

PURCHASE-OF-SERVICE CONTRACTING IN ESTONIA

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ABSTRACT. We examine the use of purchase-of-service contracting in transition countries, focusing on a case study of Estonian social services contracting at the local level. Given the nature of transition economies, we expect to find the use of relational contracting to offset problems of thin markets. We find this is the case; however we also find that the institutions and personnel are inadequate to support a relational contracting strategy. We also find that Estonian local government officials most often view the primary benefit of contracting not in terms of enhancing efficiency or effectiveness, but rather in ensuring continuous service delivery. The combination of these two findings produces a risky situation for Estonia's citizens.

INTRODUCTION

Until the 1980s, contracting for services in Western countries was limited to a few functions. Most services were delivered through government agencies. Then a sweeping political movement combined with an emerging theory of contract efficiency created a faith that contracting with private organizations could produce superior results not only in terms of efficiency, but also in effectiveness, accountability, and citizen choice (Gormley, 1999; Savas, 1987; Boyne, 1998). It is now

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taken for granted in most western countries that contracting for services is superior to in-house delivery.

The recent decade has witnessed several shifts in the course of contracting policy. The shift from Compulsory Competitive Tendering to Best Value in UK (Entwistle & Martin, 2005), public procurement reform in US (Kelman, 2001) and the recent reforms of EU procurement legislation are just the most prominent examples of that shift. The common denominator of these reforms seems to be movement away from rigid and compulsory competitive-based procurement processes towards more flexible policies which would, *inter alia*, allow employing more non-competitive award processes where appropriate. The main reason for this change is that rigid competitive bidding processes have not proved to be effective nor efficient in case of many public services, especially where there is limited or non-existent competition.

The sweeping transition of former Soviet ruled countries to democratic states with capitalist economies during the 1990s provided an opportunity for reform minded advisors to suggest that the most important public management reforms be adopted from the start of transition. And so contracting out for services became a major strategy for many newly independent states as they shrank budgets and reduced the influence of the state in many areas.

However, two problems have plagued the use of contracting for service in transition countries. The first is limited competition. In many (especially smaller) transition countries there are very few domestic providers of services available. Given this problem, one could assume that the shift towards more flexible contracting mechanism would also benefit the countries in transition. But employing more flexible contracting strategies demands that “public managers must be creative and wise in their efforts to provide incentives for administrative compliance, service improvements, and cost containment” (DeHoog, 1990). At the same time low administrative capacity of transitional governments has been acknowledged as another important problem that limits the applicability of the contracting out tool (Nemec, Merickova, and Vitek, 2005). In analyzing contracting out of public services in the Czech Republic and Slovakia, Nemec et al. (2005) concluded “the decisions are non-systematic, and there is significant potential for corruption”. Although there seems to exist common understanding that the main tool to solve the dilemma between lacking market and low

administrative capacity is to increase government's contracting capacity (Kettl, 1993), there is little evidence present explaining the specific aspects constituting the "low administrative capacity problem" in transitional countries.

The aim of the current research is to fill in the gaps by studying social service contracting in transition countries. We do this by examining the contracting strategies and decisions of Estonian local governments, attempting to answer three questions. First, what is the understanding of public officials about contracting for services? Second, what kind of contracting strategies are being used? And third, how effectively are contracting strategies being applied?

THEORY OF PURCHASE-OF-SERVICE CONTRACTING

Today one can distinguish between three basic alternatives in assigning public services to the private sector (DeHoog, 91; DeHoog & Salamon, 2002). At one end there is so called conventional contracting, which stems from the idea of classical economics, where it is assumed that competition is the key to success in contracting out public services. On the other end there is relational contracting, which assumes that trust developed from mutual cooperation rather than from competition, is the most effective motivational factor for successful contracting. In between these ends there stands negotiated contracting, which includes elements from both extremes.

