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## **Delegation without Agency Loss?**

### **The Introduction of Performance Contracts in Danish Central Government**

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## **Introduction**

Parliamentary democracies concentrate considerable authority with departmental ministers. They, on the one hand, are placed at top of an executive hierarchy. In this capacity they can issue orders down through the hierarchy and, what is more, they have the right to intervene into daily business. On the other hand, parliamentary democracy also makes it possible to hold departmental ministers accountable for whatever happens within these departmental hierarchies. Both principles presume that ministers can trust civil servants to act in accordance with their political directives and also that information on administrative practice for which the minister is accountable is not distorted and hidden. In other words, this raises the risk of agency loss customarily seen as related to delegation. An important question is therefore whether administrative strategies exist that might minimize this risk.

The present paper presents a preliminary analysis of an innovative strategy to deal with agency loss. In the early 1990s the Danish government launched a pilot project where select central agencies entered a contract with their department. The idea was that through mutual agreement ministerial departments and agencies should set the goals to be achieved for the period ahead in central policy fields. Today almost all government agencies are covered by performance contracts.

Performance contracts have been introduced into a central administration that builds on quite consistent organizational principles. With a few exceptions ministries have a two-layered organization. The department serves as secretariat to ministers. It provides them with political and policy advice, assists them in their dealings with parliament and parties, interest groups and the media. It is also responsible for the coordination of in most cases several agencies that report to the minister through the department. Agencies for their part are separate organizations with their own management and staff and normally their own budget. Ideally they are responsible for the implementation of policy within a specialized field, normally defined by one or a few laws that together form a relatively coherent policy area. Agency authority can be defined by formal law, but true to the principles of parliamentary government it is in most cases the result of delegation from the minister. Although the principle as described here is applied in a fairly general way the precise definition of the interface between departments and agencies varies considerably.

In this setting, the central problem of delegation involves remedying information asymmetries that can be assumed to work to the advantage of agencies and ensuring that agencies are responsive to ministerial goals. This paper analyzes the use of performance contracts as a potential solution to

such governance problems. Among the general questions addressed is whether it is possible to introduce contracts into a hierarchical setting like the one described above: Is the position of ministers and departments not so strong that the idea of contractual management is reduced to a symbolic metaphor? Or are the informational advantages of the specialized agencies not so strong that it remains illusory to change this relationship through the mutual agreement on performance goals?

The theoretical framework draws on Fritz W. Scharpf's theory of actor centered institutionalism and Oliver Williamson's transaction cost theory. Both see hierarchy as a framework for interaction between superiors and subordinates that ultimately rests on the authority vested at the top of the hierarchy, but they also stress the bargaining and mutuality that characterize hierarchical organizations. But where Scharpf emphasizes the limits to mutuality in the shadow of hierarchy, Williamson focuses on organizational variation following from the different nature of the tasks handled by individual organizations. Following this, contracting is understood in the context of formal hierarchical governance and variation across different types of agencies is analyzed.

The empirical analysis is based on the coding of performance contracts entered between ministerial departments/departmental ministers and ministerial agencies and covering the year 2005. It includes most government agencies as contracting is now almost universally used. The analysis starts with a discussion of a number of interesting aspects of the organization of Danish central administration. Hereafter performance goals are analyzed in order to answer questions of whether contracts can indeed be seen as a governance instrument focusing on remedying problems of goal displacement and information asymmetry. Finally, we analyze how the performance goals settled in the contracts vary with the two-layered department-agency organization that is typical in Danish central government as well as with the nature of the agency interface to citizens and private businesses.

## **Theoretical Framework**

### **Contracting and Task Differentiation in a Hierarchy**

Hierarchical organization is the backbone of public sector governance. First, hierarchy is the command and control mechanism through which the political executive provides political guidance for public authorities and institutions. Second, hierarchy is also the precondition for political accountability. It is only through the existence of an unbroken hierarchy that it makes sense to hold the political executive accountable for the decisions made within public administration. But even if hierarchy is the dominant organizational form within the public sector it rarely stands alone. The size of public sector organizations, the complexity of their tasks, and the normally high case load imply that for most of the time the operation of public administration relies on extensive delegation down through the hierarchy.

