Contracting Out
An Opportunity for Public Sector Reform and Private Sector Development in Transition Economies

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with a Foreword by Lajos Bokros
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Most countries within the 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, therefore, requires significant steps to improve the quality and cost-effectiveness of the government services—including regulation, dispute resolution, and social assistance. Increased private sector participation in the provision of public services—contracting out—will be an integral part of this next stage of reform. The benefits it can achieve and the conditions under which it is appropriate are the subject of this paper.

For these countries, contracting out 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, yields significant cost savings (often as much as 50 percent).

Of course, countries unable to conduct tenders according to proper standards of procurement, or to persuade private providers of public services that the government will honor their contracts, are unlikely to gain from contracting out. However, as the paper suggests, governments unable to handle procurement from private providers generally do not manage public provision well, either. At the very least, contracting out should be considered a low-risk reform option for the entire region.

This paper identifies other conditions, besides the legal environment, that allow countries to maximize the benefits from contracting out. Contracting out is likely to have significant benefits where private markets for a particular service are more competitive; where governments have a good sense of their own costs of provision; where the potential for innovation is great; and where the public has the opportunity to express its displeasure when poor quality services are rendered. This list helps to identify reform priorities in the transition economies: improving the rule of law, removing barriers to competition, and increasing the possibilities of feedback from the public regarding the quality of service provision. This paper, then, plots a set of important steps that all countries in Eastern Europe and Central Asia should consider to improve the services that government provides citizens, to further expand the possibilities for private sector initiative, and to raise public confidence in the state.
Despite the significant economic advances of many countries in Central and Eastern Europe and Central Asia, there is still the need to improve significantly the quality and efficiency of government service provision. There are several strategies to accomplish this; this paper examines one of them, contracting out, or the use of private firms in the provision of government services. Contracting out is a reform alternative that has been accepted in many countries; it provides an opportunity to further both private sector development and the efficiency of the public sector. In this report we will evaluate the potential and limitations of contracting out, and describe the different forms of Bank support that can augment reform efforts.

This report opens with a brief discussion of the benefits of contracting out documented in OECD countries. Then some evidence is presented regarding the troubled state of government service delivery in transition countries. Next, the different tradeoffs are identified that arise in contracting out, particularly along the lines of quality, cost, and innovation. This particular discussion considers three factors that condition these tradeoffs: the characteristics of the services themselves, market conditions, and the institutional environment. The paper ends with a discussion of practical issues in contracting out, and of potential Bank modalities for supporting it.
Under contracting out, private firms supply non-commercial government services in exchange for reimbursement from the state or from government-supported beneficiaries. These non-commercial services fall into two categories:

- **government services provided to itself, including payroll, information systems, testing of civil servants, janitorial services, and accounting**;
- **government services provided to the public, such as prisons, libraries, road construction and maintenance, ambulance and other emergency services, health care, education, and transport**.

Contracting out does not exclude the possibility of public sector provision. Many jurisdictions allow public sector employees and agencies to bid for the right to continue providing their services, or to provide those services to other government agencies that themselves seek to contract out. The city of Indianapolis, Indiana (U.S.), for example, initiated a comprehensive program of contracting out, and many existing public agencies bid successfully for the right to continue their provision. Contracting out may be conducted in a monopoly environment (i.e., bidding out a single franchise for garbage collection), or in a competitive environment (i.e., allowing the public to use any of several schools to provide education).

Contracting out has the potential to yield several important benefits. These include:

- **lower costs**;
- **higher quality and greater innovation**;
- **the encouragement of small-scale businesses, which are often in a position to easily supply contracted-out services**.

None of these benefits is guaranteed, however. Contractors may minimize their costs by reducing quality in ways that are difficult for the government to verify. Those providers operating in a monopoly environment and facing no threat of competition may innovate less. Poor contract management by the government and insufficient competition in the market may deny governments most of the cost benefits of contracting out.

Despite these issues, OECD countries are increasingly turning to contracting out. For example, 73 percent of local governments in the U.S. use private janitorial services and 54 percent use private garbage collectors (up from 52 percent and 30 percent ten years ago, respectively, according to Mercer). The popularity of a reform is, of course, not necessarily proof of its efficiency. However, evidence suggests that the benefits of contracting outweigh the costs.

Because cost savings are an important benefit of contracting out, countries with tightened budget constraints are more likely to contract out (López-de-Silanes, Shleifer and Vishny 1997). More direct and sector-specific evidence of cost savings is also available: In refuse collection, Savas (1979) summarizes five studies of cost savings in various American, Japanese, and Canadian cities. The conclusion is that the cost of municipal provision exceeds the cost of contracted provision by 29 percent (in a sample of cities with population greater than 50,000) to 124 percent (in a sample of 211 Japanese cities).

