Performance Contracting: A Strategy for Public Enterprise Reform in Sri Lanka?

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1. Introduction[1]

In the past two decades, countries all over the world have seen a re-orientation of development strategy, away from the state's pervasive role to a more liberalised approach. Privatisation[2] has been a key component of the reform process, particularly from the late 1980s, reflecting the disappointing performance record of state-owned enterprises (SOEs). Although the public enterprise reform strategy envisaged by most governments in the first part of the 1980s at least, was to adopt commercial principles, such as commercial accounting standards and commercial performance objectives rather than to introduce ownership change, privatisation soon became a global trend.[3]

One of the main economic arguments for privatisation is that ownership matters; that *ceteris paribus*, the profit stream from an asset operating under private ownership will be higher than that under public ownership.[4] *Kikeri et al (1994)* expand upon this hypothesis by enumerating the significant factors that reduce the efficiency of non-divestiture options. First, they argue that reforms that fall short of ownership change are difficult to implement, both technically and politically. Second, these reform

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1 I am grateful to Chandi Chanmugam (IPS), W.C. Dheerasekera (Ministry of Industrial Development), David Dunham (IPS), Saman Kelegama (IPS) and Shelton Wanasinghe (IPS), for comments on an earlier draft. I alone remain responsible for the views expressed in the paper.

2 In this paper, privatisation is defined rather narrowly as a change from public to private ownership. As such, privatisation and divestiture are used interchangeably throughout the paper. Private sector involvement in public sector activity through management contracts, leases, and joint ventures for instance, is referred to here as private participation.

3 The rationale for embracing privatisation over commercialisation strategies varies from country to country. However, a common factor is the speed of reform as dictated by both internal fiscal pressures and by the adjustment prescriptions and lending policies of multilateral financial institutions.

4 *Adam et al (1992)* reject the argument that differences in enterprise efficiency under public and private ownership are intrinsic in nature. They argue instead, that it is differences in the objective functions and agency relationships under the two regimes that result in differences in enterprise performance.

packages run into co-ordination problems because of the numerous steps involved. Third, performance improvements arising from these reforms are seldom sustainable, given that the impetus for these programs is often crisis management.

However, the experience in Sri Lanka as well as in many other developing countries indicates that these problems apply equally to privatisation, since technical competence, comprehensiveness, political will and a medium to long term development perspective are all preconditions for a successful divestiture program. A closer scrutiny of the privatisation experience over the past decade also suggests, that the beneficial effects of this strategy have been impaired by weaknesses in the planning and implementation of divestiture programs and the absence of supporting conditions such as sound institutional, legal and regulatory structures. More generally, the empirical evidence suggests that, contrary to the expectations of the 1980s, privatisation has not worked as a cure-all for the ills of the public sector.[5] Given that the process and outcome of privatisation in developing economies have not been as straightforward as originally expected, several governments are looking toward alternative strategies to improve the performance of SOEs.

In this context, performance contracting is one instrument that has gained widespread popularity amongst governments intent on improving enterprise performance whilst under public ownership.[6] A typical Performance Contract (PC) is a freely negotiated, performance agreement between representatives of the government and the management of a public enterprise, constructed on the premise that it is quality of management rather than ownership of an asset that determines enterprise efficiency. The main objective of a PC, is to set out a framework that would remove any ambiguities in state-SOE relations, resolve the perennial problem of autonomy versus accountability in the public sector, and facilitate managerial efficiency, by clearly specifying the expectations and responsibilities of the two parties and by providing incentives that would ensure that these mutual obligations are met.

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5 See for instance, *Adam et al (1992).*

6 Performance contract is a generic term. This instrument is also referred to as Memorandum of Understanding,Performance Agreement, Letter of Agreement, Contract Plan and Contrat De Programme in some countries.

The concept of performance contracting originated in France in the 1970s and has been adopted in about thirty developing countries over the last three decades. Although the results of performance contracting have been mixed due to country differences in the design and implementation of performance contracts and in associated government policies, the experience to date brings out some significant advantages of the contract system, particularly for a developing economy.

As mentioned earlier, the much sought-after benefits of privatisation are seldom realised in countries with under-developed market structures and a weak competition and regulatory policy environment. In such instances, the contract system is a useful interim policy tool to improve the performance of SOEs scheduled for divestiture at a later date, whilst the soft infrastructure required for privatisation is being built up. The contract system can, for instance, function as a facilitator of privatisation by injecting commercial norms into an enterprise hitherto governed by bureaucratic principles, by cutting budgetary losses, by improving the net worth of the enterprise through higher efficiency standards, and, by gradually setting the stage, both in a technical and in a political sense, for ownership change.

It is also evident that the state, in developing countries, will continue to be the major player in the provision of social infrastructure services, such as education and health, given universal service obligations and the market failures and externalities tied to these sectors. In the absence of substantial private competition, at least in the foreseeable future, the contract system can serve as a valuable public policy tool to improve the x-efficiency[7] of these enterprises, whilst ensuring that their social objectives are carried out.

In the case of Sri Lanka, the privatisation program which began in 1989 has now dealt with candidates that were relatively easy to divest. Most of the remaining SOEs, such as those in the banking, insurance, petroleum, power, transport, and social

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7 X-efficiency refers to a situation in which a firm's total costs are not minimised because the actual output from given inputs falls short of the maximum feasible level. In general, this situation is found in markets where competitive pressures are weak.

infrastructure sectors, are technically and politically far more complex and do not readily lend themselves to divestiture. As such, alternative reform strategies will have to be sought for these entities; in the interim for some as they progress along the path to eventual privatisation and on a more permanent basis for others that cannot be privatised for political reasons.

A second category of SOEs requiring an alternative reform strategy are those privatised enterprises taken back by the state under the *Public Enterprises Rehabilitation Act, No.29 of 1996*, with the collapse of these businesses due to various omissions on the part of the private owners. Given the run-down state of most of these enterprises it is highly unlikely that they will be attractive to private investors in their current condition. As such, policy makers are faced with two choices in the case of these SOEs; either revamp and revitalise these businesses so as to improve their performance and prepare them for divestiture at a later stage, or sell any remaining assets and shut down these businesses, if they are assessed to be unviable.

This paper is a critical exploration of the possibility of using performance contracting as a public enterprise reform strategy in Sri Lanka, particularly in the case of the two SOE categories referred to above, building on the country's brief exposure to this approach in 1990 -1991. It must be stated at the very outset however, that performance contracting has its limitations and, like privatisation, is not a panacea for the ills of the public sector. As such, PCs should only be used in instances where there is clear evidence to indicate that immediate divestiture or private participation are not feasible options; this strategy should not be seen as a means to prop up unviable enterprises for short term political gains. In the final analysis however, the efficacy of the PC system in Sri Lanka will depend largely on factors such as political will, political patronage, and populist measures, given that political considerations have often overshadowed technical factors in shaping the evolution and outcome of the SOE reform process, in the past.

The paper is set out in four sections. The next section sketches the structure, characteristics and conceptual framework pertaining to a generic PC in an attempt to

draw out the key pre-conditions for an effective contracting policy. Section 3 looks back at the design, implementation and outcome of Sri Lanka's original performance contracting systems, and identifies the main constraints to the effective working of these systems. Section 4 sets out policy recommendations, considering the current need for an alternative SOE reform strategy, and drawing on Sri Lanka's brief experiment with PCs in 1990-1991 as well as on the existing body of international experience in the implementation of PCs. Section 5 concludes.

2. The Conceptual Framework

2.1 Defining a performance contract

The most accepted definition of a performance contract is set out in the *Guidelines on Performance Contracting* issued by the United Nations in 1995, following an empirical study and a review by a panel of international experts. According to the UN definition, a PC is "a negotiated agreement between the management of a public enterprise and its owners (the Government) with respect to:

- the future goals of the enterprise;
- the way that performance of each goal will be measured;
- performance targets;
- management incentives;
- the financing of activities;
- the autonomy of management and defined limits;
- the information system (accounting, reporting and audit) to establish and enforce accountability through the contract; and
- procedures for variation of the contract and settlement of disputes."[8]

The theoretical underpinnings of performance contracting draws heavily from the concept of Management by Objectives (MBO),[9] which is defined as "a process based on a philosophy of participation committed to the determination of compatible institutional and personal goals."[10] The MBO approach forms the core of performance

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8 *Ramanadhan (1997: 1)*, citing *United Nations (1995: 3).*

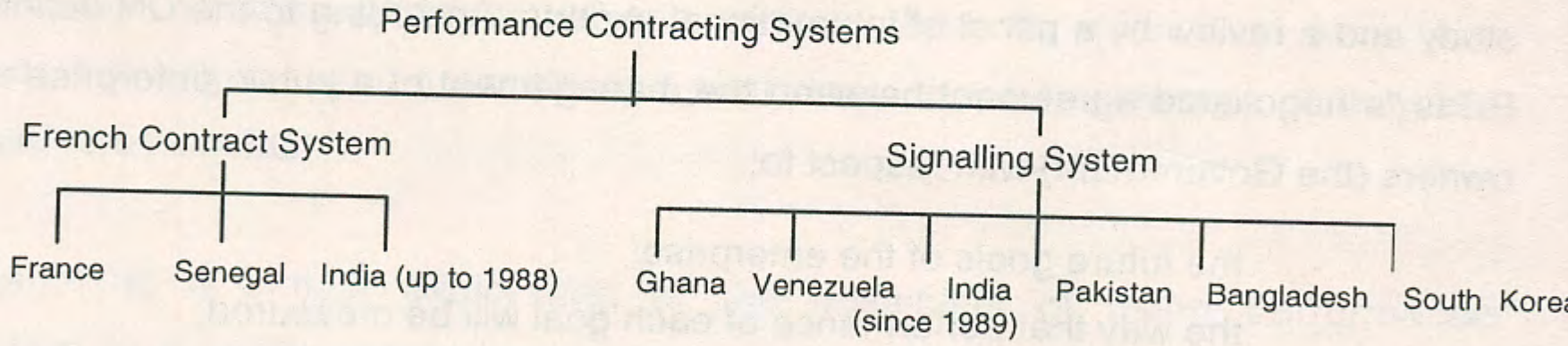
9 This concept was first introduced by Peter Drucker in *The Practice of Management (1954).*

10 Gamage*(1995:7).*

contracting systems in countries attempting to move away from controlling the individual processes by which inputs are turned into outputs within a public enterprise, to only controlling the results of this process. Some of the key questions raised under the MBO approach and translated into the contract system, for instance, are: what resources does the SOE use, what are the results, and, what is the ratio between inputs and outputs. As such, a significant advantage of this approach is that it requires few interventions on the part of the government.

