

3

Institutional Arrangements

The institutional arrangements for performance contracting depend on the environmental conditions in which the PC is introduced, the elements which go into the PC and the process that is adopted for drawing up and evaluating contracts. In short, institutional arrangements for any PC system depend on:

- environmental factors;
- content of the contracts;
- the number of agencies to which the PE is accountable; and
- the process.

The structure of the institutional arrangements and the process of the PC system are closely inter-related and one influences the other.

The environmental conditions in which the PC system is introduced may vary from a highly centralised, authoritarian administrative system to a highly decentralised, democratic form of governance. The PC system may be introduced in a country with a parliamentary form of government where ministerial responsibility is to a large number of parliament members or in a country with a presidential or autocratic form of governance where accountability at a higher level is to one person only. The institutional arrangements for the PC system would vary in both cases.

If a PC system is introduced in a country susceptible to high inflation or other changes in the macro-economic variables, the institutional arrangements should include a machinery, independent of the parties to the PC, which could compute the extent to which the achievement differed from the contracted figures, due to the impact of the unexpected variations in the macro-variables and for reasons beyond the control of the PE management.

If the country where the PC system is introduced has a regular planning process with periodic plans, e.g. five-year plans, the institutional arrangements should ensure that the targets and strategy for PE negotiated under the PC system are in line with the targets and overall strategy of the country's development plans.

The institutional arrangements would depend on a number of persons/agencies to whom a public enterprise is accountable. It is well known that PEs in general have multiple principals as well as multiple objectives. The administrative ministry concerned with the PE and the Ministry/Department of Public Enterprises are directly linked to PEs. But, on many matters, PEs have to take the permission and sanctions of the Ministry of Finance, especially the department dealing with economic/foreign exchange matters. In many countries, the Prime Minister's Office or the President's Office is the centre of power which controls all organisations of government, including PEs. Several strategic decisions of the PEs have to go the Cabinet. Needless to say, parliament has a very important role, both in defining the role of a PE as well as in evaluating its performance. Since the minister is directly responsible to parliament, he cannot be kept out of the institutional arrangements. Increasingly, in developing countries, ministers have been taking on the attitude and behaviour of the owners of the public enterprises – though their 'ownership' is described as "holding in trust on behalf of the people". The proprietorial attitude of the minister concerned would suggest that institutional arrangements should include the minister at the centre of PC system.

Institutional arrangements also depend on the nature of the contract, i.e. the details in which the performance targets relating to productivity and profitability are spelt out and the indicators used to capture the efficiency of the static and dynamic performance. Normally, the contract is signed by the PE Chief Executive and the Secretary of the administrative ministry. Admittedly, the PE has less powers than the ministry but the PE would have more information about the technical and commercial operations of the sector in which the PE operates than the administrative ministry. If elaborate indicators are used in the PC, the information needed would include the business environment, industry structure (global and national level), the public reaction to the quality and price of the product, the competitors to the specific PE, their market position, the technological advances foreseen by the industry in the short run and in the long run. It is obvious that public enterprise would have more information on many of these aspects, than the ministry. As these pieces of information are relevant to their day-to-day work, PE would keep the information up to date. This information asymmetry is unavoidable. Outside PE, such information could, however, be available with scholars and academics, working in that particular sector. Institutional arrangements should, therefore, include a Performance Information System which would collect the information needed for fixing targets and for evaluation. It is important to emphasise that the Performance Information System is critical, both at the time the PC is being drawn up and the targets are being fixed, and subsequently for monitoring and evaluation purposes. Reliable and accurate data are vital to the success of the entire system.

BOX 3.1: Institutional Arrangements for PC in The Gambia

After the introduction of the performance contract system, the ultimate control and responsibility was taken over by the Office of the President, as His Excellency The President executed the contracts on behalf of the Government. The steering committees having representatives from line ministries, the Office of the President, National Investments Board (NIB) and the enterprises were formed. These committees were given the responsibility of approving the budgets, performance indicators/targets, performance evaluation and management incentive (bonus)/sanctions. The line ministries were expected to concentrate their efforts on the development of sectoral policies, objectives and the framework within which public enterprises were expected to operate.