From the perspective of the political executive this is problematic as it risks losing control over an organization, while it remains accountable for decisions made within it. This is a realistic problem because research in organizational behavior since long has shown 1) that goal displacement may take place so that subordinate units develop their own practices deviating from official policy, and 2) that within a differentiated hierarchy like most public authorities there will exist information asymmetries hiding potentially important information and action for in this case the political executive. Together these deficiencies, inherent in any hierarchy, constitute an agency problem, and the issue is to what extent and how this problem can be minimized. The challenge is to increase the chances for the political executive to be reasonably certain that the policy delivered is actually in accordance with both its own political program and formal legislation authorizing policy. These agency problems are particularly pressing if the solutions considered are restricted to the choice between tighter hierarchical command and control or reliance on the strong economic incentives of the market (Williamson 1975; Ouchi 1980; Miller 1991).

### **The Transaction Cost Perspective**

An important strand within the theoretical literature has argued that there are at least partial solutions to these governance problems. They are brought into play because real world actors acknowledge the bounds on their own rationality, and because they take into consideration the uncertainties that confront them whenever they have to make a decision or to design an organization to make decisions on their behalf. In this realistic perspective, neither hierarchical nor market governance is frictionless. Therefore actors have a strong incentive to consider the transaction costs

involved before they decide how to set up the organization responsible for the delivery of policy. These transaction costs can be defined in purely economic terms as “the comparative costs of planning, adapting, and monitoring task completion under alternative governance structures” (Williamson 1985: 2). The argument is that variations in transaction costs explain why economic entrepreneurs often choose forms of organization that deviate from neo-classical claims about the superiority of market organization. So, under certain conditions hierarchy may be a more efficient solution than a market solution because it economizes on transaction costs as defined above.

One corollary is the existence of a wide variety of organizational solutions. Another corollary is that whatever the form of organization it involves a contractual relationship where the partners contributing to the handling of a particular set of tasks agree on the conditions for their future cooperation. According to conventional thinking this is clearly the case where an entrepreneur agrees with another entrepreneur on the delivery of a good or a service. But often such contracts are more complex in content and define the terms of cooperation over a longer period. Ultimately the superior-subordinate relationship that prevails in a hierarchical organization can be seen as a long term contract defining the mutual rights and obligations between employer and employees, management and staff. A final corollary is that entrepreneurs rarely have at their disposal a perfect solution to their governance problems. This may imply that the arrangement actually chosen in practice leaves certain problems open to be solved discretionarily. It may also imply that different forms of organization are combined. Of particular interest here is the possibility to combine formal hierarchical governance with a negotiated order – intra-organizational contracting – between the executive and the operational parts of the organization (Williamson 1985: 68-84).

The transaction cost perspective briefly summarized above is at the core of the theory of the firm. As such, focus is on governance problems faced by private firms operating at the market. However, Terry Moe (1984) was early to draw attention to the theory’s strong potential relevance for the study of public sector organizations. The presentation of organizational design issues as governance problems, i.e. as questions primarily concerning the allocation of control over an organization and its policy, are in line with the most basic political science perspective. Similarly, the idea that there is no one best organizational solution to governance problems perfectly matches the rich variation in organizational forms and steering systems in the real world of the public sector while at the same time raising the questions of when policy makers prefer one solution to another.

Transaction cost theory here remains faithful to its micro-economic sources. Its basic claim is that entrepreneurial concern for efficiency account for organizational differentiation because different forms of organization minimize the sum of production and transaction costs given variation in transaction characteristics. Maybe this holds for private firms. “Yet politicians are not primarily motivated by productive efficiency or the public interest in making such decisions. ... This means that, when politicians choose between public bureaucracy and contracting out, they are generally not choosing on efficiency grounds – nor are they in the conventional sense, seeking an optimally balanced set of hierarchical controls and monitoring mechanisms in designing the details of the contractual arrangement” (Moe 1984: 761). Therefore, transaction costs should also be conceived in political terms as the opportunity costs facing politicians in terms of votes lost or won, coalition opportunities opened or forgone, executive capacity bound or free, and executive discretion restricted or protected through more or less flexible forms of organization. Since the 1990s, political transaction cost theory has gained considerable ground in the study of public policy making and public sector governance (See e.g. McCubbins, Noll and Weingast 1987; Moe 1984; 1990; 2005; Horn 1995; Dixit 1996; 2004; Williamson 1999).