Despite the plethora of country experiences in performance contracting, there are in fact only two distinct varieties of this system: the French Contracting System and the Signalling System (see Figure 1).

Figure 1. Country Classification of Performance Contracts



Source: Adapted from *Trivedi (ed.) (1990).*

These two systems are similar to the extent that their principal concern is to improve performance in the SOE sector, to redefine the rules of the game in this sector, and to embody the obligations of the government and the management as two equal partners. However, they differ in the manner in which they seek to meet these concerns. The French System does not, for instance, clearly lay out the design of a PC, in terms of the formulation of performance indicators, a sound information system, and a management incentive system. These structural aspects however, are well established in the Signalling approach, as will be discussed in Section 2.3 of this paper.

The two approaches also differ in their evaluation of enterprise performance, with the Signalling System providing a means of making an overall judgement on enterprise

performance by way of a weighted composite score calculation, and the French System looking only at whether an individual target was met or not.[11] More generally, the empirical evidence on the two systems indicates that the French Contract System has failed to live up to expectations and that the Signalling System, which attempts to overcome the problems in the French System, is a far better option for improving the performance of SOEs.[12] This paper deals largely with the Signalling approach, given the stronger structural foundations of this system and its proven success in several developing countries.

2.2 Performance contracting in perspective

The international experience with public enterprise reform indicates that policy makers have the advantage of a wide spectrum of possible strategies, that could be tailored to specific country, sectoral, and enterprise needs. As illustrated in Figure 2, these options differ mainly in regard to the degree of private sector involvement in ownership, management and finance, with performance contracts having a high level of state involvement, Build-Own-Operate (BOO) and divestiture a high level of private sector involvement and the other strategies falling in between these two extremes.

Figure 2. Strategies for Public Enterprise Reform

State
- ownership
- management
- finance

Private
- ownership
- management
- finance

PC CPS MC LA BOT JV BOO/DIV.

Note: PC = Performance Contracts
CPS = Contracting out of Specific Public Services (Franchises, Licensing Arrangements)
MC = Management Contracts
LA = Leasing Arrangements
BOT = Build-Operate-Transfer
JV = Joint Ventures
BOO = Build-Own-Operate
DIV. = Divestiture

Source: Adapted from *Lindborg(1996)* and *Coopers & Lybrand Deloitte (undated).*

11 The limitation of the French approach is that it can only indicate the percentage, say 60% or 70%, of targets met; whether meeting 60% of the targets is better than meeting 70% would, however, depend on the relative importance of the targets in the 50% group *vis a vis* those in the 60% group *[Trivedi (ed.) (1990)].*

12 *Trivedi (1990: 8-25).*

In brief, the contracting out of specific public activities, such as garbage collection, building maintenance, and catering, for instance, transfers responsibility for the cost of service provision to the private sector, for an agreed rate of payment. In the case of a management contract, the management of a SOE is contracted out to a private party for a fixed time period. The private party is responsible for managing costs and revenues and is compensated by way of a management fee based on productivity gains. Leasing arrangements, where a public authority gives a private party the right to provide a particular service for a fixed time period, can take two forms: operating leases, which are usually a part of management contracts, and finance leases which transfer a substantial degree of ownership risk and reward to the private sector and are generally a part of the arrangements for divestiture. Joint ventures between the state and the private sector, entail the sale of a part of the state's shareholding in a SOE to one or more private parties. Finally, the BOT and BOO options involve the granting of concessions to a private sector consortium to build and finance infrastructure projects such as power stations and toll roads. The ownership of the project could either remain in the private sector (BOO) or be transferred back to the state after a specified time period (BOT).[13]

Table 1. A General Framework for SOE Reform

SOE Category	Reform Strategy
Enterprise suitable for immediate privatisation/private participation.	Joint Ventures, , BOT, BOO, Divestiture
Enterprise attractive to the private sector and suitable for privatisation/private participation, but requires some restructuring first	Contracting out of specific public services, Management Contracts, Leases
Enterprise currently not attractive to the private sector, needs substantial restructuring, and maybe suitable for privatisation/private participation in the long term	Performance Contracts
Enterprise unsuitable for privatisation/private participation, but has potential for improved performance	Performance Contracts
Enterprise unviable	Sell remaining assets and shut down business

Whilst these strategies share the objective of improving the performance of public sector activity, their potential for success differs from enterprise to enterprise, given the

13 *Coopers & Lybrand Deloitte (undated).*

nature of enterprise activity, capacity for competition, equity concerns, and the attractiveness of the entity to the private sector. As such, it is useful to draw up a SOE reform master plan, which would match the needs of a particular enterprise with the most appropriate reform strategy. The following Table sets out a possible framework for SOE reform.

2.3 The structure of a performance contract

This section looks at the structure of PCs in the Signalling System, given that these contracts are, for reasons laid out in Section 2.1, an improvement on the French contracts; and, that the previous experiences of developing countries in performance contracting have been taken into consideration in developing this system.

A typical PC in the Signalling System consists of three sub-systems: a performance evaluation system, a performance information system, and a performance incentive system (see Figure 3). The performance evaluation system, deals with the institutional set-up, the selection of a body/bodies that would take on the responsibility for designing, implementing, monitoring and evaluating a contract, and with the technical procedures involved in an evaluation exercise. The technical process involves four steps; the first three, criteria selection, criteria weight selection, and criteria value selection at the beginning of a specified contract cycle; and, the fourth, composite score calculation, at the end of the cycle.

Step 1, criteria selection, entails the selection of appropriate performance indicators for a given enterprise. The selected performance indicators could either be a mix of commercial criteria such as profitability and non-commercial criteria such as employee welfare, or be restricted to one of these categories, depending on the objectives of the enterprise and the nature of its activities.

Step 2, criteria weight selection, consists of selecting weights for each criterion so as to establish its relative importance in enterprise performance and to facilitate the calculation of a composite score. These weights need not be constant across

enterprises or over time and could vary according to the priorities of the SOE concerned.

Step 3, criteria value selection, involves picking targets, a pre-tax profit of Rs. 500,000 for example, for the chosen performance criteria. In general, these targets are set based on the objectives of the SOE (i.e. commercial or non-commercial), on the SOE's performance in previous years, and on standards set in similar enterprises in the public and private sectors and in other selected countries.

Step 4, composite score calculation, consists of comparing the actual achievements of a SOE with the pre-determined performance targets and calculating a weighted average score. The advantage of such a composite score is that it can indicate the comparative performance of SOEs in disparate sectors of the economy. An example of the calculation procedure is shown in Tables 2 & 3.

Table 2. Performance Targets set at the Beginning of the Contract Cycle

Criterion	Units	Weight	Criterion Values				
			1 Excellent	2 Very Good	3 Good	4 Average	5 Poor
Pre-tax profit	Rs. '000	.50	500	450	400	350	300
Export earnings	Rs. '000	.30	100	90	80	70	60
Project implementation	Months	.20	6	8	10	12	14

Source: Adapted from Department of Public Enterprises, Government of India (undated).