A study of 20 American cities found that, per curb mile, the cost of municipal street sweeping was 43 percent greater than the cost of contract sweeping, holding frequency of service and street cleanliness constant (Stevens 1985, p. 26). The same study shows that street repaving in the same cities was 96 percent more costly when performed by the municipality than when it was contracted out, again controlling for quality. Differences in labor productivity explain these savings. The private contractors paid higher wages (nearly 50 percent higher), but laid an average of 4,508 tons of asphalt per worker; the municipalities laid only 1,180. Similarly, road construction and maintenance were found to be 60 percent more costly when undertaken by government crews than by private contractors, even when private contractors paid

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1 Since scale economies are often low and capital constraints non-binding in public services, the optimal size of firms is often therefore small.
higher wages (Savas 1987, p. 132).

Even in fire protection, which seems to be a uniquely public function, there is evidence of significant cost savings under contracting out. Almost half the population of Denmark relies on private fire protection and has done so since the 1920s. Kristensen (1983) concludes that publicly provided professional fire service in Denmark cost 131.9 kroner per capita, compared to only 46.3 kroner per capita for private provision.²

There is also evidence of cost savings from contracting out internal government support services. Los Angeles County, California (U.S.) issued 193 contracts from 1979–1984 to allow private sector provision of 16 services, and concluded that it saved approximately 30 percent relative to own-provision (or $24.75 million).³ Pommerehne and Schneider (1985) conclude on the basis of multiple studies by other researchers that in Germany, public costs exceeded private costs by 50 percent for printing work, 85 percent for laundries, 100 percent for automobile repairs, 50 to 150 percent for floor cleaning, and 20 percent for building construction. Debt collection is another area where private contracting appears to be advantageous: The U.S. federal government was spending $8.72 to maintain and pursue each delinquent account, vs. $3.50 in the private sector (U.S. General Accounting Office, 1979, cited in Savas, p. 160).

Again, none of these studies makes the definitive case that contracting out is always beneficial. Both quality and cost results can be quite different where competition and institutional support for contracting out are weak. Nevertheless, the cost savings from contracting out in OECD countries are sufficiently striking to justify serious consideration of contracting out by countries in the transition economies.

² These results are strongest for larger municipalities.

³ The services were auditing, transportation, travel, parking revenue collection, secretarial, custodial, physical examinations for employees, embalming, microfilming, automobile liability claims management, data conversion, paramedic equipment repair, dietary, medical records transcription, laundry, and laboratory testing (reported in Savas, p. 157).
There is some contracting out already taking place in CEE and Central Asian countries: period road maintenance in the Baltic countries, Hungary, and Armenia; emergency reconstruction of housing in Armenia; and solid waste collection in Riga, Latvia, Tirana, Albania, and Hungary. However, the delivery of government services continues to be a significant problem in the region and demands a far more comprehensive reform effort. 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 (see Figure 1a). All of these obstacles suggest that the quality of government service delivery is likely to be poor. Figure 1b reports the views of firms in different regions of the world regarding the delivery of government services in 1996 relative to 1986. It is striking not only that firms in the former Soviet Union and Eastern Europe have a very low opinion of government service delivery, but also that firms in the former Soviet Union perceive no improvement over the last ten years; in Eastern Europe, they see only a modest improvement (on a percentage basis).

Other more specific evidence confirms this general view. A survey conducted among private firms in St. Petersburg indicated that many found the public services provided by the local administration to be a significant obstacle to their businesses (de Melo and Ofer 1994, p.40). As another example, maintenance of housing stock in Ukraine remained in public hands even after housing itself was privatized. The maintenance services were provided by small, state enterprises (Zheks). Despite large municipal subsidies, the service was poor and property values suffered.4
Figure 2 indicates the variation among CEE and Central Asian countries in their ability to provide high quality public services. This figure reports cross-country evaluations of bureaucratic quality with a focus on those public services (regulatory and otherwise) demanded by private investors. Those countries with low scores are unlikely to provide quality public services at the lowest possible price. In all countries of the region, however, there is substantial room for reform, especially if compared with public service provision in Western Europe or North America.