### **Contracting in the Shadow of Hierarchy**

Insights similar to those of the transaction cost perspective have been phrased by Fritz W. Scharpf. He too draws attention to the existence of several institutional solutions of which hierarchy is only one and further to the fact that information asymmetries often work to the advantage of the subordinate units in a hierarchy. The result is that hierarchical governance to a considerable extent takes the form of exchanges between the executive level and the operational units at the bottom of the hierarchy. But Scharpf also adds that even if such exchanges and negotiations, often tacit, endow hierarchical governance with a contractual quality hierarchical authority looms in the background: “The implication is therefore not only that negotiations that are embedded in a hierarchical structure are more likely to lead to agreement than freestanding negotiations would under otherwise similar conditions but also that these negotiations will be systematically influenced by the anticipation of a potential decision of the minister. In other words, the principal agency problem largely disappears if agents can only act either by agreeing with each other or by appealing to the (single) principal” (Scharpf 1997: 200).

Where Williamson (1985: 135) speaks of “the principle of selective intervention”, Scharpf alludes to negotiated coordination in the shadow of the hierarchy (Scharpf 1997: 197-200). For both the claim is that agency-problems getting so much attention in the scholarly literature, in real world contexts are largely manageable. First, political executives have developed governance structures that keep hierarchy as the institutional backbone of public sector governance, but transaction costs are at the same time minimized due to wide delegation of operational authority from the political executive to specialized subunits. Second, the risks of goal displacement and departmentalization created by this arrangement are kept in bounds by intra-hierarchical negotiations taking place in the shadow of hierarchy and forms of delegation allowing for selective intervention by the political executive.<sup>1</sup>

### **Agencies, Departments and Relational Contracting**

Transaction cost theory sees hierarchy as the dominant form of organization when it comes to handling the core tasks of government. But hierarchy takes many forms. According to transaction cost economics, the basic distinction is between unitary organizations where all tasks are handled in functionally specialized subunits ultimately reporting to a single executive and multidivisional organizations where operational tasks are delegated to divisions, specialized according to geographical or product criteria. Their managers report to headquarters that are responsible for corporate strategy and coordination, but enjoy considerable autonomy in the management of their divisions (Williamson 1985: 273-297). The theoretical claim is that the unitary hierarchy involves higher transaction costs than the multidivisional organization. It is also that the multidivisional organization is the result of institutional innovation, and this more modern form of hierarchy has spread as experience brought evidence of its comparative efficiency. This point is at the core of the theory of the firm. Its public sector parallel is the discussion of whether the public bureaucracy should be organized on a unitary basis where the administration is concentrated in a hierarchy reporting directly to departmental ministers or on a two-layer basis where departmental ministers are advised by ministerial departments on policy and political issues, while policy implementation is delegated to agencies with their own management, their own budget and staff the activities of which are coordinated by the department.

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<sup>1</sup> We use the words goal displacement and departmentalization to describe this phenomenon. These are the terms used in classical organization theory. Political science has used the bureaucratic politics, while the rational choice literature has developed its own vocabulary and speaks of bureaucratic or agency drift and provider capture. But the phenomenon described remains the same.

Like its private sector parallel the agency model is often presented as a more innovative form of organization. Again the claim is that it is comparatively superior, even if it varies whether this superiority is the result of higher efficiency or higher effectiveness. However, transaction cost economics has generally neglected the increased risk of agency problems when substantial managerial authority is delegated to divisional managers (Cooley 2005: 43-63). Moreover this risk is particularly strong when the theory is applied to public administration that operates under the presumption of democratic accountability (Christensen and Lægreid 2006).