Source: M.B.Njie, Performance Contract System in the Gambia. Prepared for the Commonwealth Secretariat, London 1994, p.6

The criteria which are adopted in finalising contracts between the government and public enterprise depend very much on these factors as well as the expectations of the government from the particular PE industry or from PEs in general. This may be a very simple system of specifying only the return on investments made, physical production levels and employment, or it may be a sophisticated system in which various factors relevant to the current performance as well as the sustained growth of the company are spelt out. But, irrespective of the degree of complexity of the PC system, there should be an attempt to ensure that the PC is finalised with clauses which are fair to the public enterprise and to the government. Consequently, an impartial agency should examine the past performance of the PE and the information on the specific industry obtained from the Performance Information System and determine the extent to which the achievements of the PE could be improved by the efforts of the management. This would constitute the Performance Evaluation System. The same agency would, at the end of the period of the contract, evaluate the actuals against targets and make allowance for deviation from expectations due to factors beyond the control of management.

There should be a high level agency/person to receive the performance evaluation report, consider the recommendations of PEs and decide on the rewards or penalties for good and poor performance. The scale of incentives and how they would be determined should be made known to all PEs concerned. This would constitute the Performance Incentive System.

It follows from the discussion above that a typical PC system should have three sub-systems:

- Performance Information System;

- Performance Evaluation System; and
- Performance Incentive System.

Under certain conditions, the Performance Evaluation System and Performance Incentive System may be merged into one. These three systems may be grafted onto existing institutions or separate agencies set up specifically to handle the tasks. The important point is that the agencies entrusted with the tasks of these sub-systems should be able to fulfil the roles expected of them.

Institutional arrangements for the PC system in selected countries

A brief study of the institutional arrangements for the PC system established in selected countries, viz France, Korea, and India, is useful for illustrative purposes at this stage.

France

In France, no separate institutional arrangements were set up for the formulation of "Contracts de programme". The French thought that it would be adequate for one committee to be set up representing the Government and negotiating the contract with a PE. The administrative ministry was to preside over the committee. Logically, several other ministries, such as the Ministry of Foreign Trade, the Ministry of Vocational Training, and the Ministry of Solidarity, would have to be on the committee. However, it was realised that if all the ministries affected by the performance of the PE were to be included in the committee, the committee would become too large and unwieldy to carry out the negotiations, which could be time-consuming and involve several meetings. This difficulty was overcome by having on the committee only representatives of the 'nodal' ministry which sets the policies for the particular sector in question, and representatives of the Ministry of State Planning (which represents all other ministries), and the Ministry of Economy, dealing with finance & economic affairs.

On the PE side, it was provided that the CEO should negotiate the contract, and report to the Directors of the Company. The constant flow of information to the Board of Directors enabled the Board, and through the Board executives and workers, to be involved in negotiations. The signed draft contract was transmitted to all parties in the PE involved in the negotiations.³

³ Yves Carsalade: "PE, State Plan and Managerial Autonomy -The French Experience" in Management and Role of PE. Indo-French Experience Ed. S.B. Jain Vol. I,

A shortcoming of the French System was that it did not provide for any correction of the information asymmetry between government and enterprises. The French Government was totally dependent on the enterprises for information which forms the basis for setting targets. This led to long delays in negotiating contracts (in some cases two years), and to specifying the targets in conditional terms. The conditionality led to frequent renegotiating of the contracts. Much of this could have been avoided if they had had a Performance Information System.⁴

While the contracts provided for mutual discussion and revision of targets, there were no sanctions in the event of either party not abiding by the provisions of contract. This is more so from the government side.⁵

Korea

The Korean PC system, based on the recommendations of the Korean Development Institute, consists of an Act of Parliament and three parts:

- Performance Information System;
- Performance Evaluation System;
- Performance Incentive System.

The extent to which government intervenes in PE affairs was defined for all PEs in the Act of Parliament called Government Invested Enterprises (GIE) Management Act of 1984. What should be done to the PE and what is expected of the PE was to be defined in the negotiated PC and these should be done in specific terms. The Act also provided for the broad outlines of PC system.