Conventional Contracting

According to the conventional approach, stemmed from the works of public choice school, traditional public organizations either oversupply public goods or produce public goods at marginal cost, which is too high for being Pareto efficient (Lane, 2000). The reason behind this claim is that politicians do not have all the information about how bureaucrats act and there are not usually sufficient motivational mechanisms present to secure efficient supply of public goods. It is claimed that as human behavior is primarily motivated by selfishness, there is, therefore, a need for competitive pressures to redirect it towards public interests (Boyne, 1998). The logic of the contracting mechanism is that in order to win the contract, the private contractor is motivated to make the best possible offer. During the contract the private provider does everything to fulfill government's wishes because a) if not, the government as the purchaser

can terminate the contract and b) from a longer perspective the contractor wants the contract to be renewed. At the same time private provider tries to be as innovative and efficient as possible in order to enhance its profits. In order to win the contract, the private provider may also promise to increase the standard of quality of a contracted service. Hence, it is believed that competition for contracts as a administrative mechanism a) enables governments to overcome the problems of information asymmetry and X-inefficiency, b) allows the revelation of the true costs of public services, and c) motivates contracting parties to work more effectively.

Negotiated Contracting

Negotiated contracting is a more informal alternative to the conventional contracting, where there is no formal bidding process, but where the government negotiates all important aspects of contracts with a small number of potential providers (DeHoog & Salamon, 2002). The basis for a relationship is the legally binding contract, which includes all important service and monitoring aspects. Compared to conventional contracting the potential providers have more influence to shape the whole process of service provision.

Relational Contracting

If the conditions necessary for competitive process cannot be met, relational contracting has been suggested as an alternative strategy for purchasing-of-service contracting. Relational contracting should be preferred when there is a history of cooperation between partners or when there is uncertainty and resource scarcity involved (DeHoog & Salamon, 2002). The other advantages of relational contracting stem from lower transaction costs, greater flexibility in reacting to changing circumstances and better use of professional expertise (Dehoog, 1990). In case of relational contracting the purpose of the both sides is to develop a stable partnership, which is not based on competition but on inter-organizational trust (Sclar, 2000). The goal is to avoid agency problems, which arise “when two parties have divergent interests or objectives and the agent has an informational advantage over the principal” (Ferris & Graddy, 1998, p. 227). This is especially relevant and therefore promising perspective for social services, where active purchase-of-service contracting is common but where competition is often limited at best.

Risks of Contracting

In spite of the promising theory and many supportive case studies, there exists a growing body of empirical evidence that most of the public services lack competition and serious principal-agent and transaction costs problems arise when governments contract out public services (Kettl, 1993; Lane, 2000; Sclar, 2000). Critics have argued that contrary to the initial expectations, competition based public service contracting has produced severe problems because of specification and output measurability problems, and because of the incomplete nature of contracts (Lane, 2000; Hart, Shleifer, and Vishny, 1997). In that context social services stand out as an example where competition is been always lacking and where gathering information about providers' behavior and service outcome is a most complicated task (Van Slyke, 2003; Johnston & Romzek, 1999).

At the same time that no empirical information is available on the effectiveness of relational contracting compared to other ways of contracting, many risks have been identified with relational contracting. Where strong political interests are involved and low ethical standards prevail, the usage of performance contracting should be taken as a risky step to take (Schiavo-Campo, 1999). Further, in the case of relational contracting monitoring may become too subjective, there is no threat of losing a contract and suppliers can easily use their information advantage (DeHoog, 1990).

To mitigate the potential problems of relational contracting, governments should first develop internal capacity for administrating contracting relationships (Brown & Potoski, 2003). As Kettl (1993, p. 180) puts it, governments, in order to be smart buyers, need to know "what to buy, who to buy it from, and what it has bought". The question of the capacity to perform contracting duties competently, efficiently, and effectively necessarily involves competencies and institutional structures in at least three major areas. The first area involves deciding whether to make or buy the service and specifying the service. The second area can be divided into two. First are the competencies and structures necessary to effectively decide on the provider for a service. This involves knowledge and design of proper bidding structures and the ability to negotiate effectively in the cases where bidding is not used. Second is the arena of contracting itself – designing and implementing an effective contract. The last area deals with the auditing and evaluation of

contracts, from the procedural safeguards put into place to deal with the contracting process to the post contract audit and evaluation of contractor performance.