**Bureaucratic Quality of Public Services**

<table>
<thead>
<tr>
<th>High quality</th>
<th>Hungary</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Czech Republic, Poland, Slovak Republic</td>
</tr>
<tr>
<td>Low quality</td>
<td>Albania, Romania, Russia</td>
</tr>
</tbody>
</table>

Three conditions affect whether the contracting out of a particular service is more or less likely than public provision to suffer from these difficulties:

1. **The intrinsic characteristics of the service being provided** Contracting out is likely to be more beneficial when quality can be monitored, and when there is potential for quality-enhancing and cost-reducing innovation. However, some services are intrinsically difficult to monitor and/or they exhibit lower innovation potential; the intrinsic characteristics of each service, therefore, must be assessed. For example, garbage collection and tax audits are fundamentally different in terms of how easy it is to monitor the quality and quantity of service provision or the potential for innovation.

2. **Whether the market environment is competitive or not** 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)—makes contracting out more advantageous. 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, janitori-

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5 This could be true because the government has no incentive to require efficient service provision, for example when officials benefit personally from diverting funds to other purposes.
al 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 in any auction for sole rights to provide telecommunication services to a jurisdiction.

3. The institutional setting 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 their commitments. Where the institutional setting encourages beneficiaries to report quality (perhaps indirectly, through their voting decisions), prods government decision makers to monitor it (e.g., in order to be re-elected), and reinforces 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 advantageous.

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. Figure 3 indicates the conditions under which contracting out is likely to be beneficial; this figure will be referred to throughout the report.
The purpose of contracting out (as with all public sector reforms) is to achieve higher quality delivery of government services at a lower cost. Efforts to reduce costs through contracting out must not sacrifice the quality of services. This section evaluates the potential tradeoffs with respect to quality and cost under contracting out.

**Cost savings** The decision to contract out has consequences both for immediate cost savings and for incentives to discover future cost savings. With regard to immediate cost savings, it is usually assumed that private providers are more likely than public providers to pursue least cost delivery solutions. More often than not, public services are characterized by at least one of the following: political decision makers prefer to provide services at a high cost to satisfy some political objective; political decision makers are uncertain of how to provide the service at least cost; or they understand how to operate at least cost but cannot implement the provision. Because private providers are not encumbered by these circumstances, they are likely to operate at lower cost.

An additional important issue, however, is whether private provision leads to greater innovation to reduce costs. In principle, governments could induce government employees to discover cost-saving innovations by guaranteeing them a share of any cost savings that they discover. Such contracts are usually not feasible, however. First, it is usually difficult to alter civil service pay regulations to allow such contracts. Second, and more importantly, guarantees that providers will receive a share of the cost savings are likely to be less credible to government employees than they are to private providers.

Generally, cost-reducing innovations will be greater under contracting out. The service of refuse collection illustrates this issue. Efficient routing of garbage trucks is necessary to achieve least-cost collection. Efficient routing requires effort and an investment in the knowledge of logistics. However, once the cost savings are finally realized in the refuse collection department of the public sector, political actors may decide to divert these savings to recreation programs or housing subsidies, rather than to allow the public managers to retain them in the form of expanded budgets for the agency or higher salaries for the managers.

**Principle 1.** The potential benefits of contracting out are greater when there are substantial opportunities for cost savings, particularly those that require significant effort to discover.

Note that there is no guarantee that private contractors will share cost savings with the government. They will do this only if private provision is competitive, or if the government has some idea of its costs.

### Table 1
**Quality Tradeoffs in Contracting out**

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

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Contracting out prison management and construction has become widespread in the United States. Quality standards, such as the appropriate use of force by prison guards, are difficult to specify in advance. It is also difficult to distinguish management failures (prison violence due to improperly trained guards) from outbreaks of violence that are due to the presence of prisoners who may be inherently violent. We would therefore expect the private sector to be more likely to extract cost savings at the expense of quality (for example, by hiring underqualified guards).

There is evidence that this trade-off occurs in the United States, although it is not clear that quality degradation outweighs cost savings. Where public monitoring of the contract has been significant, as in Tennessee, private prisons exhibit moderately higher levels of violence, but political decision-makers have judged these to be acceptable in view of the cost-savings. However, if there is little monitoring of prison management or outright corruption, quality problems (maltreatment of prisoners) can far outweigh cost savings.8

Safety inspections and prison management are areas where it is both difficult to assess quality (making quality degradation in the pursuit of cost reduction more likely) and where few quality innovations seem possible. In the case of building and other safety inspections, it is costly to determine whether inspections are thorough; at the same time, quality innovations are unlikely. Unless cost savings are significant, contracting out activities with these quality characteristics is unlikely to be beneficial. Box 1 on prison management illustrates the tradeoffs.