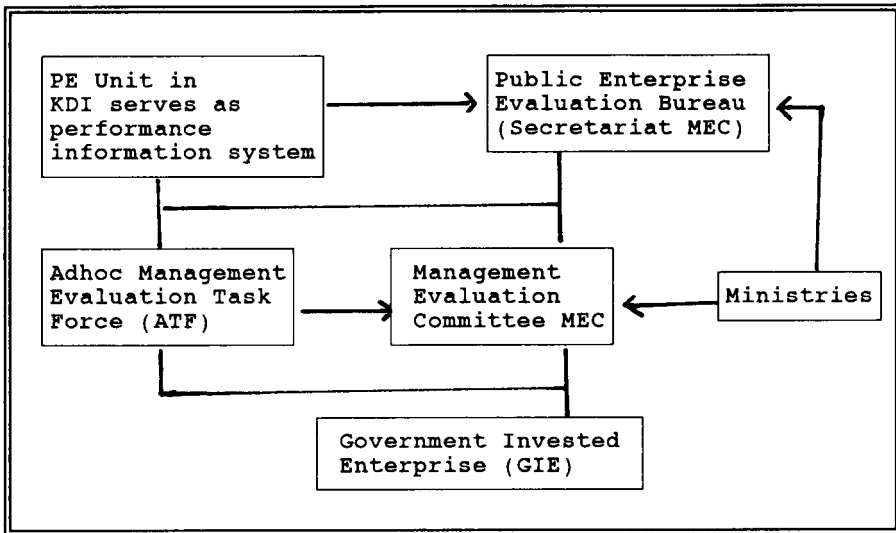
The Performance Contract System of Korea, often referred to as Signalling System, approved by the Government is set out in the figure that follows:

published by BPE, India in collaboration with SCOPE, Delhi 1986.

⁴ Prajapati Trivedi: Theory and Practice of the French System of Contracts, " Public Enterprise", 1988, Vol. 8. No.1.

⁵ Sridhar Sharma. Ibid.

The Performance Contract System of Korea



The performance evaluation is done through an institutional set up which evaluates the performance with reference to targets and criteria fixed using the Information System and the Task Forces which help in evolving the criteria for evaluation and other related details. Broadly, the evaluation responsibility was entrusted to a Management Evaluation Council (MEC) which takes all the decisions regarding co-ordinating the objectives of the GIEs, setting up of criteria for evaluation and criterion values etc. Apart from evaluating performance, MEC is supported by a secretariat which is called Public Enterprise Evaluation Bureau which is attached to the Economic Planning Board. This Evaluation Bureau is supported on the one hand by the relevant ministries who supply information obtained from government sources and also from departmental policies which might have a bearing on the evaluation of the PE. On the other hand, it is supported by an independent unit in the Korean Development Institute called the Public Enterprise Research Unit. The Bureau feeds the information into an Ad hoc Management Evaluation Task Force of experts which is set up to help the MEC. This serves as the Performance Information System.

The centre-piece of the Korean PC system is the MEC. The Act (G.I.E. Management Act of 1984) defines the functions of the MEC in detail 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 as a function of performance evaluation results, and may suggest the dismissal of officers of GIEs for poor management.

The Public Enterprise Evaluation Bureau works as the secretariat to the MEC and reports directly to the Chairman of the MEC. All the preparatory work and follow-up actions of the MEC, such as the selection of the Performance Evaluation Task Force members and the assignment of specific jobs to each Task Force member, are handled by the Bureau. The Bureau has to liaise with ten other ministries on matters concerning GIEs.

The role of the Performance Evaluation Task Force (an Ad Hoc Task Force) is to assist the MEC on professional and technical matters connected with performance evaluation. The major assignment of the Task Force is to draw up a performance evaluation manual of management guidelines and to evaluate the management performance according to the evaluation criteria of the manual. Members of the Task Force include professors in economics and business administration, senior staff from research institutes, certified public accountants and businessmen.

Analysis

The institutional arrangements for the Korean Performance Contract System has several merits. The PC system itself was introduced and is seen by PEs 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.

