Chapter 6.

Contracting out Core State Functions and Services in Fragile and Post-Conflict Situations: A Transitional Arrangement or an Option for Long-Term Delivery?

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Introduction

Given current international debates about state building and adherence to “do no harm” principles, an exploration of the potential and pitfalls of contracting out state functions is timely. Often contracting out is presented as an interim or transitional strategy – urgent functions are performed by external agencies while state capacity is developed to take on these functions over time.

As these conference papers highlight, however, the risk of such strategies is that they can erode already limited capacity and result in parallel systems of government that can undermine the legitimacy of the state. As citizens see vital services being performed by non-state actors, this can weaken the compact between the citizen and the state and create an environment conducive to continued fragility and possibly conflict. Similarly, there is a concern that there can be insufficient pressure or incentive to build public sector capacity to provide an essential service when other agencies are already providing them.

However, another view suggests that some permanent contracting out of function and service delivery can be viable, rather than as a transitional arrangement. There may be a good case for the state to “share” sovereignty in a way that does not undermine state legitimacy.

The minimal state and core state functions

There is an emerging debate in the context of state building about what constitutes the minimal state: i.e. what functions must a state be able to provide in order to meet the basic needs of its citizens? In fragile situations where both technical and financial resources are constrained, clarity
and agreement about these basic functions is important. Too often, governments in these situations
(often with the encouragement of the international community) have aspired to perform functions
that are beyond their capacity and that may not be essential. The result can be that many functions
are delivered badly, rather than the basics being performed well.

There is clearly then a need for rigorous, evidence-based priority setting by government. Coherent,
co-ordinated and sensible advice and assistance from the international donor community could be
very beneficial as governments work to determine, in consultation with their citizens, what
functions/services are essential.

How should core state functions/services be delivered?

Once there is some agreement on what core and basic functions/services are needed to ensure state
effectiveness, the question then arises of how best to deliver these.

There is a tendency in development circles to believe that direct government delivery (whether
central or sub-national) fits the democratic ideal and is thus the desirable goal. However, government
is not always best placed to fulfil that role. This is not just true of fragile situations; difficulties
balancing state responsibility and effective delivery are common in industrialised states as well
(though the options in fragile situations may be more limited).

Situations where outsourcing might be appropriate can include:

▶ Where a service/function is dynamic and/or technical in nature. It may not be feasible for
government to sustain the technical competency in-house to maintain the quality of
service provision. An example could be the provision of agricultural extension – rapidly
evolving technical solutions and a wide range of agricultural problems can make it difficult
for government extension officers to deliver comprehensive and technically up-to-date
services to farmers.

▶ Where client populations are geographically remote, making it difficult for government to
maintain the field presence necessary to deliver the services. Examples may include the
delivery of health, education and water and sanitation services to remote rural
populations. It may be that the administrative structures and distributional networks of
non-state actors are better suited to delivery in these circumstances.

▶ Where the community prefers certain services to be provided by non-government
organisations. This could include health or education services by churches, or minor
criminal prosecution and dispute mediation services through traditional justice systems.

▶ Where a function is required infrequently, making it cost-ineffective for the government
to maintain a permanent in-house capacity. Examples might include conducting a
national census every 5 to 10 years or a requirement for technically complex forensic
capacity in some criminal investigations.

▶ Where a function needs to remain at arms length from government due to severe
weaknesses in accountability or a lack of impartial decision making. Examples of this
include the Indonesian Government’s decision in the 1990s to contract out customs
management to a Swiss company; or the appointment of expatriates to fill critical
positions such as police commissioners, accountants-general etc.

In such situations, a decision to outsource a function or service, possibly for the long term, may make
good sense. We then need to ask, how do you ensure that outsourcing does not undermine the
legitimacy of the state, and that the state remains critical to the provision of the function/service so
that its essential and value-adding role is recognised by citizens? The key is to select an approach that reinforces state ownership by developing robust management capacities in government and by fostering recognition, in both the public sector and the community, of the government’s value as regulator, networker, enabler and quality controller.

**Challenges to contracting out**

Such an approach will be challenging as many (particularly the political élites) may need convincing that having government at one remove from the delivery of a function/service does not necessarily reduce its power or influence. Arguably, well-managed outsourcing could result in stronger and more stable governments by increasing citizen satisfaction with the service/function delivery.

We must be aware of the political economy of contracting out. It could reduce the potential for collecting rents to fuel patronymial systems and other opportunities for political patronage. The ability to ration access to scarce public services and allocate them to client groups would also become less viable. However, while we may criticise the efficiency and equity aspects of patronymial systems, we need to recognise their durability. They are attractive to politicians and the clients who receive the services, and thus resistance to contracting out – despite evidence of effectiveness – could be substantial.

Thus by distancing the politician or civil servants from the delivery of a valued service, outsourcing decisions may reduce opportunities for rent seeking or élite favouritism. On the other hand, if outsourcing arrangements are not structured, contracted, implemented or monitored properly, opportunities for corruption may increase.

In considering contracting out, we must also recognise the associated transaction costs and regulatory complexity. But these should be balanced against the costs of direct provision. The costs of contracting out can be offset, at least in part, by third party monitoring, *e.g.* use of parent committees to monitor school performance or the contracting out of some regulatory functions.

**Implications for capacity development**

What does contracting out mean for capacity requirements? Outsourcing requires a shift in capacity development priorities away from those needed to deliver services towards those that allow government to engage effectively with service delivery intermediaries. They must be able to engage in a manner that maximises citizen benefits and minimises the risks of delivery inequity and corruption.

