Enterprise Contracts: A Route to Reform?

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Changing the relationship between government and the managers of state-owned enterprises is key to improving enterprises' performance. Enterprise contracts can accomplish this, but only under certain conditions.

DESPITE more than a decade of divestiture and reform, many developing countries continue to have large, poorly performing state-owned enterprises (SOEs) that contribute to fiscal deficits and slow growth. In response, most governments are searching for ways to enhance efficiency and reduce their fiscal burdens. These efforts include rewriting the contract between the government and the firm by changing the explicit or implicit agreement between the government and the enterprise management (or owner, in the case of privatized firms) based on shared expectations about obligations and outcomes. These contracts are often written, although they need not be, and even when contracts are written, crucial provisions affecting incentives are frequently only implicit.

What distinguishes successful from unsuccessful contracts? Contracts are successful when they effectively address three problems: information, rewards and penalties, and commitment. *Information* problems arise because contracting agents (government, on the one hand, and public or private managers or owners of a monopoly, on the other) have different sets of information. Thus, each side can use the information it holds exclusively to improve its position at the expense of the other. Competition is one way that governments can muster more information about managerial performance, since they can compare a firm's performance with that of its competitors.

Even though information problems can be alleviated, it is impossible to design a contract that will cover all eventualities. That is why contracts usually include promises of *rewards and penalties* to induce the contracting parties to reveal information and comply with contract provisions. But promises of rewards and penalties alone are not enough. Each party needs to be convinced of the *commitment* of the other to honor its promises, even as circumstances change. This problem is especially acute when the government is a contracting party, since there is usually no way to compel it to meet its promises. By specifying a neutral mechanism for conflict resolution and placing checks and balances on its discretion, the government can signal its commitment to bind itself and its successors to the contract. Thus, contracts that provide strong links between the parties—including effective mechanisms to handle problems arising from information, rewards and penalties, and commitment—are more likely to be effective in attaining improved enterprise performance than those that do not.

This article reports on the results of the first systematic, empirical evaluation of the three forms of contracting important to SOE reform.

- *Performance contracts* define the relationship between government and public managers; the study found over 550 such contracts in 32 developing countries, plus more than 100,000 in China.
- *Management contracts* define the relationship when government contracts out management of the firm to private managers; the study found 202 management contracts in 49 developing countries.
- *Regulatory contracts* define the relationship between a government and a regulated monopoly. Such contracts may include explicit agreements about pricing or performance and implicit expectations about, for example, the powers of the regulator. Regulatory contracts are being increasingly used as monopolies in telecommunications (telecoms), electricity, and transport are privatized; the study found seven such contracts for basic telecoms service, the sector that was investigated.

Public managers

Performance contracts set targets for SOE managers to attain. Many also provide bonuses for management and workers based on achievement and pledge the government to provide greater autonomy or meet other obligations. To determine whether enterprise performance had changed in ways that could be attributed to the contract (or, more weakly, whether enterprise performance changed in ways that did not rule out the contract as an explanatory factor), our study investigated performance before and after implementation of contracts in 12 companies in 6 countries (Ghana, India, Korea, Mexico, the Philippines, and Senegal). Although the sample was small and not random, it included countries that had very different levels of income and that applied varying approaches to contracting. A consistent

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Chart 1

Better performance with contracts?