Institutional arrangements get the commitment of the political executive by keeping on the Management Evaluation Council (MEC), the Minister of Economic Planning and involving ten other concerned Ministers within the Council. The presence of the ministers on the Council 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 greatly involved in academic studies on the functioning of the Korean economy as a whole and the public enterprise in particular, has not

only designed the Performance Appraisal System but is providing support for it. It has become possible, therefore, to obtain objective advice on matters relating to the fixing targets and criterion values. The fact that the results of the evaluation have a direct bearing on the rewards given to the executive and workers of public enterprise has made evaluation system of great importance to the public enterprises. There is a great deal of seriousness attached to the whole exercise from the top political executive to the workers of PEs. In making any evaluation of the performance under the PE system, it becomes necessary to determine the extent to which the variation of the performance from the targets is due to reasons beyond the control of the public enterprise. The Korean Development Institute and the Minister on the MEC who deal with other developmental programmes in Korea are involved and are, therefore, in a position to identify these factors easily and their opinion is also accepted by all departments of government.

The Korean PE system also ensures that the 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 may be submitted to the Task Force.

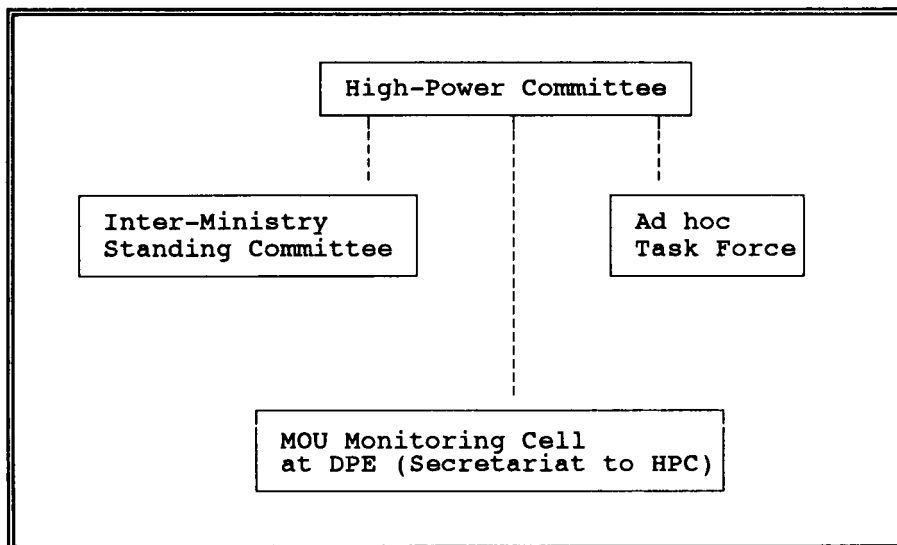
These arrangements were possible because the number of PEs subject to evaluation under the PC system were quite limited.

India

In India, the Performance Contract System is called the Memorandum of Understanding System (MOU System). The present institutional arrangements of the MOU system are set out in the diagram on the following page.

The MOU system is under the overall charge of the High Power Committee (HPC). This committee, which is chaired by the Cabinet secretary, consists of those secretaries who do not sign a MOU themselves but are concerned with the various aspects of the work of the public sector. It is set up as a third party to judge and evaluate the performance of PEs and their concerned departments in a fair, objective and unbiased manner.

The HPC is assisted by an Inter-Ministry Standing Committee (IMSC). This committee is under the chairmanship of the Secretary (PE) and consists of members from the Planning Commission, the Department of Economic Affairs, the Department of Programme Implementation and the Department of Public Enterprise. It is constituted to monitor and evaluate the MOUs at the first stage, when received from the Ad Hoc Task Force for the consideration of the HPC, and to maintain a continuous link between these entities. It is an executive committee. The actual



negotiations on targets and PC clauses are done by the Ad Hoc Task Force (ATF). It consists of independent experts such as eminent management experts, ex-chief executives, chartered accountants, academicians and economists. This group of independent experts is expected to bring in a high level of expertise and also credibility to the design and evaluation of the MOUs.

MOU-Monitoring Cell

The Secretariat of the whole MOU System is the MOU-Monitoring Cell in the Department of PEs. It is the nodal point in the Department of Public Enterprises constituted for co-ordinating all the activities relating to the design, drafting, finalisation, monitoring and evaluation of the MOUs. It acts as the secretariat to the HPC and services the Standing Committee and the ATF.