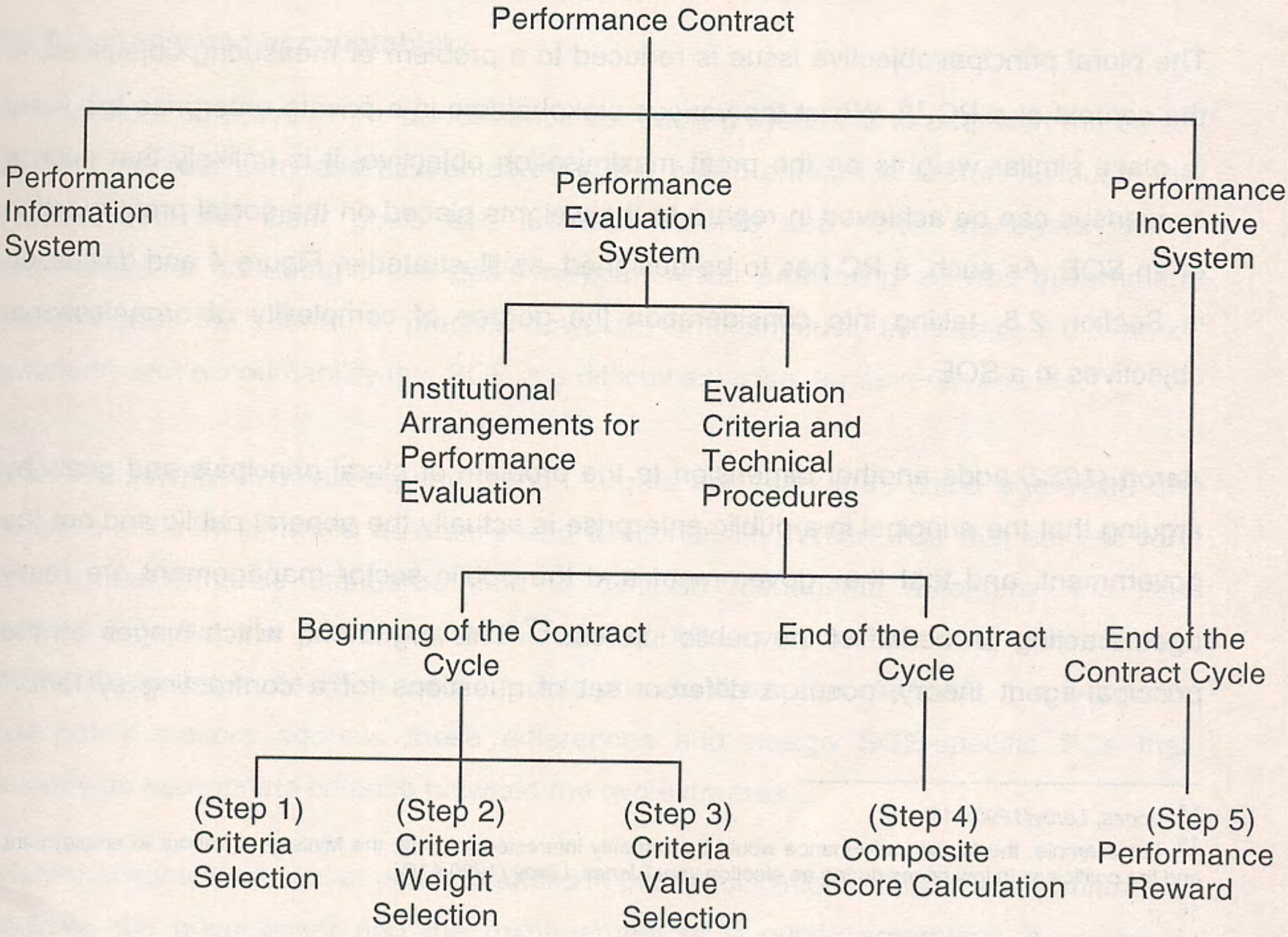
Table 3. Composite Score Calculation

Criterion	Units	Weight	Actual Achievement	Raw Score (from 5-point scale in Table 2)	Weighted Raw Score
Pre-tax profit	Rs. '000	.50	350	4	2.00
Export earnings	Rs. '000	.30	80	3	0.90
Project implementation	Months	.20	10	3	0.60
Composite Score					3.50

Source: Adapted from Department of Public Enterprises, Government of India (undated).

The role of the performance information system in a PC, is to provide timely and relevant information to public sector managers on the chosen criteria, whilst the purpose of the performance incentive system is to link the performance of managers to rewards and penalties based on the outcome of the evaluation exercise.

Figure 3. Structure of a Performance Contracting System



Source: Adapted from *Trivedi (1990: 745-746).*

2.4 Some key conceptual issues in a performance contract

(a) Multiple principals (owners) and multiple objectives

Most public enterprises are expected to pursue a mix of commercial, social, and political objectives such as, generating profits, bringing in foreign exchange, creating

employment, redistributing income, and ensuring the re-election of the political regime in power. The problem with such a plethora of objectives is that it is equivalent to having no objective at all, with SOE managers often being left free to pursue their own interests.[14] This problem of multiple and often conflicting objectives, is compounded by the involvement of various groups within the government (multiple principals) each with their own agenda, in the activities of these enterprises.[15]

The plural principal/objective issue is reduced to a problem of measuring objectives, in the context of a PC.[16] Whilst the various stakeholders in a private enterprise are likely to place similar weights on the profit maximisation objective, it is unlikely that such a consensus can be achieved in regard to the weights placed on the social profit function of an SOE. As such, a PC has to be designed, as illustrated in Figure 4 and discussed in Section 2.5, taking into consideration the degree of complexity of organisational objectives in a SOE.

Aaron (1982) adds another dimension to the problem of plural principals and goals by arguing that the principal in a public enterprise is actually the general public and not the government, and that the government and the public sector management are really agents acting on behalf of the public interest.[17] This argument, which hinges on the principal-agent theory, poses a different set of questions for a contracting system.[18]

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14 *Jones, Leroy(1990:117).*

15 For example, the Ministry of Finance would be primarily interested in profit, the Ministry of Labour in employment, and the politicians in low prices during an election year [*Jones, Leroy (1990:118)*].

16 If,

x = some objective of an enterprise,
w = weight of x in terms of other objectives,
q = degree of achievement of x

Then, measurement of objective x = f(w * q).

17 The situation is further complicated by the fact that the government itself is not a single entity. As such, the balance of power between the executive and legislative arms of government will also have an impact on the direction and performance of a public enterprise.

18 Briefly, the principal-agent theory deals with how a principal (say, the general public) can design a contract that would motivate an agent (say, the government or SOE managers) to act in the principal's best interest. In general, a principal-agent problem arises when there is imperfect information in regard to the actions that the agent would undertake. See *Ross (1973), Mirlees (1974, 1976), Stiglitz(1974,1975)* and *Rees (1985)* for detailed discussions on the principal-agent theory.

Given that both the government and the management have different trade-offs v*is a vis* the public interest and given asymmetric information between principal and agents and between agents, the question becomes which agent is best suited to serve the public interest. Again, the model control system developed in the next section (Figure 4) can provide some useful answers to this question, in the context of performance contracting.

(b) Autonomy and accountability

An important objective of the performance contracting system is to deal with the trade-off between autonomy and accountability in the public enterprise sector. As such, the contract sets out clear goals and priorities *ex-ante* and holds managers wholly responsible for achieving these goals *ex-post*, whilst prohibiting *ad hoc* government intervention in the interim. In practice however, simultaneously increasing the level of autonomy and accountability in a SOE is a difficult exercise, for several reasons.

First, the setting of detailed performance targets and standards could aggravate the negative trade-off between autonomy and accountability. While PCs that set out very detailed performance standards tend to diminish managerial autonomy, the less detailed PCs run the risk of low accountability. Moreover, the effect of performance standards on this trade-off varies from enterprise to enterprise. As such, it is important that policy makers address these differences and design SOE-specific PCs that embody an appropriate balance between the two extremes.

Second, a somewhat similar problem arises in the specification of bilateral commitments between the government and the management of a public enterprise. A complete specification of the commitments of the two parties would enhance both autonomy and accountability. However, it would also raise the transaction costs of negotiating, monitoring and enforcing these commitments. Therefore, the trade-off between autonomy and accountability on the one hand, and transaction costs on the other, is another important factor that has to be taken into account when drafting a PC.

Third, administrative accountability, which is the type of accountability that the performance contracting system is concerned with, cannot in practice be separated from political accountability, which involves *inter alia* elections, political party dynamics, and public debate.[19] As such, the political agenda and the behaviour of politicians will invariably shape bureaucratic norms in the public sector. For example, rent-seeking activities in public enterprises will flourish, if the general perception is that corruption and nepotism is the order of the day at ministerial levels. This underscores the point that political considerations often take precedence over technical ones in the public sector, and that political commitment at the highest level of government is perhaps the single most vital ingredient in the reform process.

(c) Short versus long-term contracts

The time frame of a performance contract has explicit ramifications on the direction and outcome of the contracting process. The single-period contract is based on the Signalling System and has a contract cycle of one year, while the multi-period contract, which is closer to the French System, has a longer time frame.

An important distinction between the two approaches lies in the type of efficiency that the contract strives to maximise. The one-year contract focuses on short-term x-efficiency while the multi-period contract has the additional advantage of being able to tackle dynamic and allocative efficiency. This difference is relevant in terms of the enterprise category targeted by a PC. A short-term contract is ideal, for instance, to improve the performance of an enterprise in a fixed-technology industry, producing a limited range of goods for a stable, supply-constrained market. On the other hand, a multi-period contract is useful in the case of enterprises in industries characterised by ever-changing technology, greater choices of output and input mixes, and unstable demand-constrained markets.[20]

The longer-term contracts, which are more susceptible to economic and political uncertainties, encounter moral hazard problems in trying to determine who's

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19 See, for instance, *Hulme and Sanderatne (1996)*.