Another way to overcome contractual problems is to apply performance contracting whenever possible. In performance contracting the primary attention is given to results and outcomes, the actual delivery process is mainly shaped by contractor's discretion (Dehoog & Salamon, 2002; Schiavo-Campo, 1999). If proper goals and measures were elaborated, feasible data collection systems were introduced and responsible enforcement mechanisms were utilized, then performance contracting may result in innovative solutions and enhanced accountability for service outcomes (Dehoog and Salamon, 2002).

METHODS

In order to assess Estonia's ability to contract effectively, we carried out interviews and examinations of contracts for social services in four cities in Estonia. Descriptive information regarding the sample cities is shown in Table 1 below. The cities are relatively geographically dispersed and vary in size. The two largest cities in the country are included; together these cities comprise 40% of Estonia's population. Additionally, two smaller cities are included in the sample. One possible limitation of the generalizability of the study to other areas is that no cities from relatively more impoverished areas of Northeastern and Southern Estonia were included. The other possible limitation is that no rural municipalities were included to the sample. Still, the sample captures the range of different sizes and locations of Estonian cities.

TABLE 1
Descriptive Information on Sample Cities

City	Population	Region
Haapsalu	11 800	West
Paide	9 700	Central
Tallinn	396 000	Northwest
Tartu	101 000	South-Central

The interviews were conducted with representatives of cities' social welfare departments. The welfare departments are together with central government's Ministry of Social Affairs responsible for overall social policymaking and implementation. The size and duties of the welfare departments vary according to the size of a city and according to the structure of their welfare service sub-units. Haapsalu has only four people working for the welfare department and one governmental sub-unit, which is made responsible for all welfare tasks not contracted out to third parties, Tartu has 50 people working for the welfare department and 4 municipal sub-units. In Paide the respective figures are 11 and 1, whereas in Tallinn the numbers are 27 and 7.

The questionnaire we used during the interview process is shown in Appendix 1. The first section of the questionnaire asks questions regarding the respondents as well as getting at their level of formal training and the use of contracting mechanisms by their department. The second section asks the respondent questions about contracting mechanisms as well as post-award and post-contractual mechanisms. In order to assess the interviewees' responses, we examined altogether 74 contracts concerning housing, rehabilitation, counseling, food programs, daily centers, transportation services and other areas.

FINDINGS

Contracting for services seems to be an important part of the strategy for Estonian municipality social service delivery. Between 15 and 25 percent of funds in the budget are allocated to contracting. Also, the ideology of contracting seems to have become a large part of thinking regarding social service delivery. In Tallinn, interview respondents indicated that the most important outcomes that were expected from contracting were the incorporation of professional knowledge and information, and cost effectiveness. Presumably, the officials there believe that government agencies do not provide these two outcomes or that they provide them less effectively or reliably than do private contractors. And in Tartu, officials reported that the most important value in the contracting process was a fundamental belief in the market mechanism. This is not surprising given that city administration comes from the Reform Party, which has for years pushed a liberal reform agenda. In Haapsalu, the principal reason for contracting was to provide services. A governmental unit there provides some basic services, but all

new services are contracted out. Without contracting, it was unlikely that some services would be provided. This is probably due to the seasonal nature of demand for some services like transport and housing of the elderly, infirm, and impoverished. During the long winters, a provider is definitely needed to provide this service. But in the late spring through early autumn, many of those can do without these services. Such flexibility in demand is a reason to use contracted services.