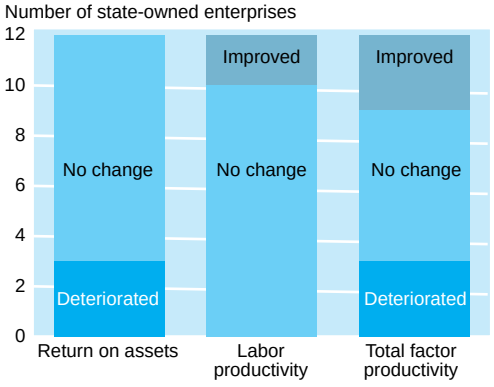


Chart 2

Contract implementation results

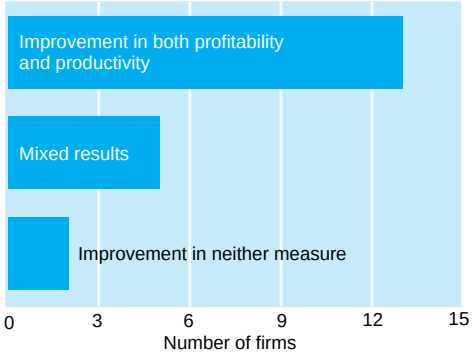
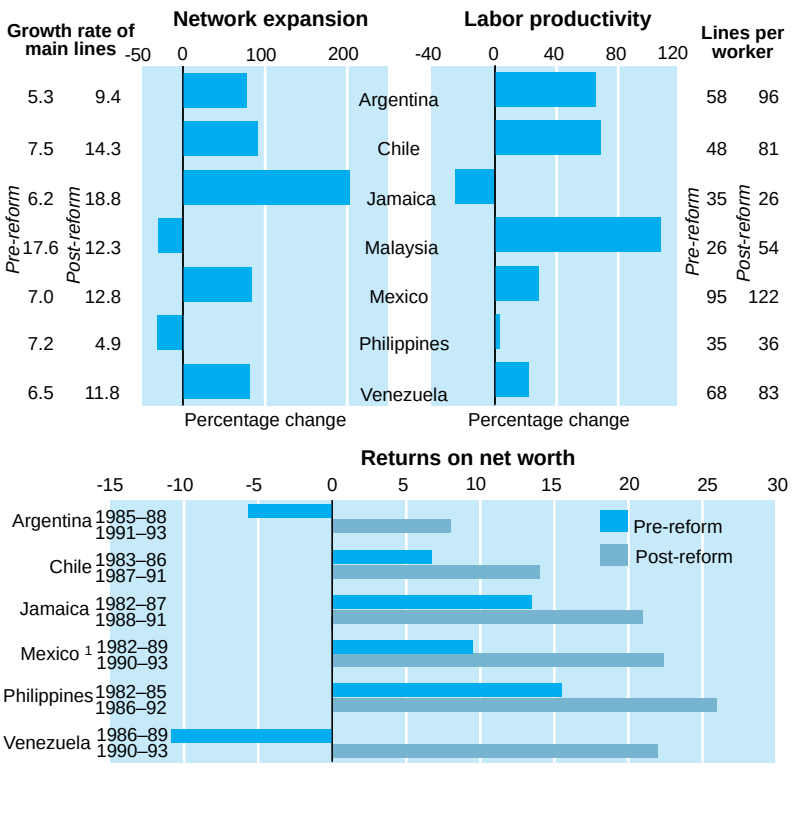


Chart 3

Telecommunications reform brings rewards



Source: *Bureaucrats in Business: The Economics and Politics of Government Ownership*, Oxford University Press for the World Bank (New York,1995).
[1] Post-reform data are estimates based on World Bank projections of revenues and expenses.

pattern across these countries would suggest that performance contracts were working (unless some other factor was at work—something we also investigated).

To assess the companies' economic performance, we compared trends in profitability (return on assets), labor productivity, and total factor productivity before and after the introduction of the contract. To explore the underlying factors, we used a questionnaire and interviews with people in the country and World Bank staff knowledgeable about the enterprises.

Our findings give little support to the premise that these contracts help improve SOE performance. As Chart 1 shows, only 3 of the 12 case study companies showed a turnaround or acceleration in total factor productivity after contracts were introduced (Ghana Water, Mexico Electricity, and Senegal Telecoms); six continued their past trends; and three performed substantially worse than before. The other indicators suggest the same results: trends in rates of return on assets deteriorated for three firms; the rest showed little change; and only two firms showed a change in trends in labor productivity.

Performance contracts failed to solve all three of the problems outlined above. Since all of our sample were monopolies (for which performance contracts are typically used), the government could not use comparisons with competitors to reduce its information disadvantage. Instead, managers were able to use their information advantage to negotiate targets that were easy to achieve. Managers lobbied for many targets (over 40 in the case we investigated in Korea) and fluctuating targets (over one-third of Ghana Water's targets changed every year), making it harder for monitoring agencies to track and assess performance. Some of the contracts also suffered from flawed targets (for example, India Energy could achieve its target volume of energy just by increasing inputs) or soft targets (in India, negotiations sometimes dragged on so long that targets were set on the basis of actual achievements).

The information disadvantages of the agencies responsible for negotiating targets and monitoring and evaluating results were aggravated by the agencies' dependence on the firm for information, and by their lower pay and status compared with those of the enterprise representatives with whom they were negotiating. The agencies were further weakened by frequent changes in responsibility and authority.