For refuse collection, equipment repair, immunization services for transport (logistics) and specific medical interventions, such as kidney dialysis, quality is relatively easy to assess, and substantial quality innovations are possible. Contracting out is likely always to be beneficial.

QUALITY Concerns about quality in public services parallel those of cost. First, in their eagerness to increase profits, private providers are more likely than public to under-provide quality. Their ability to do this depends on the costs of preserving quality.6 Second, the private sector is more likely to invest in observable measurable quality innovations because they are more likely to get paid for such innovations compared to their public sector counterparts.7

PRINCIPLE 2. The benefits of contracting out are likely to be greater if the quality and quantity of service outputs are easy to specify and verify, or if the service is characterized by large potential improvements in observable quality.

Government services can be classified into four categories, as Table 1 illustrates, depending on whether assessing quality is easy or difficult, and on whether potential quality innovations are large or negligible.

For transport (logistics) and specific medical interventions, such as kidney dialysis, quality is relatively easy to assess, and substantial quality innovations are possible. Contracting out is likely always to be beneficial.

6 Measuring quality is costly, first, when outputs are simply difficult to measure (e.g., the amount of student learning); second, when there are multiple outputs that are difficult to weight (student learning and improved citizenship are both objectives of state education systems); third, where recipients of services are heterogeneous in important and unobserved ways (do students perform better on tests because of better teaching, or because of unobservable family characteristics?); and fourth, where inputs (such as number of teachers and number of days in class) bear only a scant relationship to outputs (such as student performance on tests).

7 The standard argument in the public administration literature is that contracting out is most beneficial in those activities where the quality and quantity of outputs can be specified with relative ease (see Laking p. 21). This section suggests that one ought to consider, in addition, the potential for cost-saving or quality improving innovations.

8 The discussion in this box comes from Hart, Shleifer, and Vishny (1996).
nizations, street cleaning and routine road maintenance, janitorial services, medical records transcription, food services, laundry, and microfilming, quality is easy to assess, but few quality innovations seem possible. Nevertheless, as long as the costs of public service provision are excessive, and persuading public providers to reduce costs is more difficult than contracting out, contracting out is a preferred modality for service provision.

For other services, such as medical care, military procurement, data management, education, road building and periodic maintenance, investments in quality improvement have a large payoff, but it is also costly for the government to detect whether quality on some dimensions has been sacrificed to achieve lower costs. However, where cost savings and innovation are possible and significant, contracting out can be beneficial. For example, the quality of periodic road maintenance—repaving highways—can be under-provided by the use of poor or inappropriate materials. Government laboratories can test for this if governments make investments in these facilities, or contract with independent firms that perform these tests. The experience of World Bank highway projects in the Baltics is that cost savings of perhaps 30 percent are possible under the contracting out of periodic road maintenance, with quality improvements, provided that governments invest in appropriate testing facilities and personnel. Telecommunications companies may choose to under-provide customer service (hard to observe), but expand the set of high quality, easily observable products they offer (call waiting, CallerID, Internet). Manufacturers of military equipment may cut corners on the durability of weapons systems (difficult to monitor) in the pursuit of lower costs, but at the same time invest significantly in performance improvements that are easily monitored by the government. Education and health providers face similar tradeoffs. Despite these ambiguities, in U.S. military procurement, for example, there is evidence that the benefits of quality innovations outweigh the problems of cutting corners in the pursuit of lower costs.

**Government credibility and contracting out** Contracting out is a more promising form of public sector reform in those countries where government commitments to the private sector are more reliable. Two indicators measure the extent to which governments respect contract and property rights. One of these is an evaluation of credit risk by international bankers; another is an evaluation of the extent to which countries are governed under the “rule of law”—that is, the extent to which disputes are settled predictably and according to formal legal rules (see Figure 4). Countries that score relatively low on these indicators are less likely to experience quality-improving and cost-saving innovations under contracting out.9

### Markets and contracting out

Markets and institutions also influence the magnitude of trade-offs between cost and quality. One of the important market characteristics is the level of “contestability.” Contracting out is most beneficial when markets are contestable—where there are multiple actual or potential competitors (see Lakey, p. 21). More contestable markets improve the government’s information about quality. They also increase the incentives of providers to invest in cost reduction and quality improvement, and to share cost savings with the government. There are many examples of the effect of contestability in contracting out. One particularly dramatic one was reported by the U.S. Government Accounting Office (USGAO). An unsolicited bid by a major U.S. aircraft manufacturer to take over the maintenance of U.S. Air Force bombers was adjusted downwards by 39 percent after capacity

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9 As Laffont and Tirole (p. 637) and Hart, Shleifer, and Vishny (1998) argue, it is generally more costly for governments to renege on commitments to private firms than on commitments to public agencies. This gap is likely to grow as the private property rights become more secure.
constraints at a government-owned repair facility were lifted, and the facility was able to compete with the private firm (USGAO 1997b).