20 *Mallon, Richard (1990:56)*.

responsible for what in enterprise performance. [21] This problem is greater in the case of enterprises whose performance is directly linked to the behaviour of other agencies, such as input suppliers or import permit authorities. Moreover, specifying the contingent commitments of all parties to the contract in advance, is more difficult when the degree of uncertainty is higher. As such, these multi-period contracts also carry higher transaction costs in terms of negotiation, monitoring, and enforcement.[22]

However, a long-term contract has a relative advantage over a single-period contract, in regard to the efficacy of incentive structures, given that the twin-objectives of an incentive mechanism are to reduce informational asymmetries and to induce better managerial performance. In a short-term contract, managers have a greater motivation to conceal the actual state of affairs in the enterprise and to persuade the government to accept lower standards, so as to maximise their rewards for good performance. Conversely, in a longer-term contract, managers would prefer to exaggerate performance prospects so as to attract more resources to the enterprise.

(d) The "publicness" of a public enterprise

A typical SOE has two dimensions: the social or "public" dimension dealing with social obligations such as employment creation; and the "enterprise" dimension dealing with the commercial and profit-oriented functions of the entity.[23] Ideally, a performance contract should function as an instrument that reflects the degree of publicness that an SOE is expected to carry and identifies the comparative advantage of an entity being in the public sector, as opposed to the private sector.[24]

However, a common problem in the drafting of PCs is the difficulty in formulating measurable social parameters, that could be incorporated into a composite score

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21 The moral hazard problem refers to a situation where imperfect information leads to a divergence between the private marginal cost and the social marginal cost of an action, which in turn leads to a non-optimal allocation of resources. In the case of multi-period PCs in SOEs linked to other agencies, imperfect information and the possibility of holding these other agencies responsible for meeting the set targets, results in a situation where the management may not seek to maximise the socially optimal level of performance.

22 *Mallon, Richard (1990:56).*

23 *Kumar (1996).*

24 *Ramanadhan (1997).*

calculation. A possible strategy to resolve this problem, would be for a PC to set out the social parameters category separately and not as a part of the composite score. For instance, the specified absolute values and the expected minimum/maximum limits of achievement for items such as the rate of employee hiring/ firing, the shutting-down of unproductive units, and subsidised price sales, for instance, should be placed under separate headings in the contract. It should be noted however, that items such as consumer satisfaction and human resource development, which are internal to enterprise management, can , unlike the social parameters mentioned above, easily be included in the weighted-score system.[25] The usefulness of such an approach is that it would help to define the composite responsibility of a particular SOE, and to decide, on the basis of the PC outcome, if the SOE should continue under the public sector, be transferred to the private sector, or be dissolved altogether.[26]

2.5 Pre-conditions for successful performance contracting

Despite country disparities in the implementation and outcome of performance contracting, the international experience provides guidelines on the fundamental pre-conditions for a successful contract, based on the consensus that this strategy is [27]:

(a) an integral part of the national economic strategy;

(b) a means of reflecting the nature and extent of "publicness" or social accountability shouldered by a public enterprise;

(c) a means of establishing the comparative advantage of a public enterprise; and

(d) a step in the privatisation exercise, in the case of SOEs with little or no comparative advantage.

The pre-conditions for an effective performance contracting approach are as follows:[28]

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25 *Ramanadhan (1997).*

26 Clearly, the time span between the introduction of a PC and a decision of this nature would vary from enterprise to enterprise.

27 *Ramanadhan (1997).*

28 This section draws heavily from *Trivedi(ed.) (1990).*

(a) A specific time frame

The definition of a time frame is relevant to the outcome of the evaluation process, given that short-term contracts tend to give precedence to technical and x-efficiency, while longer-term contracts have a greater focus on allocative and dynamic efficiency.

(b) Clearly defined and carefully selected performance criteria

The performance criteria set out in the contract have to be defined clearly, and should only cover areas within the control of public sector management. In addition, the parameters have to be picked so as to ensure that SOE managers are not rewarded for actions that could be detrimental to the overall welfare of the country. A common mistake for instance, is the choice of capacity utilisation as a performance parameter. Although the rate of capacity utilisation can be controlled by the management, this choice is not conducive to the maximisation of national welfare since capacity utilisation can be increased by simply postponing regular repair and maintenance. [29]

(c) A negotiated agreement on enterprise priorities

Both parties to the agreement, the government and the management, have to agree on the relative priorities pertaining to the enterprise and assign weights to the relevant performance criteria on the basis of this negotiation, at the beginning of the contract cycle. A negotiated agreement on the relative priorities of a SOE is particularly important given the problem of multiple objectives and principals in the public sector.

(d) Assignment of target ranges

Specific targets, preferably target ranges, must be assigned to each of the performance parameters at the beginning of the contract cycle. Again, these targets have to be negotiated with SOE managers and not arbitrarily imposed by the government.

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[29] In addition, capacity utilisation may not reflect true performance potential, since output can increase through productivity increases in capital and labour inputs, even after the set target for capacity utilisation has been met.

(e) Non-interference of the government and management authority limits

Once the performance targets have been agreed on at the beginning of the contract cycle, the government should not interfere with the management of the SOE, if the PC is to deal effectively with the autonomy/accountability trade-off.

However, the PC has to clearly set out the division of labour between the government and the SOE management in regard to the enterprise. In general, the government is likely to retain control over areas such as long-term corporate planning, large-scale borrowing, capital expenditure, and financing of non-commercial obligations, whilst the management assumes control over pricing, small-scale borrowing, human resource development, etc. However, this delegation of powers will vary from sector to sector and from enterprise to enterprise.

(f) A comprehensive and unbiased evaluation system

Enterprise performance has to be evaluated, at the end of the contract cycle, against the pre-determined targets and using a composite score calculation. The evaluation process is best conducted by a third party evaluator.

(g) A sound performance information system

A sound information system has to be built into the institutional apparatus for performance contracting, to have a balance in the availability of information to the government and the management of an enterprise. Given that SOE managers tend to have more information than government officials on the feasibility of a particular target, for example, a disclosure bonus system could be built into the incentive structure to prevent managers from negotiating unrealistically low targets.

(h) A sound performance incentive system

A workable incentive system linked to the performance of the SOE has to be set up, to reward or punish enterprise managers for their achievements. The incentive system has to be transparent and carry carrots and sticks that actually matter to public enterprise managers.

(i) Bilateral commitment

The institutional set up has to ensure bilateral commitment on the part of the contracting parties. Whilst the incentive system deals to some extent with the commitment of the management, it is usually very difficult to compel the government to keep to its promises. It is possible however, for the government to signal its commitment to the contract by setting up a neutral mechanism for conflict resolution.

In addition to the core criteria outlined above, it is essential that the inherent differences amongst public enterprises be taken into consideration when developing an organisation control system for the SOE sector. Figure 4 illustrates a typology for SOEs, based on the degree of difficulty in output measurement and on the degree of complexity of organisational objectives [30]

The framework of this typology sets out two basic principles for an organisation control system. First, as the objectives of an SOE become increasingly complex, the focus of the control system is to translate these objectives into clear operational targets. Second, as the outputs of the SOE become harder to quantify, the system moves away from evaluating results to evaluating the process.

The SOEs that fall into Cell 1, are typically enterprises operating in competitive markets and producing goods or services that are also produced in the private sector. Such enterprises have very straightforward goals and easily quantifiable outputs (for example, a private firm nationalised to protect employment). Whilst these SOEs function best with professional, private sector-style management, and with substantial autonomy, they generally have to continue under public ownership for strategic reasons (such as for instance, locating in particular geographical areas or investing in particular projects). As such, a state-appointed Board of Directors, consisting of professionals with substantial experience in the SOE's field of activity, can play a useful and active role in insulating the entity from political interference detrimental to

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30 *Menon, Krishnagopal and Srinivasan Umapathy (1990: 95).*

operational efficiency, and in ensuring that the enterprise competes effectively in the market place.

Cell 2 includes SOEs with complex objectives and easily quantifiable outputs. These entities face a trade-off between commercial and social objectives and are usually protected from competition (for example, an artificial monopoly granted by the state). Given that managing these enterprises requires the prioritisation of complex and conflicting goals, an MBO approach with organisational objectives being defined at the highest administrative level, is perhaps most appropriate for this group. Therefore, the Board of Directors has to play an active role in these enterprises to take difficult trade-offs between objectives, articulate the priorities of the organisation, turn these priorities into a corporate action plan, and set out deadlines and targets for individual enterprise managers. Moreover, given the problem of conflicting objectives in these SOEs, it is important that the Board represents heterogeneous viewpoints.

Figure 4. A Typology for Performance Contracting in the Public Enterprise Sector

Degree of Complexity of Organisational Objectives	Degree of Difficulty in Output Measurement: Low	Degree of Difficulty in Output Measurement: High
Low	Cell 1 Market Control	Cell 3 Professional Control
High	Cell 2 Administrative Control	Cell 4 Political Control

Source: *Menon, Krishnagopal and Srinivasan Umapathy (1990: 95).*

In contrast to the enterprises in Cells 1 and 2, those in Cells 3 and 4 have to rely on controlling procedures rather than results. The SOEs in Cell 3 are characterised by simple organisational goals, but face difficulties in measuring performance outputs

quantitatively (for example, research organisations, public radio and television organisations). As such, this group requires the technical expertise of external professionals to periodically review enterprise activities and progress. In addition, those who benefit from the outputs of these entities can also play an important role in providing qualitative performance assessments.