The sample performance contracts rarely included rewards and penalties that could motivate managers and staff to exert more effort. Where cash bonuses were offered (in 5 of the 12 cases), they had little effect because they were linked to flawed targets, not to better performance. Other promised incentives, such as greater managerial autonomy, were often not delivered; and penalties for poor performance, such as firing or demotion, were seldom applied. Finally, governments demonstrated little commitment, frequently reneging on key promises; for example, in some countries, the government reneged on its contract pledges to help firms collect payments owed by the government and other SOEs or to approve tariff increases in a timely fashion. This increased managers' incentive to use their information advantage to negotiate easy targets.

These problems are illustrated by the performance contract governing the Senegal Electricity Company, SENELEC. The

contract included 22 criteria for judging performance, but no rewards if managers attained them; moreover, government regulators lacked the power to enforce penalties reliably. Finally, although the government promised to take actions that would make it possible for the firm to meet its targets, such as forcing other SOEs to pay their electricity bills, these promises were often broken. The company has suffered declining productivity. Indeed, as with several other enterprises in our sample, it appears that the contract may have actually worsened incentives and performance.

Analysis of the outcomes and incentive problems associated with performance contracts suggests that they should be used sparingly, and only when government commitment is manifest, since the mere formality of negotiating a performance contract wastes time and effort and could possibly even harm performance. The idea that SOE performance can be improved without any change in government behavior by designing a contract that provides targets and incentives directed at managers alone proved illusory. Managers' incentives depend on government actions, whether or not these actions are specified in a performance contract.

Private managers

A management contract is an agreement between the government and a private party to operate an enterprise for a fee; the government does not receive a fixed rent (as it would with a lease); it is responsible for fixed investments (which it would not be with a concession); and it holds majority ownership (as distinct from a joint venture). While they are not widely used, management contracts have generally been successful. Our analysis of 20 management contracts governing SOEs in 11 countries (Bulgaria, the Central African Republic, Egypt, the German Democratic Republic, Ghana, Guinea, Guyana, Kenya, Pakistan, the Philippines, and Sri Lanka) found that profitability and productivity improved in two-thirds of the cases, and results were mixed for most of the remainder. Only two of the contracts were rated as failures on both counts (Chart 2).

Where management contracts succeeded, they addressed the problems of information, rewards and penalties, and commitment effectively. In our sample, governments used competition to reduce management's information advantage. Of the 13 successful contracts, 10 involved SOEs in competitive markets; the other 3 involved competitive bidding for monopoly enterprises (two water companies and a container port). Successful contracts also established meaningful rewards and penalties, usually by limiting (or eliminating) fixed fees and linking the contractor's fee to the firm's performance. Take, for example, the management contracts of two sugar enterprises in Kenya. Nzoia Sugar's contract failed to improve performance; its large fixed fee ensured the contractor a good return regardless of performance. Mumias Sugar's contract was successful; its fixed fee covered only the contractor's costs and the contractor made a return only when the firm become profitable. More than 80 percent of the successful contracts gave the manager significant autonomy to set wages and to hire and fire, while all but one of the less successful contracts limited management's authority over labor. Finally, successful contracts were set up in ways that elicited a strong commitment from both parties. For example, they were for longer periods—13 years, compared with 4 years for less successful contracts—with greater prospect for renewal.

Ninety percent of the successful contracts were in three sectors: hotels, agriculture, and water. Information is more easily available, and contract transaction costs are thus lower, in sectors such as these where technology is not changing rapidly and output is a single, homogeneous product (for example, water or sugar); where the private contractor has an international reputation to protect; the market is competitive; and quality is easily compared (as with hotels). This suggests that performance contracts work best in such sectors. Moreover, under the competitive conditions where management contracts have been used, privatization often provides governments with higher benefits (the selling price) and lower costs (by eliminating the need to monitor, enforce, or renegotiate the contract). Because management contracts are less visible than outright privatization, they may be less politically costly, but only slightly so. Successful management contracts require government to pay political costs: they must stop using the SOEs for patronage purposes; they must allow layoffs when appropriate; and, frequently, they must relinquish managerial control to foreigners (95 percent of the contracts in our sample went to foreign firms).

Regulatory contracts

Regulatory contracts, which typically arise when government privatizes infrastructure, define the relationship between government and the owners of a private, regulated monopoly. Although our sample of countries where the basic telephone network has been privatized is small and not random (Argentina, Chile, Jamaica, Malaysia, Mexico, the Philippines, and Venezuela), its diversity—in terms of economic development, rate of economic growth, initial telecoms development, the pace and timing of regulatory reform, and the extent of divestiture—enables us to analyze different aspects of regulatory design under a wide variety of circumstances. Except for the Philippines, where the telecoms sector has been privately owned for decades, the year of reform coincided with the year of privatization.