Capacities associated with contracting, regulation and monitoring become more important in the public sector, while the need to establish and maintain the technical expertise associated with particular forms of service delivery diminish. Similarly the size and profile of the public sector may change with a reduced need for in-house technical skills. However, this does not necessarily imply a smaller workforce involved in delivering the function or service, but simply a transfer of tasks to non-state actors. This may result in greater employment overall as the capacity to deliver the service deepens through effective intermediary arrangements.

These approaches should not be presented as second best solutions, but rather as pragmatic, effective appropriate solutions for service delivery, which maximise the use of available resources.
The case for output-based approaches to service delivery

The World Bank and others have been testing output-based approaches (OBA) to contracting. In some sectors, these appear to be a useful alternative model for delivering public services. OBA links payments to the delivery of specific services or outputs. Under an OBA scheme, service delivery is contracted to a third party, usually a private firm or NGO, which receives a subsidy to complement or replace the user charges that would normally be levied. The service provider is usually responsible for financing the project until output delivery. The subsidy is performance-based, meaning that most of it is paid only after the services or outputs have been delivered and verified by an independent agent. The subsidy is explicitly targeted to the poor.

Drawing upon experience with performance contracting in the private sector, there has been a move by some governments and, in developing country contexts, donors, to look at output-based contracting to increase the efficiency of service delivery where market-driven provision is not viable.

The Global Partnership on Output-Based Aid (GPOBA) was established in January 2003 by DFID and the World Bank as a multi-donor trust fund administered by the bank. GPOBA’s purpose is to fund, demonstrate, and document output-based aid approaches to facilitate increased access to reliable infrastructure and social services by the poor in developing countries. The programme’s focus sectors are water, sanitation, electricity, telecommunications, transportation, health and education.

Most OBA activity funded by the partnership has occurred in lower income countries, especially in the energy, water and sanitation, telecommunication and health sectors. However, an analysis of the GPOBA Trust Fund programme shows some use in fragile situations.73

The potential of OBA in fragile situations

The GPOBA review indicates that, in general, OBA should not be considered a silver bullet. Using OBA as the contracting mechanism for a total service can be risky where capacity is weak. Greatest success is apparent where OBA has been used as a poverty-targeted supplement to an existing service.

The potential for OBA to provide incentives for improving service delivery to targeted communities makes it an attractive financing option. A limited examination of the approach highlights a number of advantages of particular relevance to fragile situations:

► It can leverage greater levels of private sector financing and expertise than more traditional approaches.
► It allows for highly precise beneficiary targeting.
► With payments linked to independently-verified performance, it is potentially less corruptible than other more traditional forms of delivery.
► It may be useful where governments are exploring the decentralisation of service delivery as it allows for relatively standardised management/regulation of multiple service providers across different geographic areas.
► It can provide incentives to shift the role of the public sector from service deliverer to enabler and regulator.
On the other hand, OBA's success depends on some fundamental requirements that may be difficult to ensure in fragile contexts:

- It is most successful where there is reasonable private or non-government sector capacity to deliver basic services, such as water and sanitation and health, in a cost-effective and efficient manner, with user charges covering at least operational and maintenance costs.
- The operator should be able to pay upfront expenses, given the output nature of the subsidy disbursements. This finance can either be from the operator's own cash flow or through commercial bank lending. However, such finance markets may not be well developed in some states.
- Limited diversity in the private or non-government sector in some states can make it difficult to generate positive competition.
- OBA design and implementation need to be based on a sound appreciation of the parameters of the service provision and a good understanding of beneficiary and private/non-government sector behaviour. This is essential so that tendering, contracting and management arrangements anticipate and counter any behavioural bias and maximise both cost effectiveness and quality.
- The output-based focus of these contracts requires fiduciary and regulatory competence at different points in the management process, just as for standard public financial management. For example, good practice requires the verification of outputs by an independent agent, and subsidy payment after output delivery must be quick, dependable and accurate. Ensuring that capacity exists (or is developed) in the right areas is critical to successful implementation.
- Potential service providers need to be confident that the agencies (generally public) managing and overseeing the OBA project can perform their functions efficiently and impartially and make timely performance payments.

One interesting recent development is OBA's potential during the reform of a social service obligation (often a subsidised service), and where there is a move from public to private service provision. For example, the Australian development agency AusAID is exploring with its partners the potential of OBA to address the perennial problem of essential but uneconomic inter-island shipping in the Pacific. It is hoped that OBA could be a more sensible and transparent subsidisation approach for shipping provision by the private sector.

**Initial conclusions from OBA implementation**

While still in its infancy, early evidence is clear that OBA can deliver effective and targeted service delivery. However, we do not yet have enough experience of OBA in fragile situations to know how useful it could be as a financing mechanism in these environments.

Fragile situations are high-risk environments for development assistance; the risk for OBA is likely to be similar for other forms of financing. However, its potential to mobilise private sector resources, minimise fraud and corruption, and target beneficiaries means that it merits greater consideration.

It is clear though that much of OBA's success rests on the quality of design and contracting and the ability to mobilise a relatively capable private/non-government sector. Thus we need to understand the implementation conditions that are conducive to OBA and ensure that these conditions are put
in place. This also means that OBA should not be considered where fast implementation is a priority. Where OBA has been successful, a comprehensive understanding of the delivery environment informed the specific approach taken. Additionally, if weaknesses in critical capacity are identified, other preparatory activities may be needed. Both these requirements can significantly extend timeframes. With these caveats, an outputs-based approach to service delivery remains an option worth considering for states exploring the outsourcing of service delivery.

**Endnotes**

77 Also, USAID’s tied aid policy doesn’t allow projects to be given to non-US companies; this policy is often criticised.