### **A Transaction Cost Perspective on Performance Contracts**

The delegation of tasks and authority to government agencies entails problems of ensuring that agencies actions are in correspondence to the preferences of the political executive. Based on the above discussion, contracting can be seen as an organizational solution to such governance problems. Contracting must be understood in the context of hierarchy. The contract regime is combined with formal hierarchical governance and contractual negotiations take place in the shadow of hierarchy. A first element in analyzing the use of relational contracting therefore involves specifying the organizational context and the nature of the negotiated contract framework:

1. If the government chooses an organizational form where central administration is organized on a two-layer basis, where is the line drawn between departmental and agency responsibilities?
2. To what extent and in which form do ministerial departments engage in negotiations with agencies in order to specify the framework within which they operate for a period of some length?

Such negotiations taking place within the executive hierarchy do not have the properties connected with either the classical, presumably complete contract between two independent parties or the neo-classical, incomplete contract where two parties agree to engage in third party arbitration in case of conflict. Rather agreements reached under negotiations in the shadow of the hierarchy take the form of relational contracting. In Williamson's words (1985: 71-72) "progressively increasing the 'duration and complexity' of contract has thus resulted in the displacement of even the neo-classical adjustment processes of a more thoroughly transaction-specific, ongoing administrative kind. The fiction of discreteness is fully displaced as the relation takes on the properties of a 'mini-society with a vast array of norms beyond those centered on the exchange and its immediate processes.'"

The concept of relational contracting is not only descriptively precise because it explicitly acknowledges the reciprocal character of hierarchical governance. The introduction of performance contracts at the same time represents a complementary device to hierarchical governance. They are the result of a negotiation taking place within a strict hierarchy. The strength of the commitment represented by the contracts thus lies not only in the precision of their terms, but also in the strength and character of the norms governing the interaction between department and agency.

Many performance contracts explicitly state that they are not formal contracts. Still, a performance contract of the relational type may complement the governance in two important ways. First, departmental ministers and their departments may use performance contracts to fill out holes left by the use of other instruments. In a policy perspective this is important because neither specific nor general delegation of decision making authority to agencies provides much policy guidance. From a ministerial perspective agency loss may be the result if the agency exploits its specialist knowledge to pursue policy goals that represent agency practice without explicit authorization by the department and eventually the minister. Similarly, if the budget is primarily used to allocate resources within the portfolio without specification of financial performance goals, e.g. productivity demands there is again a risk of agency shirking. In either case a performance contract may serve as a managerial complement to traditional hierarchical governance that makes it possible for the department to specify the demands to be met by its agencies during the contract period.

Second, for the agency performance contracts represent a potential solution to the uncertainties that may result from ex post opportunism by the political executive and the department (Miller 2000). If the performance contracts are truly relational as defined by transactions cost theory they provide the agency with ex ante certainty as to what is expected by it during the period covered by the contract, provided the department and the minister does not give in to ex post opportunism. In a political environment this is a critical condition. Ministerial and departmental attention may change without notice and leave the agency in a situation where it does not matter much that its behavior actually met the demands stipulated in a contract. In this case the shadow of the hierarchy prevails.

However, this is an institutional fact inherent in ministerial organizations anchored in parliamentary democracy. The real issue therefore is whether performance contracts can be phrased in a way that anticipates this risk of sudden policy reversals without emptying the contracts of operational content. In this case they are reduced to entirely symbolic manifestations. This

discussion of the relational and complementary nature of performance contracts leads to two important questions concerning the use of negotiations within the ministerial hierarchy:

3. To what extent do contracts reflect attempts to solve problems of goal displacement and information asymmetry?

When Terry Moe introduced transaction cost theory and the new institutional economics to political scientists, one issue was whether the economist's concern for the linkage between organizational design and economic efficiency was of any relevance if the logic was applied in the political setting of public sector governance. His speculation amounted to an unequivocal no (Moe 1984). Other theoretical work in political science has come to the same conclusion that politics is more important than economics. Concern for control and power together with distributional issues are what matter in public sector governance and management (Hammond and Miller 1994). Still, much of the rhetoric on public management and managerial reform is one of economic efficiency. Add to this that even if the concern for efficiency is not the prime concern for elected politicians public sector organizations operate within budgets. To the extent these budgetary constraints are credible they create incentives to consider operational costs and managerial efficiency. In the end it remains an empirical issue whether cost and efficiency concerns play a role in relational contracting within government or whether such contracting only addresses the problems of policy effectiveness:

4. How do contracts entered between ministerial departments and agencies balance demands for policy effectiveness against demands for cost efficiency?

The four questions raised above do not differentiate between agencies. They are posed under the assumption that in all cases the agencies have tasks the handling of which presumes considerable asset specificity in the form of specialized staff and an organizational capacity that rests on the long term development of highly specialized procedures. In transaction cost theory such asset specificity, as noted above, leads to the hypothesis that tasks will be solved within a hierarchical organization which evidently is the case for the agencies analyzed in this paper. However, there is considerable differentiation of the tasks delegated to these agencies. This task differentiation follows two dimensions. The first, the precise line of specialization between the ministerial department and the agency has primarily to do with the distinction between policy-development and policy-making as opposed to policy implementation (Scharpf 1997: 198-199). The second dimension concerns the discreteness of the managerial tasks delegated to agencies (Williamson 1985: 74). Task discreteness increases if the agency handles a large number of cases that are precisely defined in the authorizing

legislation; it decreases if the agency handles more heterogeneous cases, maybe even cases that have the character of specific and temporary projects rather than administrative case work defined by law to be handled on a long term and continuous basis. Task differentiation of either kind may have consequences for relational contracting within the ministerial hierarchy. The more discrete agency tasks are, the easier it will be to specify general performance criteria in an agreement or contract, and the more agencies are involved in policy work the less likely it is that ministerial departments enter specific. Thus the question is:

5. To what extent do task differentiation between departments and agencies and varying degrees of task discreteness between agencies influence the form and content of contracts entered between ministerial departments and their agencies?

## **Design and Data**

The empirical focus of the paper is performance contracts for agencies in the Danish central administration. The research strategy was threefold: First, all agencies with performance contracts in 1995, 2000 and 2005 were identified and the contracts in force for these years collected. Second, the performance contracts were coded with respect to a number of interesting variables. Third, data was collected on relevant background variables such as departmental model and agency functions.

In regard to the collection of performance contracts, a list of agencies existing in the relevant years was compiled and used as the point of departure. A ministerial agency is a national authority not reporting directly to a minister, but with decision making authority within a precisely specified field of legislation and, depending on the specific departmental organization, tasks related to policy advice and development. A ministerial agency is distinct from on the one hand ministerial departments serving as secretariats to ministers, on the other hand state institutions providing particular services like museums, theaters, and applied research institutions.<sup>2</sup>

All present-day agencies were contacted and asked for performance contracts from the relevant years. Other sources such as relevant departments, the Ministry of Finance and the Auditor General have been contacted in order to procure contracts from agencies no longer existing or agencies not able to provide contracts. In particular regarding the early period, it has been necessary to draw on various sources to secure a complete dataset as many agencies did not have archives containing

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<sup>2</sup> By concentrating on contracting between ministerial departments and agencies our analysis rests on narrower data base than previous discussions, Greve (2000) and Greve & Ejersbo (2005).

previous contracts. In order to verify the completeness of the set of performance contracts, official reports on the contract paradigm have been consulted.

The result is a set of performance contracts that is very likely to be complete. Table 1 presents a first overview of the contracts. As can be seen from the table, in the first period only 9 agencies had performance contracts. This reflects the experimental character of the contract paradigm in the beginning of the 1990's (Greve 2000: 157; Greve 2006: 166-167). In the second period, 35 agencies corresponding to more than sixty percent of government agencies were covered by performance contracts. By then contracts had found a place as an important tool in the central administration. In the last period, the use of performance contracts had become almost universal as more than ninety percent of agencies had contracts. This paper analyses the 54<sup>3</sup> contracts valid in 2005. Hence, the present paper analyzes the mature contract paradigm rather than the development of contract governance.