The enterprises grouped in Cell 4, face multiple, conflicting goals and produce outputs which are difficult to evaluate objectively (for example, public utilities). Given that various interest groups with conflicting priorities are usually linked to these entities, only a political solution can help to arrive at some consensus on the direction and performance of the enterprise. Therefore, it is important that the Board of Directors in such SOEs represents a wide range of political view points and that there is parliamentary involvement, through the formation of parliamentary committees for instance, in evaluating the performance of these entities.

3. The Sri Lankan Experience: 1990-1991

3.1 Introduction and evolution of the performance contracting approach

Sri Lanka's brief experiment with the PC approach is best described as a phase in the country's public enterprise "reform pendulum" : a financial crisis in the public enterprise sector, implementation of a new reform strategy, renewed disillusionment, and a new crisis in the sector.[31] As such, the public enterprise reform process in Sri Lanka has gone from corporatisation in the '50s to nationalisation in the '70s, commercialisation in the '80s, and privatisation in the '90s. Although fiscal considerations played an important role in these policy shifts over time, factors such as the political ideology of the ruling party/coalition, populist measures to ensure re-election, and rent-seeking behaviour had a greater impact in shaping the content and direction of the SOE reform process.

The concept of performance contracting was first introduced to the public sector in 1989, as part of an overall SOE reform strategy, with commercialisation and privatisation (or "peopleisation" as it was then called, to reflect broad-based share-

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31 *Trivedi (1990: 4).*

ownership) taking on complementary roles. This policy stance was set out as follows in *A Strategy for Industrialisation in Sri Lanka, 1989*, put out by the Ministry of Industries .

> "All public manufacturing enterprises will be progressively commercialised and peopleised, except where there are over-riding social considerations which require continuation of public ownership...The enterprises selected for peopleisation will be commercialised in the first instance, by converting them into public limited liability companies under the Companies Act.....The commercialised public companies and retained public manufacturing enterprises will be given greater autonomy to make decisions on their own and will be held responsible and accountable for their decisions and consequent actions. All enterprises will have their own Corporate Plans. They will also develop Action Programs to increase efficiency and rationalise their duties. These enterprises will be restructured in order to infuse a high degree of competitiveness and export orientation. The relationship between the Government and the enterprise will consequently be similar to the relationship between the Government and the private sector. A Performance Contracting System which will establish a contractual arrangement between the management and the Government will be introduced."[32]

Following this policy statement, PCs were designed for two SOEs, the Sri Lanka Tyre Corporation (SLTC) and the Ceylon Leather Products Corporation (CLPC) by a World Bank team, which included high-ranking public sector officials as well as international experts with substantial experience in setting up PCs in developing countries.The rationale for moving toward performance contracting systems in the SOE sector was, purportedly, to bring about performance improvement by increasing the levels of managerial autonomy and accountability.[33] Moreover, performance contracting was conceived as an initial step in a gradual process of privatisation. However, there is no conclusive evidence on the effectiveness of the PC approach in this regard, given that this strategy was abruptly abandoned in 1991, with the move to privatise both SLTC

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32 *Ministry of Industries (1989: 19)*.

33 Up to this point in time, major operational decisions in SOEs were made by outside authorities such as, the Cabinet, Ministry officials and Tender Boards, and not by public sector managers.

and CLPC, and with no plans in place to extend this system to other SOEs. In retrospect, it appears that PCs were entered into as a stop-gap measure, as the need to extend political patronage with the 1988/1989 Presidential and general elections, and the heightened anti-state insurgency in 1989/1990, forced the government to go slow in its privatisation drive.

3.2 Internal operationalisation and outcome of performance contracts

The Ministry of Industries, entered into performance contracts with SLTC and CLPC in March 1990, following a Cabinet decision to this effect in September 1989.[34] The two performance contracts developed in Sri Lanka followed the basic format of the single-period, Signalling System adopted by Pakistan, South Korea and Bangladesh. As such, these contracts had the following features :[35]

- the Chairman and Directors of the SOEs negotiated PCs with the Ministry of Industries on the basis of goals and targets specified in the medium-term corporate plans of the entities;
- the delegation of responsibilities between the government and the SOE were separated as political/strategic control and operational control, respectively, to increase autonomy and accountability; political control included, *inter alia*, "control over the goals and long term objectives of the Corporation to ensure harmony with national and sectoral objectives, and definition of any non-commercial objectives and compensation to be paid to the Corporation for their fulfilment"; operational control included, *inter alia*, "control over purchasing, production, marketing, personnel, finance and all functional areas of the Corporation, within the framework of a political and strategic control, and the laws of Sri Lanka".[36]
- targets were set taking into account past performance, planned improvements in productivity, expected prices, salary scales, etc.; adjustments to targets were allowed for factors outside the control of the management, such as the state of capital assets, human resources, and market conditions;
- each PC listed the agreed goals and targets and weighted them so that they could be combined into an overall index of performance (composite score);
- profitability, the primary indicator for measuring short-term operational efficiency, was only one component in the overall performance index; the PCs took into account the trade-off between short-term profitability and other supplementary indicators required to keep the

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34 The Ministry of Industries was chosen to represent the government in this instance, because SLTC and CLPC came under its auspices.

35 See Appendices A and B for a detailed version of the two contracts.

36 See Appendices A and B.

enterprise viable in the long run, such as staff training, management development, technological improvement, market research, product development, computerisation programs, and new investment projects; these supplementary indicators were dealt with in the same manner as social objectives by weighting them on a priority basis and combining them into the performance index;

- performance was monitored and measured by officials of the Ministry of Industries, in accordance with the set targets, at the end of the year; and,
- all employees were to be given a bonus payment, not exceeding three months pay, depending on the degree to which the stipulated targets were realised.

The specific goals and targets determined for the PCs in SLTC and CLPC are given in Table 4.

Table 4. Goals & Targets in Performance Contracts

	Sri Lanka Tyre Corporation (SLTC)	Ceylon Leather Products Corporation (CLPC)
GOALS (WEIGHTAGE)		
Profitability	90%	90%
Export Earnings	–	7%
Human Resources Development	10%	3%
TARGETS		
Profitability	Rs. 35.9 mn	Rs.21.0 mn
ROTA (Return on Total Assets)	6.8%	20.1% (Capital Productivity)
SUB - TARGETS		
Production	(Std. Tyres) 240,858	Rs. 31.24 mn worth of Leather Products
Sales	(Std. Tyres) 240,648	Rs. 175.05 mn
Usage of Nylon Cord	2.97 Kgs. (Per Std. Tyre)	–
Usage of Natural Rubber	18.32 Kgs. (Per Std.Tyre)	–
Hide Collection	–	1.919 mn Kg.
Hide Conversion Ratio	–	1.56 DSM per Kg.
Chemical Usage Efficiency	–	Rs. 13.18 per Kg of Hides
Leather Output	–	2.998 mn DSM
Shoe, Slippers and Sandals Output	-	447,300 pairs (Material Productivity)

Note: - = not stipulated
Std. = Standard
DSM = Deci. Square Meter

Source: *Ministry of Industrial Development, Sri Lanka.*

A compensation package for achieving/exceeding the goals and targets specified in the PCs was calculated based on an increase in value-added, and adjustments were made for labour productivity by reducing increases in personnel emoluments. Accordingly, the following formulae were used to calculate the annual bonus in SLTC and CLPC.

(a) **SLTC**

59 per cent of increase in value-added in 1990 over the average of years 1986, 1987, 1988 minus the increase in personnel emoluments in 1990 over the average of years 1986, 1987, and 1988.

(b) **CLPC**

64 per cent of increase in value-added in 1990 over the average of years 1986,1987,1988 minus the increase in personal emoluments in 1990 over the average of years 1986,1987, and 1988.

A higher percentage of increase in value-added was allowed in CLPC as it was comparatively more labour intensive than SLTC. The minimum bonus was Rs. 1000/- per person and the maximum bonus payable was equivalent to three months wages. The minimum bonus was paid irrespective of the achievements under PCs.

While SLTC achieved the targets stipulated in the PCs for the year 1990 and paid the three months bonus to all eligible employees, CLPC could not meet the targets and paid only the minimum bonus of Rs.1000/- payable to employees of all SOEs. An evaluation of CLPC's performance by the Ministry of Industries indicated however, that the targets set for CLPC were unrealistic and also that CLPC was badly afflicted by a shortage of raw hide during the contract cycle. Moreover, these results are not sufficient to make a realistic assessment of the PC approach in Sri Lanka, given the brief time span of the contracts and given that these contracts were limited to two SOEs. This experiment in performance contracting does however, point to some underlying weaknesses in the planning and implementation of the PC system, as discussed in the next section.

3.3 Some problem areas

(a) Weak political commitment

The international experience indicates that one of the most fundamental pre-conditions for a successful performance contracting policy is strong support from the highest echelons of government. Unfortunately however, weak political commitment was Sri Lanka's biggest obstacle in moving toward a more comprehensive contracting program in the SOE sector. As mentioned before, performance contracting was only adopted as a temporary measure, to tide over the political climate in 1989/1990. As such, the contracting system was not given a chance to work, and was abandoned with the privatisation drive that began around 1990 and continues to date.