Overall, in Tartu and Haapsalu contracting for services is seen as the major tool for future provision of public welfare services. For Paide contracting for welfare services is relatively new avenue; the respondents there acknowledged that the choice for contracting was purely pragmatic decision. In Tallinn it is believed that contracting for services at a large scale becomes problematic due to administrative problems and weak partners, which why they are in favor of contracting back in many services.

Respondents did not feel direct political pressure influencing contracting decision. Only in Tallinn, where the political power is very unstable, a respondent stated that there have been cases where some areas have been given extra finances to enlarge a certain activity. It appears that social service networks, consisting of welfare specialists, representatives of NGOs and local as well as central government, have big influence on the local governments' decision making. In Paide, Tallinn and Haapsalu the networks are places where many policy decisions about welfare services are made and which the local governments consider as important source for contracting activities.

Given this belief in the power of contracting, it is somewhat surprising that very little attention seems to be paid to developing the abilities of contract specialists. In Tallinn Haapsalu and Paide, no personnel had taken formal courses in purchase-of-service contracting. In Tartu there were some courses, but the content of the courses was about general principles of procurement. More training will obviously need to be a top priority if there is more emphasis on contracting as a service delivery strategy. Another somewhat surprising result was the lack of written policies in Tallinn, Haapsalu and Paide. Tartu has formal internal rules for contracting, which are clearly oriented towards conventional contracting, but which has no implications on monitoring issues. In Haapsalu there exists a policy on social service provision, which

considers contracting for services as one option. This item will also deserve attention.

In terms of the bid and award process, there are significant differences that emerge. In Tallinn, Paide, and Haapsalu, most of the contracts are awarded through mechanisms other than competitive or negotiated bidding. Competitive contracting is used only when law obliges to do so. However in Tartu, all contracts over 50 000 Estonian kroons (roughly € 200) must be competitively bid. Respondents in the former three cities felt that in the cases that were competitively bid there was little difference in the award. This was because of the thinness of the market; in most cases there was only one potential bidder. This problem was particularly acute in the two smaller cities. No cities have invested directly in market creation, although in many cases the current non-governmental providers have grown out from projects partly funded by the local governments.

The thin market situation produced an interesting paradox in the case of Tartu. Tartu respondents generally felt that price was the most important bid information (it was given a weight of 55 percent in consideration of contracting), but since the competition was nonexistent or very limited at best, the costs were usually negotiated. One may reasonably ask whether the costs reflected through negotiation were the true cost of service given the lack of competition. Additionally, it appears that the make-or-buy decision is nonexistent for Estonian local governments. In Tartu where price information was viewed as the most important, as well as in all other cities where costs were viewed as important, there was no costing mechanism for internal services. So it was effectively impossible to compare costs of private providers with government provision. Nor was there any internal bidding allowed in either city. Existing departments were not allowed to compete to have or keep services. Again, this will tend to reduce the potential for contracting to provide cost savings through reducing the pool of competitors.

In Tallinn, Haapsalu and Paide, less concern was paid to cost in the contracting process. The primary goal of contracting according to the respondents was to maintain service continuity. This is a statement that contradicts with the conventional understanding of contracting for services. One of the most important benefits to government provision of services is continuity – once a government agency is established it provides service at a certain level until it is disbanded, which is

infrequent. So one might reasonably ask why contracting is pursued in Estonian local governments at all given their stated goals. Also, given thin markets the concept of service continuity as a primary goal is problematic. In this case there might emerge a potential strategy for providers to get the initial contract to provide a service then threaten to not bid for a follow-on contract unless paid more money than the government might otherwise be willing to pay.

When talking about pre-audit procedures, Tallinn, Haapsalu and Tartu respondents found it important to receive information on qualifications and past service history and references of bidders. All the respondents admitted that they have a strong trust in the provider organization professional skills and ethics. For these reasons most of the contracts are re-awarded to the same partners. In most cases, we can say that this is an important quality control mechanism. But again, one must remember the thin market situation. If a bidder was found to be not particularly qualified for provision of the service, it is unlikely that there would be an alternative available for the government.