The current institutional arrangements in India were designed after a careful study of the Korean PC system. The merits claimed for it are that it:

- ensures commitment from the highest level, i.e. the HPC, an apex body chaired by the Cabinet Secretary;
- enables objective third party evaluation, i.e. the independent third party (ATF) introduces an objectivity into the whole exercise as ATF members are neither a part of the PE nor the Government;

- provides a high level of expertise (ATF) and ensures a professional approach to the examination of MOUs and performance evaluation at the end of the year;
- creates a perfect buffer between HPC & ATF through inter-ministry Standing Committee to ensure a smooth two-way flow of information.

Analysis

The major difference in the system adopted in other countries and in India is the number of PEs covered under the Indian MOU system. It started with about 14 and now within four years, over 110 PEs are covered. It is proposed to cover over 200 PEs in the years to come. Furthermore, MOUs are signed on an annual basis. The large numbers and frequency have made the MOU negotiations highly routinised, as adequate time is not available for the deliberation of the issues concerned.

The Korean system was based on the recommendations of a very influential research institute and was introduced as part of a comprehensive PE reform package which was considered by Parliament which passed an Act approving the comprehensive package.⁶ On the other hand, the Indian system is a partial reform to correct the PE-government interface and has not received the strong support of Parliament as in the Korean case. Another important difference lies in the political will which backs up the two systems. The MEC in Korea is presided over by the Vice-Prime Minister and includes nine other ministers, while the Indian counterpart, a High Power Committee (HPC) is headed by the Cabinet Secretary, (no doubt the most senior civil servant but not the same as a political executive). A number of cases have already come to notice where the assurances given by the 'government' through the PC by the administrative ministry have not been fulfilled by the other departments.

The other major difference is that the Korean evaluation system would directly lead to the distribution of rewards to workers and executives of the enterprise concerned, in a graded manner according to performance. The Indian MOU system only leads to an award (not a cash dividend) to the best performing enterprise based on the

⁶Song, Dae Hee, "A New Performance Evaluation System of Korean Enterprises", Public Enterprise, Vol. 8, No.1, 1988, pp. 84-92.

composite score. Even then, the enterprise which gets the award does not give any monetary benefit to the executives or workers.⁷

Lessons from the review of country experiences

From the foregoing review of experiences with the use of the PC system, the following observations and suggestions could be made. A PC, even though contracted between PE and the administrative ministry of the government, is best negotiated under the guidance of an independent agency. Nowadays, in most of countries, there are nodal agencies or departments of government in charge of PEs. Such a department or agency can be used as the nucleus of the PC system for that country. While such an agency/department can provide secretarial assistance, the essence of the PC system should be a Performance Evaluation Committee or Council. In order to give it proper political backing, it should be headed by the minister in charge of PEs or in charge of planning, or the minister in the Prime Minister's Office or in the finance ministry, nominated by the Prime Minister or the President of the country. Other members of the Council should be the most senior secretaries in charge of the Cabinet, finance, PE, planning and in the important administrative ministries which deal mostly with PEs, i.e. the Department of Industry. In addition, one or two ministers selected from among these ministries could also be members. This should be treated as a senior committee whose function is only to give guidance and to record the performance.

In order to evaluate the performance and to study and fix the targets which are to be included in the criteria in each individual PE, there should be another junior body consisting of experts and working on a part-time basis. Depending on the number of PEs which are to be brought into the PE system, this group of experts could be one or several. These may be called PC teams or task forces and for best results its members should be drawn from academia, the corporate sector and include former civil servants and public and private enterprise executives. The number of teams/task forces would have to be decided with reference to the number of PEs to be covered under the PC system. A team or task force can deal effectively with about six PEs. It is also necessary that widely divergent PEs are not placed under one task force. If there are a number of mining industries in the public sector, a task force exclusively for the mining industry may be appropriate.

The task forces as well as the performance evaluation council should be serviced by a performance information system. This should be set up as a new division

⁷Sankar, T L., MOU: The Wrong End of the Stick, The Journal of the Institute of Public Enterprises, Hyderabad, Vol. 13, No. 2, 1990.

within the planning department or the department of PE. The best arrangement would be to contract out the service to an academic institution within the country.