The lack of political commitment to a sustainable contracting process shows up in the *ad hoc* institutional arrangements surrounding the contracting system. Although one of the main arguments for introducing the contracting system was to increase the levels of autonomy and accountability in SOEs, the dual role played by the Ministry of Industries as a party to the contractual arrangement and as an arbiter of performance runs contradictory to the very essence of the contracting approach. Clearly, this arrangement permits political interference and is not conducive to enforcing the principle of bilateral commitment, since, in effect, the government monitors itself. Additionally, the nepotism surrounding the appointment of non-professionals to the Board of Directors and to managerial posts in the SOE sector, provided ample opportunities for political interference and undermined the performance improvement goal.

(b) Technical and operational inadequacies

Perhaps due to the extremely brief exposure to performance contracting, Sri Lanka lacks the fundamental technical ingredients for a successful performance contracting program. Although some initial attempts were made in the late 1980s to build up corporate planning capability in the SOE sector,[37] this area remains under-developed,

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37 Both SLTC and CLPC had medium-term corporate plans in place when they entered into PCs.

with the enterprise budget being used as a planning mechanism in many instances. Clearly, the use of a budget, which is exclusively a financial instrument, as a proxy for a corporate plan, which includes management, production, and financial guidelines, is not conducive to enterprise efficiency.

The common misconception amongst enterprise managers in the public sector appears to be that the development of a corporate plan is a useless exercise, given the inevitability of privatisation. It is important to note however, that the drawing up of a corporate plan and divestiture are not mutually exclusive events. Rather, privatisation becomes an easier and more efficient exercise when a corporate plan is in place. Moreover, given that privatisation is not a suitable policy for all SOEs, corporate planning is essential to improve performance whilst under public ownership.

Another area requiring attention is the training of personnel to carry out performance evaluation. Skills training is lacking, for instance, in the technicalities of prioritising and balancing conflicting commercial and social goals, in constructing quantifiable performance parameters, in formulating realistic targets, and in accommodating the differences amongst enterprises in the manufacturing, trade, and service sectors.

(c) Unrealistic incentive structure

As mentioned in Section 2, a workable incentive structure linked to actual performance in an enterprise is essential for a contracting program to be successful. The incentive system used in Sri Lanka provided a bonus payment not exceeding three months basic salary, to every single employee, on the basis of achieving the targets set out in the contract.

The problem with this universal incentive structure is that any single employee can free-ride on the efforts of another. Although the days of leave taken by an employee were taken into consideration when calculating bonus payments, in an attempt to address this free-rider problem, there was no mechanism by which the efficiency or inefficiency of an employee present at the work place could be assessed. It was

possible, therefore, for a relatively lazy, unproductive worker and an efficient worker to receive an equivalent share of the bonus payment, if they both registered the same number of work days. As such, a more selective approach, such as an award for the employee of the month/year for instance, might have been a more efficient incentive strategy.

4. Policy Recommendations

The international experience in performance contracting indicates, that mastering this strategy requires considerable skill and practice. France, for instance, went through four phases of the PC system in two decades, whilst India, which began experimenting with PCs in 1987-88, has had several years to review the functioning of this system and come up with an appropriate PC structure for its public enterprise sector. Although Sri Lanka's experience in performance contracting is brief in comparison, taking advantage of the existing body of international experience in this area can keep us from re-inventing the wheel. This section provides policy recommendations for the effective implementation of performance contracting in Sri Lanka, taking into account the country's political economy, and drawing from the SLTC and CLPC experiments described in Section 3, as well as from the accumulated experiences of other countries, set out in Section 2.

The policy recommendations for the implementation of performance contracting in Sri Lanka are based on the four major objectives, mentioned earlier in this paper - i.e., that the contractual approach should be:

(a) an integral part of the national economic strategy;

(b) a means of reflecting the nature and extent of "publicness" or social accountability shouldered by a public enterprise;

(c) a means of establishing the comparative advantage of a public enterprise; and,

(d) a step in the privatisation exercise, in the case of SOEs with little or no comparative advantage.

In addition, these recommendations are derived on the premise that performance contracting is not a panacea for the problems of the SOE sector and that its use should be limited to the enterprise categories identified in Table 1.

4.1 Securing political commitment

As discussed earlier, political will and political commitment at the highest level of government is perhaps the single most important ingredient for a sustainable reform program. In South Korea, for example, the public sector management, who initially viewed the contractual approach with much scepticism, conformed to the system only because the President himself vehemently supported the strategy and personally announced the results of performance evaluation at the end of the contract cycle. In India, political commitment to the PC strategy has seen this system evolve from its tentative beginnings to a comprehensive and structurally sound system.

Unfortunately however, Sri Lanka's experience with public enterprise reform, is replete with examples of the lack of political commitment and of *ad hoc* political interference, leading to the complete or partial reversal of the reform process. As such, it is evident that any SOE reform strategy will have to dove-tail into the political agenda if it is to be sustainable. The challenge then becomes one of sound marketing; selling the concept of performance contracting to decision makers at the highest level of government. The following suggestions address this issue, taking into account the current political-economic trends in the country.

(a) focus on public enterprises that are difficult to privatise

As mentioned in the introductory section of this paper, SOEs in the banking, insurance, petroleum, power, transport, health and education sectors are difficult to privatise for technical and political reasons. Given that loss reduction and performance improvement are critical issues in the case of these SOEs however, alternative reform strategies will have to be put in place, on an interim basis for entities that can eventually be privatised and on a more permanent basis for those that will remain under state ownership for political reasons.

As illustrated in Table 1, performance contracting is one option that can be used in the case of SOEs that either require substantial restructuring prior to divestiture or are unsuitable for privatisation or private participation.[38] In instances where PCs are used as an interim measure, the resulting performance improvement can increase the net worth of the entity and establish a better sale price at the time of divestiture. Moreover, performance contracting can gradually expose workers to commercial principles of management and production and to the benefits of private-sector style management, and help to avoid the industrial disputes that have characterised many of the enterprises privatised between 1990 and 1993 in Sri Lanka.[39] The PC option is also very useful in the case of SOEs that are to remain under state ownership on a more permanent basis, such as those in the social infrastructure sector, given that they will have to maximise both allocative and x-efficiency if they are to fulfil their social obligations without draining scarce public resources.

(b) focus on turning around sick enterprises

Performance contracting can also be marketed as a useful strategy in the case of the SOEs taken back by the state under the *Public Enterprises Rehabilitation Act, No. 29 of 1996,* due to various financial and labour problems in these enterprises. The results of a PC can, for instance, help to establish the comparative advantage of a SOE, to revamp the enterprises that can be turned around and eventually privatised, and to establish a case for shutting down units that are not viable.

4.2 Enhancing autonomy and accountability

One of the lessons coming out of the international experience in performance contracting, is that the government and the SOE management tend to develop a mutually exploitative relationship, with the government manipulating weak management to serve its political agenda and the management using political interference as an excuse for poor performance. As such, it is vital that a contract is very clear as to the

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38 In South Korea, for instance, the application of PCs in enterprises retained by the state for strategic reasons, led to cost saving rates of 3.0%, 4.1% and 5.4% in 1984, 1985 and 1986, respectively *[Song, Dae-Hee(1990 :597)]*.

39 There is a possibility that employees in an SOE would resist a PC if they perceived it as a step toward eventual privatisation and retrenchment. However, such resistance could well be offset by the publicity given to employee share ownership, dividend payments, and attractive compensation schemes under the privatisation program.

limits and separation of autonomy and accountability, if it is to avoid such pitfalls. The following recommendations focus on increasing the levels of autonomy and accountability, through a PC, in Sri Lanka's public enterprise sector.

(a) revamp the original institutional arrangements

As mentioned in Section 3, the contracting system practised in Sri Lanka in 1990-1991, was reduced to a contract between two unequal partners due to the institutional arrangement where one party to the contract (the government) also functioned as the judge of the contract. A possible solution to this *impasse* is to bring in a third-party evaluator responsible for the following functions:

- reviewing and approving the draft PC before the final version is signed;
- evaluating performance at the end of the year; and,
- acting as the policy formulation body.

A similar approach has been resorted to in India, through the setting up of a High Power Committee (HPC), which includes, *inter alia*, the Cabinet Secretary, the Finance Secretary, the Chief Economic Advisor, Ministry of Finance, and the Chairman, Public Enterprise Selection Board, and excludes any Ministry Secretary or official who is a party to signing a PC. [40]

A second issue involving institutional change, is the problem of information asymmetry between the government and the management of the enterprise. Again, the Indian experience provides a possible solution. The government of India set up an Ad-Hoc Task Force consisting of management professionals with considerable experience in both ministerial and enterprise matters, as well a Permanent Task Force consisting of representatives of the HPC to ensure a free flow of information between the HPC and the Ad-Hoc Task Force. This institutional set-up proved to be effective in reducing the imbalance in technical expertise between the government and the management.[41]
A third somewhat related issue is the absence of a management information system

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[40] Department of Public Enterprises, Government of India (undated: 20-21).
[41] *Ibid* (21-23).

within an enterprise, to provide timely and reliable information to enterprise management on their operations. Given that the efficacy of a PC depends heavily on the kind of reporting systems operating within an enterprise, it is important that an appropriate and comprehensive Database program be installed in the SOEs selected for these contracts.

(b) revamp recruitment and training policies in the SOE sector

The combination of weak management and strong trade unions in Sri Lanka's SOE sector provides a fertile breeding ground for *ad hoc* political interference. If managerial autonomy is to be enhanced, the recruitment of political appointees has to be replaced by the recruitment of professionals on the basis of merit. It also follows that the public sector has to upgrade its salary scales to attract and retain suitably qualified and experienced personnel.