As for the actual contracting, it appears that most of the contracting is vague. According to the contracts reviewed for the study the agreements are very often declarative in their nature, no detailed specification or monitoring mechanisms are used. However, contracting executed under Procurement Act is more detailed and in some cases detailed performance standards are used. It appears that the contract language amounts to a missive to carry out a particular service.

There is no sign of outcome-based performance contracting in Tallinn, Tartu, Haapsalu or Paide, although the respondents claimed that they are interested in outcomes. In Haapsalu, the city is actively developing standards for welfare services. In Tallinn the standards have been developed but not yet implemented. In Tartu and Paide, the respondents made it clear that they thought that the development of standards was the proper job of the central governments' Ministry of Social Affairs. There are some outputs specified in most contracts like hours to be spent on counseling or minimum clients' satisfactory rate, but what the cities do not do is analyzing causal relationship between the outputs and expected outcomes. Furthermore, no attempts could be found of applying incentive systems into contracts. Although it is rather complicated to introduce performance contracting to all welfare services due to the immeasurability of outcomes, there is possibility to use it as

part of a whole package in case of some services like transportation or job counseling.

In terms of implementation audits, in all cities the emphasis is on verifying the written qualifications of personnel involved in service delivery, and descriptive reports of services delivered. In smaller cities Haapsalu and Paide, but also in Tartu the respondents admitted that as they all know the service providers in person, they are not afraid of agency problems. There appears to be no summative evaluation that is carried out on service delivery. This is a potentially extremely important deficiency. Given that there is little competition; one would expect that a goal for contracting would be to improve service delivery by the monopoly provider. Without such summative evaluation, it is difficult to see how contractors can make improvements in service delivery until after the contract is completed.

After the services are delivered and the contract is fulfilled, both cities engage in post-implementation audits. In all cases, city personnel examine reports, make random site visits, and in few cases obtain client questionnaires. Tartu, Tallinn and Haapsalu additionally obtain unsystematic client feedback through direct communications. This is promising as a way to constrain contractor behavior and force accountability. The key to this linkage is how effectively the promise of future contracts can be tied to audit results. If contractors can be made to feel that they will lose significantly from having any misdeeds punished, then they will be constrained to only good behaviors. But if contracts proceed fairly the same as before, then monitoring is not in itself useful.

DISCUSSION

Advocates of contracting claim that transitional countries should take advantage of market incentives and introduce purchase-of-service contracting to increase effectiveness and efficiency of public service provision. The current study demonstrates that although contracting for public services helps local governments in transition countries to maintain service provision, there are serious problems with public sector's capacity to contract and expectations associated with effectiveness and efficiency may not be realized in practice.

In spite of the fact that contracting for welfare services is done using legally binding agreements and in some cases using competitive bidding

procedures, the contracting relationship between Estonian local governments and social service providers can be in most cases characterized as relational. This means that agreements made are declarative, service providers are granted with large amounts of discretion and monitoring is paid small attention. In some cases the contracting procedures still try to capture the advantages offered by competitive and negotiated contracting. Taking into account the fact that competition in Estonian welfare service market is limited and often non-existent and that the nature of welfare services makes the evaluation of outcomes difficult, the direction towards relational contracting instead of competitive contracting should be seen as positive. In this way the local governments have managed to create relationships that can benefit from high degree of trust and professional ethics. However, if the contracting relationship is mainly relational, the local governments cannot expect that market discipline takes care of service provision as anticipated in the conventional theory of contracting. The current study reveals that in spite of a decade long practice, local governments in transitional countries do not fully acknowledge the nature of purchase-of-service contracting.