Even with only a few bidders, contracting out of road maintenance in the Baltics has yielded significant cost savings. In markets where governments can always procure services from any number of providers, even from multiple providers simultaneously, contestability is easy to achieve. This is the case for most government services (janitorial services, data processing, facilities management, schools, and so forth). Only if there are barriers to entry in such markets is contestability in question. For other public services, such as urban water supply, network economies make provision by multiple providers inefficient. In this case, contestability can be achieved by allowing multiple providers bid for the sole right to offer the service.

On balance, competition is likely to lead to improved quality as well as lower costs. It is true that, when the quality of services is hard to monitor, greater competition may heighten provider incentives to cut corners in order to improve profits. Nevertheless, there are significant incentives for private providers to offer higher quality. First, providers operating in a competitive market are likely to care about brand name (reputation) effects more than monopoly public providers. Consequently, where a public provider might ignore quality problems that show up with a lag, a private provider concerned about reputation would pay attention to them. Second, providers in a competitive market are also likely to invest more in quality improvement, in order to remain competitive into the future.

What is the empirical evidence regarding the effect of contestability on quality and innovation? Most studies conclude that both quality and innovation are greater in competitive industries (Rey 1997). In the specific case of contracting out, anecdotal evidence is compelling. Six state and local governments in the U.S. reported quality improvements after contracting out, and the facility was able to compete with the private firm (USGAO 1997b).

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What is the empirical evidence regarding the effect of contestability on quality and innovation? Most studies conclude that both quality and innovation are greater in competitive industries (Rey 1997). In the specific case of contracting out, anecdotal evidence is compelling. Six state and local governments in the U.S. reported quality improvements after contracting out, and the facility was able to compete with the private firm (USGAO 1997b).
petitive contracting out services including administration of a worker's compensation fund, the enforcement of child support payments, wastewater treatment, social services revenue management, highway maintenance, and management of nursing homes. For all services then (except for those where quality is hard to assess and potential quality improvements are minimal), the benefits of contracting out rise when the markets are more contestable. That is:

**PRINCIPLE 3.** The gains from contracting out are greater when the market for provision of government services is contestable, or where the market for firms is active.
The benefits of contracting out can be directly linked to a country's institutional environment. Social and political institutions can help or hinder the ability of beneficiaries to inform government decision-makers about the quality of service provision. They also influence the way government decision-makers react to information received from beneficiaries and if they search for lower cost, higher quality service provision.

**Beneficiary Feedback**

When political institutions allow beneficiaries to provide feedback on the quality of services that they receive, political decision-makers can be informed of attempts by private providers to minimize costs at the expense of quality. Box 2, on pollution, illustrates the importance of beneficiary feedback, and suggests that it may be a more powerful influence on private than on public entities, which indicates a synergy between beneficiary feedback and contracting out.

**Principle 4.** The gains from contracting out are greater if beneficiaries can provide feedback on the quality and quantity of service provision.

Countries in Central and Eastern Europe and Central Asia differ significantly in the extent to which they allow citizens to communicate the quality of public services. Figure 5 illustrates this variation, based on evaluations of the activities of media and citizen groups. Typical channels that beneficiaries use to communicate the quality of services include contacting the provider directly, appealing to government decision makers (legislators, for example), responding to user surveys commissioned by government decision makers, suing in the courts to oblige providers to improve service, and voting against political decision makers who fail to provide decent services. In countries where the media is more developed and where citizen groups are more active, we would expect all government services to be provided more efficiently. We would also expect contracting out to be more beneficial than public provision of these services.

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12 Naturally, beneficiary information is biased since beneficiaries may have an unclear understanding of what services they should receive, given legal and budgetary requirements. Nevertheless, government decision-makers can compare information from beneficiaries with what they know about the budgets and contractual service obligations of providers to assess service provision.

13 Beneficiaries have greater voice to the extent that they have the ability to communicate information to governments, and governments have an incentive to respond to this information.