A similar, apolitical strategy has to be adopted in regard to the selection of the Board of Directors in a SOE, as the Board forms an important link between the Government and the enterprise management. As such, the composition of the Board has to reflect a suitable balance between the government and the executive management team, with government appointees also being chosen on a professional basis. Moreover, the differences in enterprise priorities and challenges, illustrated in Figure 4, should also be taken into account when selecting the members of the Board.

Since managerial autonomy is also linked to the skills level and bargaining power of the management, it is important that training programs be launched to educate and equip enterprise personnel with the skills required for the performance evaluation process. However, given that there appears to be a general apathy toward training amongst public sector workers, it follows that the political will for reform has to come from the upper levels of the political hierarchy.

4.3 Technical issues

(a) criteria selection and target-setting

The international experience in performance contracting combined with the SLTC and CLPC experiments, emphasise the importance of the following considerations when selecting performance parameters and setting targets.

- the selection of performance criteria has to be sensitive to the differences between SOEs, as illustrated, for instance, in Figure 4
- traditional performance indicators such as capacity utilisation should be replaced by innovative indicators, measuring customer satisfaction (such as, for example, delivery of orders, product/service quality, customer complaint resolution, etc.)
- traditional social parameters such as regional development, employment creation, and price subsidisation, for instance, must not be included along with items such as customer satisfaction, human resource development and enhancement of environmental standards in the composite score; instead, the maximum/minimum target range for the conventional indicators should be given under separate headings
- the third-party evaluator has to ensure that the government and the management reach a negotiated agreement on the weights attached to performance criteria
- performance standards in the SOE sector will have to conform to global standards if these enterprises are to survive in the medium to long term scenario
- performance targets have to be set separately for each enterprise, each year, and renegotiated for the next contract cycle on the basis of the end of the year performance evaluation exercise
- too low a target will have no incentive effect, while too high a target will leave the management alienated and unmotivated
- a disclosure bonus, where a higher level of bonus is offered if the management is willing to raise the targets and a lower level of bonus is given if the management insists that the targets are too high, can be introduced to get to more realistic targets

(b) performance incentive system

Given that the objective of the reward/penalty approach is to create incentives for higher levels of performance, the following considerations have to be taken into account when structuring an incentive system.

- the performance incentive system has to be directly linked to the composite measure of performance (which, as shown in Tables 2 & 3, is comparable across SOEs)
- the internal procedures for distributing rewards/penalties must be fair and transparent; one way of doing this is to ensure that the detailed criteria for reward/penalty eligibility is approved by the third-party evaluator, put into print, and distributed to each employee in the enterprise
- the rewards must be given at as close a time period as possible to the performance achievement for which they are being awarded
- the rewards/penalties have to be of sufficient magnitude to act as an incentive and to bring out the productivity gain-sharing aspect of the PC system
- the incentive scheme should consist of a mix of monetary and non-monetary rewards/penalties; monetary rewards/penalties could include bonuses and pay cuts, while non-monetary rewards/penalties could include, *inter alia*, employee of the month/year awards, promotions/demotions, and dismissals
- the government could also be given a monetary statutory payment, such as a dividend payment, as an incentive to keep to its side of the contract

5. Conclusion

In recent years, Sri Lanka's public enterprise reform efforts have focused almost exclusively on encouraging varying degrees of private participation in state-owned enterprises. These efforts however, have increasingly posed challenges to policy makers, given the weakness of the supporting regulatory and legal framework. Although these problems were rampant even in the first phase of privatisation, from 1989 to 1994, most of the enterprises privatised during that period required a far less complex institutional structure, while the enterprises now remaining in the state sector are more complex in both a technical and political sense. Given the current fiscal constraints and the high level of state transfers to these entities however, it is clear that other options will have to be explored to improve the performance of these SOEs.

The focus of this paper has been on assessing the advantages of using performance contracting to satisfy the current need for an alternative public enterprise reform strategy. A key advantage of the PC approach in this regard, is that it requires far less complex legal and regulatory structures than a privatisation strategy. Moreover, it facilitates privatisation by revamping an enterprise and making it more attractive to the private sector, and also by exposing the work force to commercial practices. In the case of SOEs where private participation is not a feasible option even in the long-term, the PC approach can serve a useful function in replacing bureaucratic practices with commercial performance standards , improving enterprise efficiency and cutting back on wasteful state expenditures. In addition, a PC helps to establish the comparative advantage of a SOE by serving as a useful indicator of the extent to which it meets its social or "public" obligations.

In spite of these advantages however, the performance contracting approach confronts a fundamental question of realism, given that the government is a party to the contract, that administrative accountability is inextricably linked to political accountability, and that the success of this strategy hinges on the political factor. Whilst the appointment of a neutral third-party evaluator, can address the problem of political interference to some extent, even this arrangement would be futile in the absence of political commitment to the performance contracting strategy.

One possible way in which to ensure political commitment to this strategy is to move in tandem with the current political-economic agenda. Going by this principle, two sets of SOEs emerge as suitable candidates for performance contracting in Sri Lanka : SOEs in the service sector that are difficult to privatise for technical and political reasons, and SOEs taken back by the state under the Rehabilitation Bill. Even in regard to these enterprises however, it is important that evidence exists to show that options such as contracting out of public services, management contracts, and leasing arrangements, for instance, are not feasible, before entering into a performance contract.

In sum, the message to policy makers is clear. Performance contracting is not a panacea for the problems confronting Sri Lanka's public enterprise sector, and should

not be viewed as a means to avoid privatisation for short term political gains. As such, the usefulness of performance contracting as a strategy for public enterprise reform in Sri Lanka, is limited to the case of specific enterprise categories where private participation, of any degree, is not a feasible option.

PERFORMANCE CONTRACT

FOR THE YEAR 1990

BETWEEN

THE MINISTRY OF INDUSTRIES

AND

CEYLON LEATHER PRODUCTS CORPORATION

PERFORMANCE CONTRACT FOR THE YEAR 1990

With a view to increase the autonomy and efficiency of operation of the Corporation, and to make the Corporation more fully responsible and accountable for its use of public funds, the following arrangements will apply in respect of financial year 1990.

1. Political and strategic control over the Corporation will be to the Government.
2. Operational control will be exercised solely by the Board of Directors of the Corporation, within the parameters of political and strategic control.

   The term 'Political and Strategic Control' is defined as follows:

   1 - Control over the goals and long-term objectives of the Corporation to ensure harmony with national and sectoral objectives, and definition of any non-commercial objectives and compensation to be paid to the Corporation for their fulfillment;

   2 - Appointment and determination of remuneration of Directors and the Chief Executive Officer of the Corporation;

   3 - Any single project investment estimated to cost more than Rs.10 million (Fixed and Working Capital) or having an annual recurrent cost of more than Rs.0.5 million;

   4 - Any investment outside the Corporation other than domestic short-term bank deposits (including investment in a Joint Venture, or setting up a subsidiary company, or investment in assets outside Sri Lanka);

   5 - Any sale of land, or of a major part of the undertaking of the Corporation, or liquidation of the Corporation;

   6 - Loans to Directors, or any other benefit or perquisite except as authorised by Government;

   7 - Annual bonus on performance;

   8 - Borrowing or lease commitments which would result in total debt exceeding twice the book value or equity, or finance charges exceeding half the earnings before interest and tax, or any foreign borrowing or commitment;

   9 - Payment to the Consolidated Fund by way of special dividend or capital dividend;

   10 - Submission of annual updated corporate plan (including budget), quarterly progress reports, and final accounts, all in CERS formats;

   11 - Appointment of auditors and receipt of auditor's report;

12 - Review of performance by Ministry of State and Parliamentary Committee on Public Enterprises.

The Corporation remains subject to the Constitution and all laws of Sri Lanka.

The term 'Operational Control' is defined as control over purchasing, production, marketing, personnel, finance and all functional areas of the Corporation, within the framework of a political and strategic control, and the laws of Sri Lanka, as above. The following controls will be discontinued or amended as follows:

Purchasing - Individual purchases below Rs.5 million will be made by the Corporation on the authority of the Board of Directors; purchases of Rs.5 million or more will be made by Cabinet-appointed Tender Boards unless and until the Cabinet decides otherwise.

Pricing - Corporation will price their output according to market conditions with a view to profit maximization, in accordance with the Industrial Policy Statement. Where the Government wishes to subsidise a product it will do so explicitly. Products prescribed under the Fair Trading Commission Act will be subject to the provision of the Act.

Personnel - The Board of Directors is responsible for the recruitment, transfer, promotion, lay-off, discipline and dismissal of personnel. Salaries and other emoluments will be determined on the basis of job evaluation and the market rates to attract competent personnel.

Borrowing - Subject to the overall gearing limits laid down, the Corporation may borrow from the banking system on its own assurances and security. No Government guarantee will be given, express or implied. Previous borrowing limits will lapse.

Foreign Travel - The Board of Directors may approve travel abroad for purposes of training, export marketing, acquisition of technology or any other purpose intended to serve agreed Corporation goals. Such travel remains subject to Prime Minister's authorisation, unless or until the Cabinet decides otherwise.

Other Controls - All other restrictions and directives issued by M/1 or the Treasury lapse except in so far as they are included in the framework of political and strategic control.

