Contracting Out
An Opportunity for Public Sector Reform

Most transition economies have made remarkable progress to maintain appropriate macroeconomic policies, increase private ownership, and ensure competitive markets. Nevertheless, their citizens and firms are still likely to receive poor, arbitrarily provided public services. The next stage of reform requires improvements in the quality and cost-effectiveness of the services that governments offer. Private sector participation in the provision of public services—contracting out—will be an integral part of this next stage.

Contracting out increases both private sector development and the efficiency of the public sector. This report evaluates the potential and limitations of contracting out, and describes the different forms of Bank support.

Improving Government Services

The delivery of government services is a significant issue in the CEE and Central Asian region. A survey conducted for the World Development Report 1997: The State in a Changing World makes the issues clear: Firms in the survey rank public sector corruption, poor infrastructure provision, and regulatory uncertainty as three of the five most important obstacles to doing business. All of these obstacles suggest that the quality of government service delivery is likely to be poor. It is striking not only that firms in the former Soviet Union and Eastern Europe have a very low opinion of government service delivery in general, but also that these firms perceive little or no improvement over the last ten years.

These results strongly suggest that the transition economies would benefit significantly from improved government services. One way to improve services is to contract them out to private firms. Contracting out has the potential to yield several benefits; it is likely to lead to lower costs, higher quality, and more rapid innovation. This is not because the private sector has greater talent or better intentions than public officials; rather it is because governments can more easily reward private providers than public officials for low cost, high quality service. This is the reason that the private provision of services around the world in areas as varied as cleaning services, road construction and maintenance, laundry, data processing, and fire fighting have yielded significant cost savings (often as much as 50 percent).

When Is Contracting Out Most Successful?

The benefits of contracting out are likely to be greater if the quality (and quantity) of output is easy to specify and verify or if the service is characterized by large potential improvements in observable quality. Based on this principle, the table on the following page tentatively classifies services into four categories based on quality assessment and range of innovation.
Quality tradeoffs in contracting out

<table>
<thead>
<tr>
<th>Quality innovations possible</th>
<th>All important quality dimensions easy to assess</th>
<th>Some important quality dimensions difficult to assess</th>
</tr>
</thead>
<tbody>
<tr>
<td>Substantial</td>
<td>Transport (logistics),</td>
<td>Military procurement,</td>
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<tr>
<td></td>
<td>specific medical</td>
<td>communications, education,</td>
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<td></td>
<td>interventions</td>
<td>health, road construction,</td>
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<td></td>
<td>(kidney dialysis),</td>
<td>and periodic maintenance</td>
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<tr>
<td></td>
<td>equipment maintenance</td>
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<tr>
<td>Few</td>
<td>Laundry, janitorial,</td>
<td>Safety inspections, prisons</td>
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<tr>
<td></td>
<td>street cleaning, routine</td>
<td></td>
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<tr>
<td></td>
<td>road maintenance</td>
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</tbody>
</table>

Greater competition—either competition in the market (multiple providers of the service) or competition for the market (multiple providers bidding for the sole right to provide the service)—allows contracting out to flourish. More competitive markets increase the government’s information, making it easier for them to capture cost savings. Such markets also increase provider incentives to innovate and cut costs. (For example, janitorial services have more potential providers, and are therefore more competitive than urban water supply; telecommunications is less competitive in the product market, but there are literally hundreds of potential bidders for sole rights to provide telecommunication services to a jurisdiction.)

Political and social institutions determine the information available to decision makers, the incentives of decision makers to respond to the information, and the credibility of the commitments. Where the institutional setting encourages beneficiaries to report quality (perhaps indirectly, through their voting decisions), government decision makers to monitor it (e.g., in order to be re-elected), and the credibility of government contracts with private firms (e.g., because more than one decision maker must agree to a change in contract), contracting out is more likely to be successful.

Each of these three dimensions can compensate for deficiencies in the other. For example, institutions that encourage public feedback on the quality of provision can offset the incentives that competition might present to cut corners on quality.

How the World Bank Can Help

Governments that embrace contracting out are likely to require assistance in the following areas: identifying the appropriate areas for and likely savings from contracting out; setting up procurement and tender standards; training government contract officers and establishing contracting and performance auditing capability (particularly related to technical assessment of the quality of service provision); setting up systems for quality feedback from benefici-
ries; and purchasing equipment to manage information flows and analysis. Some of these activities (evaluation of savings and setting up tenders) parallel necessary steps in privatization. Other activities, such as establishing a procurement law and training government contract officers, are more closely identified with public administration reforms. Lending instruments that are appropriate to either of these are therefore likely to support contracting out. There are many Bank modalities for funding and providing this assistance: technical assistance loans, adjustment loans with counterpart funds set aside, investment loans, and adaptable project lending.

**Technical Assistance Loans**
Under a technical assistance loan, the government would designate an agency to be responsible for managing the contracting out process. TA loans are small, and are even less well-adapted than adjustment and other loans to persuade a government to lower its resistance to a particular reform. However, for governments that generally support contracting out, the flexibility and longer time span over which TA loans can be disbursed make them a good match to the timeframes necessary for implementing public sector reform.

**Adjustment Loans with Counterpart Funds Set Aside**
Adjustment loans have also been commonly used to support both privatization and public sector reform efforts. As part of the loan's conditionality, the government would set aside counterpart funds to finance the implementation of contracting out. These loans can be constructed to permit multi-tranching, which is permitted under World Bank guidelines when long-term monitoring is necessary.

**Investment Loans**
The World Bank makes these investment loans to implementing agencies (rather than to governments) in order to improve performance in specific sectors. Much of the support that the Bank has given for contracting out has been in the context of investment loans (for example, in road construction). Investment loans must be used with caution. Because they are channeled to specific agencies, they have the potential for subverting government budget processes and investment planning.

**Adaptable Project Lending**
Although the main objective of contracting out is to improve the provision of government services, it may not be clear whether it is contracting out or some other strategy that would be the most appropriate. Adaptable Project Lending (APL) provides a more flexible approach to institutional reforms in individual sectors, lengthening the timeframe for reform and promoting a more programmatic approach. However, APLs conform to conventional investment lending by focusing on hard investments; therefore, their benefits for institutional reforms in the public sector may be limited.
Conclusion

Improving the provision of government services within a sound fiscal framework is a key goal of World Bank assistance to CEE and Central Asian countries. Improved government services help cement political and economic reforms in transition countries, raise the standard of living of citizens (particularly those who are most vulnerable in times of great economic change), and increase the speed of private sector development. Within the menu of possible public sector reforms, the potential for contracting out is large, particularly for those governments that are committed to improving the services they provide their citizens.

World Bank involvement in reforms to improve government services is useful in several ways. First, for governments confronting severe fiscal constraints, World Bank financing can be a financial bridge to successful reform. Second, World Bank involvement can expand the set of private sector firms willing to participate in the contracting out process. Third, the World Bank can assist countries by providing worldwide expertise to design effective and sustainable programs of contracting out and/or to determine whether contracting out is indeed appropriate for a particular country’s private sector development.