14 Beneficiaries who pay user fees may be especially motivated to provide feedback on service quality.

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**Box 2: Pollution and the Influence of Beneficiary Feedback**

Countries in Eastern Europe and Central Asia left behind enormous environmental problems. Because those affected by these problems have more opportunities now than they did before the transition to indicate their displeasure, these problems are now being addressed. Private firms may be more sensitive to such feedback than public firms (perhaps because polluting firms have a more difficult time selling their output, obtaining capital, or are more vulnerable in other ways to public displeasure). In the U.S., the problems of nuclear waste have been much graver in the nuclear facilities of the military (generally not subject to significant public scrutiny) than in those of private electric utilities, where scrutiny is exhaustive. In Brazil, pollution from state-owned enterprises was shown to be greater than the emissions from private enterprises, controlling for the age of the plants and the nature of the output (CETESB 1994, cited in World Bank 1995).
Are There Opportunities for Beneficiaries To Provide Feedback on Services?

Many

- Hungary, Poland, Czech Republic
- Slovenia, Estonia, Latvia, Lithuania

Slovakia, Russia, Macedonia, Moldova, Bulgaria, Romania, Croatia, Ukraine, Armenia, Albania, Georgia, Kyrgyz Republic

Azerbaijan, Kazakhstan

Belarus, Tajikistan

Uzbekistan

Turkmenistan

Few

Do Government Decision-Makers Have Incentives to Respond to Beneficiaries?

Many

7 ECA countries in this range

9 ECA countries in this range

9 ECA countries in this range

Few

Government Officials Respond to Beneficiary Feedback

Beneficiary feedback on the quality of services is effective only when government decision-makers have an incentive to respond to the information. This depends on the institutional environment, which can be an obstacle to reform if decision-makers derive few benefits from improved provision of government services. Where government decision-makers face greater competition for their positions, and where beneficiaries of government services can influence the outcome of that competition, decision-makers are likely to be more responsive to feedback from beneficiaries. On the other hand, where shoddy service delivery has few consequences for government decision-makers, there is naturally little incentive on their part to monitor service quality. Figure 6 demonstrates that there is significant variation in the level of competition across countries in Central and Eastern Europe and Central Asia. Where competition is higher, the assumption is that there are more incentives for decision makers to listen to public feedback.

Decentralization also influences the effectiveness of beneficiary feedback. Voters are unlikely to base their selection of central government political decision-makers on the size of potholes on city streets, even if they understand that central government off-

15 Laking (p. 38) mentions without elaboration stakeholder pressures as a determinant of organizational choice in the provision of public services. Of course, where providers are compensated in part based on beneficiary feedback, they are more likely to be concerned with quality issues.
Are There Checks and Balances Inside the Government?

Many

- Hungary, Poland
- Czech Republic
- Estonia
- Latvia, Lithuania, Slovenia

Slovakia, Croatia, Macedonia, Russia, Bulgaria, Kyrgyz Republic, Moldova, Romania, Armenia, Georgia, Ukraine, Albania

Kazakhstan
- Belarus, Uzbekistan
- Turkmenistan
- Tajikistan

Few

Officials are responsible for them. If, on the other hand, local officials are responsible for potholes, it is more likely that their performance in filling the potholes will have electoral consequences.

Finally, where multiple government decision-makers have oversight responsibility for service provision, beneficiary concerns are more likely to be acted upon.

The uneven experience with contracting out in U.S. prisons is one important example of the consequences of little beneficiary feedback and low government incentives to respond to quality problems. Prisoners are notably lacking in political representation. Consequently, the incentives of political actors to monitor the quality of prisons, privately managed or not, are low.

Figure 7 demonstrates that the countries in the region exhibit considerable variation both in the extent of decentralization and in the number of decision-makers that generally participate in national political decisions. In those countries where decentralization is greater and the number of decision-makers larger, contracting out is more likely to be advantageous relative to public provision.

**Principle 5.** Contracting out offers greater benefits if the institutional environment gives government decision-makers a greater incentive to monitor the quality and quantity of service provision.

**Locking in Reform**

Contracting out may be advantageous even for governments confident about their ability to provide quality services under traditional, hierarchical forms of service provision, located entirely within the public sector. Even under these circumstances, contracting out is helpful for locking in reform. This advantage grows when governments do a better job of protecting contract and property rights, as in Figure 4. For example, a government takes office and decides to de-emphasize patronage and stress efficiency in the provision of public services. It successfully implements this strategy by initiating a program of contracting out. If this government is subsequently replaced by one that again prefers patronage, the new government could only pursue its patronage goals by renegotiating the agreement with the private provider, compensating the provider for extra costs, or by reneging on the agreement entirely.