Goals and Targets:

Goals of the Corporation, and their respective weighting (national importance) are agreed as follows:

Profitability	-	90%
Export earnings	-	7%
Human resource development	-	3%

These are all commercial objectives, and no claim for compensation arises.

1. The profitability target for 1990 is agreed at Rs.21.008 million that is Rs.32.586 million before interest on total assets of Rs.157.6 million which is a 20.1% return on total assets. The profit target is based on the following targets.

Hide collection	1.919 million kg.
Hide conversion ratio	1.56 DSM per kg.
Chemical usage efficiency	Rs.13.18 per kg. of Hides
Leather output	2.988 million DSM
Shoe, Slipper and Sandals output	447,300 pairs
Leather Goods Production (at selling prices net of BTT)	Rs.31.243 million
Sales Revenue (Net of BTT)	Rs.175.057 million

2. Foreign exchange earnings (FOB export earnings) target for the year 1990 is Rs.20.950 million.

3. The third target is to establish a further work centre for rural employment, including giving training; seven work centres should be in full operation by the end of 1990.

Corporation Bonus Calculation:

Annual bonus for 1990 will be given on the performance achieved, subject to the Auditor General's report and Cabinet approval. The bonus will be calculated in three parts:

(i) Bonus on actual operating profit (before interest and tax) after adjustment for (a) the impact of any Government directives, (b) any changes in accounting policies by the Corporation, and (c) errors found in the accounts for 1990.

Bonus 1987 - 64% increase in value added in 1990 over the average of 1986, and 1988.

Minus - the increase in personnel emoluments in 1990 over the average of 1986, 1987 and 1988.

Valued added 1986 - 1988 was as follows:

	1986 Rs. m.	1987 Rs. m.	1988 Rs. m.	Average Rs. m.
Personnel Emoluments	21.335	26.163	37.376	28.291
Depreciation	4.071	4.440	4.829	4.447
Operating Profit	12.281	12.355	1.886	8.841
	37.687	42.958	44.091	41.579

For purpose of example, suppose value added for 1990 were as follows, before declaration of annual bonus.

Personnel Emoluments	Rs.38.346 million
Depreciation	4.995
Operating Profit	32.586
	75.927

On the performance, profit bonus for 1990 would be 64% (75.927 - 41.579) - (38.346 - 28.291) = Rs.11.928 million.

The starting point for a bonus more than Rs.1000 is an operating profit of Rs.15.710 million, equivalent to a net profit of Rs.4.132 million.

(ii) The foreign exchange earnings target is Rs.20.950 million. If this is achieved, the bonus on this, which would be in proportion to the weight assigned to this goal, is 7/90 x bonus on target profit as calculated above. If the foreign exchange target were exactly achieved foreign exchange bonus would be 7/90 x 11.928 million - 0.927 million.

This is also on a linear sliding scale for any increase over the average foreign exchange earnings in 1986, 1987 and 1988, which were Rs.6.921 million. Thus, if the foreign exchange earnings were Rs. 11 million only, the bonus on this would be 11.00 - 6.921/20.955 - 6.921 x 7/90 x 11.928 million = Rs.0.270 million. Over - achievement of the target would not count for additional bonus: Rs.0.927 million is the maximum of this element.

(iii) The Work Centre target carries a bonus entitlement of 3/90 of the bonus of target profit. If the latter were Rs.11.928 million, 3/90 of this would be Rs.0.398 million. This is an all-or-nothing goal; nothing would be allowed for partial achievement, and nothing more would be allowed for over-achievement.

Corporation bonus for 1990 is the sum of the three components, calculated as above with a minimum of Rs.1,000 per person, and a maximum of three months basic salary per person.

Individual Bonus Calculation

Corporate bonus will be divided over all persons working full time in the Corporation in 1990 in proportion to basic salary received in 1990.

Sgd. SECRETARY
MINISTRY OF INDUSTRIES

Sgd. CHAIRMAN
CEYLON LEATHER PRODUCTS
CORPORATION

Date: 7/3/1990

PERFORMANCE CONTRACT

FOR THE YEAR 1990

BETWEEN

THE MINISTRY OF INDUSTRIES

AND

SRI LANKA TYRE CORPORATION

SRI LANKA TYRE CORPORATION

PERFORMANCE CONTRACT FOR FY 1990

1. With a view to increase the autonomy and efficiency of operation of the Corporation, and to make the Corporation more fully responsible and accountable for its use of public funds, the following arrangements will apply in respect of financial year 1990.

    1. Political and strategic control over the corporation will be reserved to the Government.

    2. Operational control will be exercised solely by the Board of Directors of the Corporation, within the parameters of political and strategic control.

2. The term 'political and strategic control' is defined as follows:

    1. Control over the goals and long-term objectives of the Corporation to ensure harmony with national and sectoral objectives, and definition of any non-commercial objectives and compensation to be paid to the Corporation for their fulfillment.

    2. Appointment and determination of remuneration of Directors and the chief executive officer of the Corporation.

    3. Any single project investment estimated to cost more than Rs. 10 million (fixed and working capital) or having an annual recruitment cost of more than Rs.0.5 million.

    4. Any investment outside the Corporation other than domestic short-term bank joint venture, or setting up a subsidiary company or investment in assets outside Sri Lanka.

    5. Any sale of land, or of a major part of the undertaking of the Corporation or liquidation of the Corporation.

    6. Loans to Directors or any other benefit or perquisite except as authorised by Government.

    7. Annual bonus based on performance.

    8. Borrowing or lease commitments which would result in total debt exceeding twice the book value or equity, or finance charges exceeding half the earning before interest and tax, or any foreign borrowing or commitment.

    9. Payments to the Consolidated Fund by way of special dividend or capital dividend.

    10. Submission of annual updated corporate plan (including budget), quarterly progress reports, and final accounts all in CFRS formats.

    11. Appointment of auditors and receipt of auditors' report.

    12. Review of performance by Ministry of State for Industries and Parliamentary Committee on Public Enterprises.

The Corporation remains subject to the Constitution and all the laws of Sri Lanka.

3. The term 'operational control' is defined as control over purchasing, production, marketing, personnel, finance and all functional areas of the Corporation, within the frame work of political and strategic control, and the laws of Sri Lanka, as above. The following controls will be discontinued or amended as follows:

Purchasing	-	Individual purchases below Rs.5 million will be made by the Corporation on the authority of the Board of Directors. Individual purchases of Rs.5 million or more will be made by Cabinet appointed Tender Boards unless and until the Cabinet decides otherwise.
Pricing	-	Corporation will price their output according to market conditions, with a view to profit maximisation, in accordance with the Industrial Policy Statement. Where the Government wishes to subsidise a product it will do so explicitly. Products prescribed under the Fair Trading Commission Act will be subject to the provisions of that Act.
Personnel	-	The Board of Directors is responsible for the recruitment, transfer, promotion, lay-off, discipline and dismissal of personnel. Salaries and other emoluments will be determined on the basis of job evaluation and the market rates to attract competent personnel.
Borrowing	-	Subject to the overall gearing limits laid down, the Corporation may borrow from the banking system on its own assurances and security. No government guarantee will be given, express or implied. Previous borrowing limits will lapse.
Foreign Travel	-	The Board of Directors may approve travel abroad for purposes of training, export marketing, acquisition of technology or any other purpose intended to serve agreed Corporation goals. Such travel remains subject to Prime Minister's authorisation unless or until the Cabinet decides otherwise.
Other Controls	-	All other restrictions and directives issued by the Ministry of Industries or the Treasury lapse except in so far as they are included in the framework of political and strategic control.

4. <u>Goals and Targets</u>

Goals of the Corporation and their respective weighting (national importance) are agreed as follows:

Profitability	90%
Human resource development	10%

These are all commercial objectives, and no claim for compensation arises.

1. The profitability target for 1990 is expected at Rs.35.9 million that is, Rs.41.6 million before interest, on total assets of Rs.525.6 million, which is a 6.8% return on total assets. The profit target is based on the following sub targets:

Usage of Nylon Cords per std. tyre	2.970 kgs.
Usage of natural rubber per std. tyre	18.32 kgs.
Production (standard tyres)	240,858
Sales (standard tyres)	240,648

2. The second target is to promote development of Sri Lanka Tyre Corporation employees by the programmes listed in the Corporation Plan 1990-1994 (Volume 2 Section B, 1990 targets).

5. Corporation Bonus Calculation

Annual Bonus for 1990 will be given on the performance achieved, subject to the Auditor General's and Cabinet approval.

Bonus on actual operating profit (before interest and tax) after adjustment for (a) the impact of any Government directives, (b) any changes in accounting policies by the Corporation, and (c) errors found in the accounts for 1990.

Bonus = 59% of increase in value added in 1990 over the average of years 1986, 1987, 1988 minus the increase in personnel emoluments in 1990 over the average of 1986, 1987, 1988.

Minimum bonus is Rs.1000/- per person, and maximum bonus is three months' pay.

6. **Individual Bonus Calculation**

Corporation bonus will be divided over all persons working full time in the Corporation in 1990 in proportion to basic salary received in 1990.

Sgd. SECRETARY
MINISTRY OF INDUSTRIES

Sgd. CHAIRMAN
SRI LANKA TYRE CORP.

7 March 1990.

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