Estonian administrators see contracting for services as a tool for maintaining a minimum level of service delivery. Efficiency and effectiveness are declared to be important considerations when contracting for welfare services, but in practice there are no detailed cost comparisons that made between inside units and external offers. Moreover, participation of inside units has never been an option for the local governments in Estonia. No systematic monitoring and evaluation procedures are elaborated which would allow administrators and officials to assess the efficiency and effectiveness of the contracting tool. Management practices do not include employment of positive or negative incentives.

Further, the deficiency in monitoring and evaluation procedures puts Estonian cities at risk for maintaining accountability in welfare service provision. The possible explanations to the situation can be that no significant scandals in contracting have occurred so far and that the local governments are not aware of emerging transaction costs and accountability problems. All the respondents indicated that until the current date no major interruptions or problems have occurred with the contracted out services and because of trustful partnership all issues can be solved in due course. One respondent stated that contracting out of

public services is actually a good way for a public authority to avoid responsibility if something bad happens with service provision.

Our study shows that Estonian public administrators view contracting for services in different ways than theory has indicated. They view contracting not necessarily as a tool of greater efficiency, but as a tool of service continuity. Also, the strategies used by public organizations in Estonia tend to involve relational contracting. However, serious deficiencies are present in the ability of Estonian government officials to efficiently and effectively employ relational contracting. There is much room for improvement in the use of contracting for services in Estonia. Given previous findings in other transition countries (e.g. Nemeč *et.al*), one must harbor serious doubts about the usefulness of contracting in its current form in these countries. More research and comparative work is urgently needed to document deficiencies in other countries, and more training and institutional structures are needed if transition countries are ever to reap the potential benefits of contracting for services.

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APPENDIX 1

Questionnaire Outline

Background Information

1. How long have you worked for your government?
2. How long have you worked in government as a whole (any government)?
3. How many training courses have you received regarding contracting?
 - a. What topics were covered
4. What is your highest education?
5. What percentage of social service budget is allocated to:
 - a. Direct provision of services?
 - b. Contracting out?
 - c. Grants?
 - d. Lump-sum support?

Contracting Tools, Decisions, and Information Section

6. Is there a special policy dedicated to contracting out?
7. How many people are involved in the decision-making process regarding contract awards?
8. Please describe the decision-making process surrounding contracting and role of public servants in it?
9. As you understand it, what information is gathered in terms of potential bidders?
 - a. Cost information
 - b. References, quality information
 - c. Professionalism of personnel?
 - d. Other?
10. What outcomes is your department most interested in when awarding contracts?
11. What values, beliefs, and attitudes affect the contracting process?
12. Were there social goals that affected the award process for any contract on which you have worked (such as improving the role of NGO's, supporting local entrepreneurship, or specific promotion of minority-owned companies for awards)
13. Were there political considerations that affected the award process for any contract on which you have worked?
14. Where there any investments made in order to create market for contracted services?

15. Were there legal requirements that affected the award process for any contract on which you have worked?
16. What is the percentage of contracts allocated based on:
 - a. administrative act?
 - b. administrative contract?
 - c. civil contract?
17. What kind of audit mechanisms are in place for contracts?
 - a. Pre-award
 - b. Implementation
 - c. Post-implementation
18. How the outcomes of contracts are evaluated?

Award Section

19. What percentage of contracts were made on the basis of:
 - a. Competitive bidding processes
 - b. Negotiated bidding processes (RFP then bids)
 - c. Other processes (e.g. relational contracts)
20. What is the average number of bids made for competitive bidding processes?
21. What is the average number of qualified suppliers available for non-competitive bidding processes?
22. What percentage of contract awards were made to:
 - a. Private for-profit companies
 - b. Private NGOs
 - c. Government-owned profit and not-for-profit organizations
23. How many contracting initiatives have been won by an in-house unit?
24. What percentage of contracts were:
 - a. Input-oriented
 - b. Output-oriented
 - c. Outcome-oriented
25. How much do the following factors influence the contracting procedures?
 - a. Market situation
 - b. Legal environment
 - c. Political decision-making
 - d. Other