enterprise in particular, has not only designed the Performance Appraisal System but is providing information support. It has become possible, therefore, to obtain objective advice on matters relating to the fixing of criterion values. The fact that the results of the evaluation have a direct bearing on the rewards given to public enterprise (both the executive and the workers within it) has created an evaluation system of great importance to public enterprise. There is a great deal of seriousness attached to the whole exercise, from the top political executives to the workers of PEs.

The Korean PC system also ensures that workers are involved in the whole exercise and are committed to the target fixed by the MEC. Performance Evaluation starts with a Self-Evaluation Report by the PE and during the course of evaluation, written comments and complaints can be submitted to the Task Force.

These arrangements are possible because the number of PEs which are subject to evaluation under the system is quite limited. The performance of PEs has improved significantly.

Pakistan: Signalling System

Pakistan's signalling system was established essentially to improve the operational efficiency of public industrial enterprises. Until the late 1970s, these enterprises were characterised by a combination of adverse financial and operational features, i.e. declining profitability leading to weak financial structures, imbalanced debt equity ratios and inefficient asset usage, etc. In the early 1980s, the Government entrusted the task of new investments to the private sector and the public sector was expected to improve its operational efficiency.

BOX 2.2: Evolution of the Signalling System in Pakistan

During 1981, in order to improve operational efficiency of the public industrial sector under the Ministry of Production, the Government decided to set up the Signalling System for Public Enterprises. In November 1981, the Experts Advisory Cell (EAC) was given the responsibility of setting up the project. The project has three components:

- (i) A performance information system to measure accurately actual behaviour.
- (ii) A performance evaluation system to specify socially desirable behaviour.
- (iii) An incentive system to reward or penalise managers for their actual performance at the end of the period, i.e. one year.

The development of the system took about three years. During this process major efforts were made to evolve a performance information system. In 1983 the Government approved the operation of the system but after significantly modifying the original proposal.

The Signalling system originally envisaged that social profitability, known as public profitability, should be the primary indicator of performance. Public profits are private profits adjusted for those elements not deemed relevant to a PE. For example, taxes and interest which are private costs but public benefits, are excluded so as not to encourage PE managers to devote to minimise taxes or interest arbitrage. In other words, public profitability aims at encouraging managers to maximise net economic benefits judged from the national perspective. However, in approving the signalling system, private profitability instead of proposed public profitability at constant prices, was kept as the primary criterion of evaluation. The task of incorporating improvement in productivity in this criterion was left to the professional in the Cell.

Source: I. Mehdi, op.cit, p.3

Following this policy as a first step, several re-organisation measures were adopted to streamline the organisational structure of this sector. At the completion of the exercise, a fairly smooth control structure emerged. In this new structure, about 70 manufacturing enterprises were controlled by the administrative ministry through eight holding corporations. Since, in this organisational set up, the ministry was operating like a head office of a large industrial conglomerate, an independent technical unit, i.e. the Experts' Advisory Cell (EAC) was created to assist the ministry in performing this function. The need for this unit was felt, since the ministry run by civil servants was not equipped with the expertise required for the new function.

One of the first tasks of the cell was to identify ways and means of improving the performance of public enterprises. It was identified that there was a need for setting up institutional arrangements to guide and evaluate performance of managers so that they could also be rewarded for good performance. It was against this background that the signalling project was developed at EAC.

The Gambia

The performance contract system for public enterprises was introduced in The Gambia in 1987. As a prelude to identifying those PEs to come under the PC system, the PE sector was divided into three schedules:

- (i) enterprises in which government is a minority shareholder;
- (ii) enterprises in which government is a majority shareholder, or has 100% shareholding; and
- (iii) strategic corporation/departments.

Only PEs under schedule three were identified as suitable candidates for performance contracts. Under the first phase in 1987, performance contracts were developed for three PEs only. Under the second phase in 1990, performance contracts were developed for another three PEs. It was envisaged that contracts for the third phase would be consummated in 1994 for yet another three PEs.

The contracts were executed for a period of three years, and were signed by His Excellency the President on behalf of the Government, and by the Managing Director on behalf of the enterprise.

The PC system involves the following steps:

- definition of enterprise objectives;
- identification of the commercial and non-commercial activities of the enterprise;
- development of the mechanism for reimbursement of non-commercial/social services;
- selection of performance indicators and fixing of targets for a particular year;
- determination of management incentive/sanctions scheme;

- execution of the performance contract;
- monitoring of contract compliance;
- performance evaluation on a quarterly (now bi-annually) and yearly basis;
- award of management (bonus) or sanction.