We found that regulatory contracts usually improved performance, resulting in more rapid network expansion, increased labor productivity, and higher returns on net worth. Not all regulatory contracts were successful, however (Chart 3). Chile, where the results were positive, and the Philippines, where the results were negative, represent the two extremes. The rate of network expansion almost doubled in Chile to a whopping 14.3 percent a year; labor productivity grew by over 50 percent a year; and returns on net worth were a reasonable 13.8 percent. Reforms in the Philippines had no positive effect on network expansion (which declined to 4.8 percent a year) and spurred very small gains in labor productivity.

Once again, successful contracts addressed all three issues—information, rewards and penalties, and commitment—which we can illustrate by comparing Chile and the Philippines. Chile's government reduced its information disadvantage by selling the franchise for local telephone service through competitive bidding and by injecting other elements of competition into the contract wherever possible. In contrast, the Philippine government did not use competition to reduce its information disadvantage. It has had the same incumbent supplier for many years, with no credible threat of competition if the enterprise fails to improve performance.

Rewards and penalties in regulatory contracts depended on pricing regulation, and in Chile price regulations were designed to reward improved performance and penalize failure to improve. Chile's benchmark pricing is based on a fair rate of return to a hypothetical efficient firm and is reviewed only once every five years. This encourages the company to improve efficiency, since it reaps the benefits until prices are adjusted, at which point the savings are passed on to the consumer. In contrast, the Philippine

government set prices on the basis of the rate of return with no clear rules on timing or limits on the regulator's discretion, merely a ceiling (12 percent) on the operator's returns.

Finally, the Chilean government demonstrated to investors its commitment to abide by the contract itself and also to bind its successors. For example, the legislature passed laws defining step-by-step procedures for arbitration and appeal of disputes, including, ultimately, appeal to the Supreme Court. Since laws are not easily changed in Chile, and the Supreme Court is known for its independence, this set up a neutral mechanism for resolving disputes, largely insulated from politics. The Philippine government has not instituted clear nonpolitical mechanisms to resolve disputes. The regulatory contract is unclear, which provides a poor basis for a company to appeal.

Which contract?

Our case studies suggest that management and regulatory contracts do a better job of improving performance than contracts with public managers. One reason for this is that private owners and, to a lesser extent, private managers have a greater stake in the outcome of the contract than public managers. They have a greater claim on enterprise returns if performance improves, and they stand to lose if things go wrong. If the private party has its reputation at stake (as with hotel management chains), the incentive to improve is even greater. In contrast, public managers in our sample were not penalized for poor performance and were seldom rewarded for good results.

A contract with a private party also changes the incentives of government bureaucrats. Since such contracts are more prone to scrutiny by the press and public than contracts with public managers, bureaucrats have an incentive to select the contractor carefully; to demand simpler, more easily monitored targets; to monitor results scrupulously; and to enforce the contract. Private parties also have an incentive to agree to simple, easily measured standards that can be defended against critics. Such targets reduce the likelihood of disputes or, if a dispute is unavoidable, make it easier to appeal to arbitration or courts when possible. Private parties also demand evidence that a government is prepared to abide by the contract before they undertake risks. Of course, the stronger private stake in outcomes may also give private managers and owners stronger incentives to try to exploit a government with weak negotiating and monitoring skills. Safeguards can be designed to reduce the risk of exploitation—where this was done successfully, the gains were significant.

In theory, contracts with public managers could employ the same mechanisms that led to success in the contracts with private parties. SOE managers could be required to compete for the right to operate the enterprise and face the risk of losing their franchise if they fail to meet certain targets. Similarly, SOE pricing regulation could be designed to motivate efficiency, as it was with the more successful regulated private firms (such as Chile Telecom). Public managers could be given the autonomy to take necessary steps to improve performance, as well as a bonus linked to better returns and/or shares in the company. Government could introduce the sort of checks and balances and conflict-resolution mechanisms that signal commitment to private owners in its dealings with public managers as well. The fact that this was not tried in any countries in our sample, or indeed by most of the performance contracts we encountered in our search, suggests that the political forces that motivate and sustain public ownership make it difficult to implement market mechanisms.

F&D

This article draws on the background work done for, and in particular Chapter 3 of, Bureaucrats in Business: The Economics and Politics of Government Ownership, *Oxford University Press for the World Bank (New York, 1995).*