**Principle 6.** The more difficult it is for government decision-makers to change the terms of its

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16 There are many examples of new governments undertaking dramatic cost-reduction efforts in particular state agencies. Alberto Fujimori, upon assuming the Peruvian presidency, began a vigorous privatization program. However, he slashed employment in the social security administration without privatizing the agency.
agreements with private providers, the greater are the likely benefits of contracting out.

**Political Obstacles to Contracting Out**

The institutional environment affects not only the incentives of government decision-makers to monitor the quality of service provision, it also influences whether they will support any sort of public sector reform at all. This is especially true if the institutional environment encourages corruption or patronage. Where government officials are largely motivated by their ability to use the provision of government services as a tool for their personal enrichment, their interests are neither in cost savings nor in quality improvement. For them, contracting out is likely to be counterproductive and hazardous because in this environment, officials are likely to ensure that service provision is contracted out to firms that they control. Such officials are unlikely to press for high quality, low cost provision of services, and are unlikely in any case to share cost savings with the government. Corruption is considered by independent observers to be a serious problem in some countries in the region. Figure 8 documents this for a small subset of CEE countries (the data are unavailable for Central Asian countries).

Studies in the U.S. also indicate that where public employees are politically powerful, contracting out is a difficult reform to implement. López-de-Silanes, Shleifer, and Vishny (1997) find in a sample of more than 3,000 U.S. counties that contracting out was less likely in counties where public employees enjoyed significant union representation and the right to strike.

On the other hand, where government officials are restricted from using the provision of services to further their political or personal interests, they are more likely to support contracting out. López-de-Silanes, Shleifer, and Vishny find that counties were more likely to adopt contracting out when their public employees were prohibited from engaging in political activity and where they were subject to merit-system laws, both of which restricted the extent of political influence on public sector service provision decisions. Similarly, they find that contracting out is more likely where local officials are required by state governments to use particular procurement standards which are less subject to manipulation.

**Principle 7.** Where public officials derive significant private benefits from the provision of public services, contracting out is likely to have few benefits. Where they derive significant political benefits from public provision of services (e.g., through patronage), they are likely to oppose contracting out.

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17 Recall that it is relatively costly for political decision makers to contract out patronage decisions to private actors, since it is likely to require constant and costly renegotiation with the private provider.
There are several practical issues to be considered in the implementation of contracting out. The first is
government knowledge of the costs of public provi-
sion. Where governments do not know public provi-
sion costs, they are likely to find it difficult to assess
bids from private providers. Because it has the knowl-
dge to evaluate costs, the U.S. Air Force concluded
that contracting out engine repair to a major aircraft
manufacturer would not save $4.7 billion, as the man-
ufacturer contended, but would cost the Air Force
$1.3 billion (USGAO 1997b). The United States
General Accounting Office (USGAO) concluded in a
study of six governments (five state and the city of
Indianapolis, Indiana), that initial measure-
ment of costs, including the imputed overhead, was
essential for constructing tender documents and evalu-
ating contractor bids (USGAO 1997c). Government
assessment of its own costs is especially important if
government agencies are permitted to compete in the con-
tracting out process. World Bank technical assistance
has been used to assist countries in costing out gov-
ernment provision of public services.

A second implementation issue relates to legal
standards and judicial resolution of commercial dis-
putes. One expert observer has noted that most
courts and lawyers in Latvia were still (in 1998)
uncomfortable dealing with commercial disputes, a
problem exacerbated by their lack of contracting
experience and their loosely or incorrectly written
contracts. Another observer reported some dissatis-
faction with contracting out among public administra-
tors in local governments in Hungary, likely due to
the very small size of some local governments and the
burden of procurement procedures.

Contracting problems in procurement should all
be mitigated in time. Some governments in the
region, particularly Hungary, already have adequate
legal standards governing procurement; other govern-
ments are working towards them. These standards
are necessary whether or not governments contract
out because even public provision regularly demands
the purchase of goods from the private sector. Many
countries have developed and implemented their own
procurement reforms; some have done so with World
Bank technical assistance, often in the context of
adjustment loans.

Legal problems can have an underlying cause
unrelated to procurement laws, which is the unwillingness or inability of government decision-makers to
specify the outputs they expect. This is a necessary
condition for government service provision to improve
under any modality, public or private. In nearly all
CEE and Central Asian countries, public providers of
government services are not formally required to
achieve any particular output or outcome, nor are
their efforts and performance carefully monitored,
even when to do so is relatively easy. This shortcomings both private and public provision of
government services.

A third practical obstacle arises if there are few
private firms currently able to provide a particular
service. The U.S. General Accounting Office reported
this issue regarding the efforts of large (governmental
and private) organizations to contract out finance and
accounting functions (USGAO 1997a). However, the
GAO report concluded that this problem was likely to
be transitory, and that as the demand for contracting
out increased, a large and dramatic supply response
was expected.