The work of the PC system should be made manageable by reducing the number of PCs covered by the system. Usually a question is raised as to how to reduce the number of PEs to be covered by the PC system, especially where the country has a large number of PEs. This is not difficult. First, PCs which have no public purpose or functioning under competitive market conditions should be given to a competent board of management and allowed to function in competition with other private enterprises in the same sector. The profits shown in the balance sheet could be a good indicator of the performance. If the country is undertaking liberalisation or divestiture, such enterprises (without public purpose) could be chosen for at least partial divestiture. If it is partially divested, the price variations of the shares of these enterprises on the stock market under normal conditions could be taken as a good indicator of performance.

PEs which are subjected to a PC system should be limited to a few enterprises whose performance could not be judged purely on the basis of the annual financial accounts. The criteria of evaluation to be included in the PC system should be few, while long and complex discussions on criteria and weightages could be avoided if meaningful and widely agreed typology of PEs is developed, and criteria/weightages are fixed for each type accordingly. The criteria should be easily understandable and quantifiable.

The PC system should provide an opportunity for the negotiator, on behalf of the PE, to detail the Board of Directors, select a group of workers and executives, and get their acceptance or views before referring back to the PC system for further negotiations or for signing the contract.

There should be a vital linkage between the performance efficiency as evolved under the PC system and the rewards and penalties imposed on the executives and workers. The incentive system should be fair to all PEs and to the government and should be well understood by all, including the general public.

If there are major changes in the macro-economic environment during the period of the contract to an extent which was not anticipated at the time of signing the contract, the PC system should provide for procedures and principles for correcting the achieved performance with reference to the changes in macro-economic environment.

Box 3.2: Lessons from the Bangladesh Experiment with PC

In Bangladesh the experiment of design, development and implementation of performance contracts is the first action-research project of its kind. The main purpose of the experiment was to ascertain whether the methodology that proved most effective in other countries could be implemented in Bangladesh and if so, in what shape. The experimental application of the system in 20 PEs over the last eight years has revealed the following:

1. In a situation where political linkage of the ruling party flows to the PE managers, staff unions and down to the labour leaders, the implementation of a goal-oriented performance scheme is a difficult task. Especially in a corporate culture where workers, employee and officers all have the tendency to gain more through political linkages other than working hard, it is difficult to earn confidence for such systems.
2. The institutional structure planned for implementing the contracts could not establish its due footing. In the absence of any clear decision from the controlling ministry, other ministries and corporation officials involved in the process were not adequately enthusiastic. The Cell had limitations of manpower, both in terms of number and skill to handle a large number of contracts. The Task Force, planned for developing goals, objectives and strategy with the help of technocrats, could not function.
3. In the absence of appropriate institutional support, the Monitoring Cell of the finance ministry had to take up the role of supreme authority for implementing/applying the contracts. The finance ministry, being at the parallel position with other ministries, did not have the full authority to instruct the supervising ministries. Whatever support it had was by virtue of its authority to approve the PE annual budgets.
4. As the contracts are technical in nature and the personnel implementing them are of limited management qualifications and background, the fewer the number of criteria, the less complicated the exercise will be.
5. Any reform measure, to be effective, must be acceptability to those who are involved in the implementation process. In an environment where the implementors are inadequately educated in the field of modern management techniques and are prone towards controlling the PEs, the need for attitudinal change is of utmost importance.
7. The whole process of formulating clear goals and objectives, strategic planning, target-setting and achievement of the targets, provides better appreciation of the problem of PEs. This served as a good vehicle for management development by providing effective training to personnel who do not have the appropriate management background. The process of preparing the contract – through analysing, discussing and inter-

organisational communication, was as valuable as the end-product of the exercise (i.e. the contract).

8. If any of the parties involved in the contract are having goal incongruent behaviour, the whole exercise becomes ineffective. To cite an example, one of the contracts handled by the Monitoring Cell was involved in a second PE that was the sole purchaser of its output. Due to the conflicting interests of some of the senior officials in the second PE, the management of both the PEs could not be brought to agree on this criteria and an account of the conflict, the contract was abandoned.

Source: M.A.K. Mazumdar, Performance Contracts in Bangladesh. Prepared for the Commonwealth Secretariat, London 1994, p.16 & 17