One last important practical consideration is gov-
ernment capacity to monitor contracts and, especially,
the quality of service provision. Even in the U.S., one
of the greatest challenges has been auditing not only
contracts—whether contractors are paid as the con-
tract specifies and whether formal contractual obliga-
tions are fulfilled—but especially performance and

18 The discrepancies arose from different assumptions regarding general and fuel inflation rates, the number of repairs per engine, and engine unit repair costs.
19 Michael Clarke, Deloitte, and Touche, Riga, Latvia.
20 Professor Laszlo Varadi, NISPA, Hungary.
technical monitoring, which ensures that services meet contract specifications for quantity and quality (USGAO 1997c). An important part of World Bank assistance related to road maintenance in the Baltics and Armenia has been to set up or improve testing laboratories and to raise levels of expertise so that governments (and contractors) can better monitor the quality of materials and construction.
Contracting out is already taking hold in CEE and Central Asian countries, in many cases with World Bank support (although the opportunities and potential for this reform have not been fully realized). World Bank investment loans for periodic road maintenance are supporting contracting out in the Baltic countries and Armenia; and World Bank loans for emergency reconstruction of housing in Armenia also drastically increased private sector provision of housing in that country. This resulted in higher quality and lower cost expansion of the housing stock than would otherwise have been possible.

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 beneficiaries; and purchasing equipment to manage information flows and analysis. Assistance may also be required in providing transitional payments to public sector employees who lose their positions as a result of contracting out (see Sherif, Clarke, and Djankov, 1998). 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 be suitable 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, and investment loans.

**Technical Assistance Loans** These loans have been used to help countless privatization and public sector reform efforts (see Figure 9a). Under a technical assistance loan, a government would designate an agency responsible for managing the contracting out process. The agency providing the service would be the natural designee, provided that key personnel support the contracting out initiative. Alternatively, the government could set up a new agency, bypassing obstacles to reform in the existing bureaucratic structure. If the services to be contracted out are in several line ministries, or have not yet been selected, then a new or existing central agency, rather than a line agency, is likely to be the appropriate designee.

TA loans are small, and even less well-adapted than adjustment and other loans to persuade a government to lower its resistance to a particular reform. They also run the danger of being uncoordinated and conflicting, particularly if multiple TA loans for simultaneous reforms in different line ministries are in place. However, for governments that support contracting out and public sector reform more generally, the flexibility and longer time span over which TA loans can be disbursed make them a good match to the longer time horizons needed to successfully implement contracting out and other public and private sector reforms.

**Adjustment Loans with Counterpart Funds Set Aside** These loans have also been commonly used to support both privatization and public sector reform effort (see Figure 9b). 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** A third loan vehicle is direct investment lending, typically operating as in Figure 9c. The World Bank makes these loans to implementing agencies (rather than to governments) in order to
improve performance in specific sectors. Much of the support that the World 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** The main objective of contracting out is improving the provision of government services. However, it may not be clear whether it is contracting out or some other strategy that is best. 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 to reform. To the extent that APLs conform to conventional investment lending parameters by focusing on hard investments, however, they may have only limited applicability for strictly institutional reforms in the public sector.

**Project Expenditure Reform Loans**
Reforms such as contracting out can also be part of programs supported by Public Expenditure Reform Loans (PERLs), particularly for cross-sectoral efforts to introduce contracting out. PERLs are programmatic—multi-sectoral—investment operations. They are driven by bottom-line program performance, and are subject to periodic Bank/country review. As such, they are more loosely designed than conventional projects. Through the leverage provided by substantial transfer of resources, they offer the impact of adjustment but also provide support for ongoing technical work. Some of their key features include:

- Periodic, regular disbursements (e.g., semi-annual) against the public investment program as a whole and against progress on management improvements.
- Customized design to allow for uneven progress in institutional reforms and flexible implementation schedules.

- Linkages among several sectoral and institutional objectives in a common framework (e.g., investments to support waste disposal can be linked to civil service reforms involving contracting out, reforms to decentralize fiscal administration in municipalities, and environmental programs).
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 reform success. Second, World Bank involvement can expand the set of private sector firms willing to participate in the contracting out process, increasing their faith in the terms of agreements that are reached. Third, the World Bank can assist countries in harnessing worldwide expertise (a) to help determine whether contracting out is an appropriate course for speeding private sector development and improving government performance, and (b) to help design effective and sustainable programs of contracting out.
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