[Table 1 about here]

Performance contracts typically consist of general statements (such as agency missions and statements of mutual agreements between the agency and department) as well as specific performance demands. In order to gain an adequate understanding of the character of contracts it is necessary to investigate the actual performance demands. As displayed in table 1, the average number of performance goals per contract has been rising throughout the period beginning with only about 20 in 1995 and so far peaking at 37 in 2005. For present purposes, the 1,998 performance goals on the 2005 contracts will constitute the basis of analysis. Three aspects of each demand have been coded: 1) the overall focus of the demand if possible specified in regard to the group for which the fulfillment of the demand will be particularly important, 2) the type of demand in terms of the content of the specific activity required and 3) whether the goal is quantified and the fulfillment of the goal assessable. Contracts have also been coded in respect to other parts of the content. Of specific interest here is whether the contract contains any concessions to the agencies in terms of expanded authority to decide for example on matters of budget and personnel. Such concessions can be interpreted as reflecting a quid-pro-quo character of the contracts where agencies gain increased independency in return for fulfilling performance demands. Further discussion of the specific categories used in regard to performance goals and concessions to agencies can be found in connection to the analysis of the data.

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<sup>3</sup> One agency – the Danish Road Directorate – had three separate contracts in 2005 and in some analysis the number of cases is therefore 56.

Of interest here is not only the contracts themselves, but also how these reflect and relate to other aspects of the ministerial organization. It has therefore been necessary to collect information on a number of background variables. These are described in detail in the next section. Information on departmental models has been extracted from a report published by the Ministry of Finance (2006); the source of budget information is the general comments to agency budgets in the State Budget; and data on the legal basis for delegation to agencies have been found by searching agency web pages as well as general legal databases.

## **Analysis**

It is now time to turn to the empirical analysis. The analysis will follow the logic laid out in the five theoretical questions raised. The first section establishes the base-line for analyzing performance contracts, as it investigates the dominant traits in the Danish ministerial hierarchy. In particular it focuses on the task differentiation between departments and agencies as well as some of the general instruments available for controlling agencies. The second section investigates performance contracts. It concentrates on the nature of performance demands in contracts and whether these can be seen as directed towards remedying delegation problems as well as targeting issues of agency effectiveness and efficiency. Lastly, possible variations across agencies depending on the nature of departmental models as well as the degree of task discreteness are investigated.

### **The ministerial hierarchy**

The dominant form of ministerial organization is the double layered department-agency form. Its basis is the split of ministerial tasks in those defined as departmental and those defined as agency tasks (Christensen 1997). Departmental tasks are policy and politics related. According to this thinking the department is defined as secretariat to the minister while at the same time being responsible for the coordination of agency business. The ministerial agencies according to this model are responsible for policy implementation. They are organized along functional criteria. In most cases they are responsible for the administration of one or few laws, but a recent development in Danish central government means that the ministries quite often have pooled all routine business related to financial and personnel management to an agency servicing the entire ministerial organization.

The department-agency form presupposes delegation to the agencies that is wide in scope and based on general criteria. By itself it does not affect the principle of ministerial accountability.<sup>4</sup> This raises two interconnected questions concerning the precise implications of the department-agency form. The first concerns the precise definition of the interface between the department and the agency. This interface varies to a considerable extent even if most ministries since the 1990s apply the department-agency form. A simple way of distinguishing between different applications of the model is to differentiate between ministries that keep a department with broad responsibilities and ministries that keep a department with narrow responsibilities. This distinction is applied in a report published by the Ministry of Finance (2006: 47-57). The distinction is based on these criteria:

- The broad department holds a relatively large capacity for hierarchical governance of its agencies. Policy and political advice to the minister is a departmental responsibility with agencies providing information and support on a partnership basis. Departmental capacity is ensured through upholding a relatively large departmental staff that is specialized according to functional and policy criteria that matches specialization between the ministry's agencies. In 2005 20 agencies belonged to ministries applying the broad model (see table 2 below).
- The narrow department holds a relatively smaller capacity for hierarchical governance of its agencies. The departmental staff is relatively small and the department is not organized according to policy criteria that match specialization between its agencies. The narrow model concentrates on intra-ministerial coordination and servicing the minister. The implication is that the agencies are in charge of both policy work (e.g. drafting of bills) and the preparation of any documents made in the name of the minister (e.g. the drafting of answers to parliament and parliamentary standing committees) as well the drafting of briefings to the minister before meetings in parliament or with interest organizations. No or little departmental screening of briefings and drafts produced by the agency for the minister is foreseen. In 2005 18 agencies belonged to ministries applying the narrow model (see table 2 below)

With the wide adherence to the department-agency form most ministries have applied a general distinction between departmental and agency business. This makes it possible to group them in the two categories defined above. However, some ministries do not apply the form consistently. While

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<sup>4</sup> In a few cases the ministerial hierarchy is broken because the agency according to the law reports to a management board rather than to the ministerial department, cf. Christensen & Yesilkagit 2006.

for most parts of the portfolio they have delegated tasks to specialized agencies they retain other tasks in the department. The result is a differentiated form of organization that for business with agency coverage is similar to the broad departmental model, while for tasks without agency coverage it applies the unitary model. This hybrid organization is an excellent example of partial delegation.<sup>5</sup> In 2005 16 agencies belonged to ministries applying the differentiated model (see table 2 below).

A ministerial portfolio covers a policy area thereby signaling its set of policies to be viewed in a common policy perspective. This calls for the department to develop procedures for systematic and regular coordination of its agencies. In the traditional ministerial organization such coordination was ad hoc. Increasing concern for departmentalization of governmental policy along agency lines during the 1980s led to efforts to tighten intra-ministerial coordination between ministerial departments and their agencies. The metaphor used to give meaning to these efforts was the presentation of the department and its agencies as a multidivisional corporation and the challenge was to develop coordination procedures that could further the creation of a joint policy profile and corporate identity for the ministry and its subsidiary agencies (Hassenkam 1987). These corporate management systems as they are officially named have since been adopted by most ministries (Ministry of Finance 2006: 94-98). They create a forum where the permanent secretary and the departmental chiefs of section on a regular basis meet with the agency heads. The agenda concentrates on administrative and financial issues of common relevance, on strategic priorities, and on intra-ministerial governance. Individual cases are rarely on the agenda of the corporate management forums.

Adherence to the department-agency form raises a second question. It concerns the forms and tightness of departmental governance of the agencies. Delegation of administrative tasks to an agency may endow this agency with considerable autonomy, even if the typical organization places the agency as an integral part of the ministerial hierarchy (Christensen and Yesilkagit 2006). This opens for departmental guidance and control that relies either on ad hoc intervention into agency business or on general instruments. These general instruments take different forms. The most important are the agency budget together with organization schedule and the legal rules specifying the delegation of tasks. To this come procedures for intra-ministerial coordination between the department and its agencies described above. But while these procedures are fairly general the

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<sup>5</sup> Siqueira (2007) offers a theoretical discussion of this issue.

tightness and explicitness of both budgetary provisions and the form of delegation to agencies may vary:

1. The agency budget is without exception an envelope budget that with very few and general constraints authorizes the agency head to spend next year's appropriations as she or he finds appropriate. However, any appropriation proposed in the annual budget proposal is accompanied by more or less specific comments. These comments may stipulate the assumptions underlying the budget, e.g. by setting up an output target or by specifying productivity goals to be reached. These comments are not legally binding, but the more specific they are in setting up either policy or efficiency goals the tighter departmental constraints on agency operations are.
2. The core idea behind the department-agency model is the delegation of policy implementation to agencies reporting to the minister through the ministerial department. But the basis for this delegation varies considerably. One option is to delegate on the basis of a command and control procedure where the department defines agency responsibilities in general terms and then task by task specifies agency responsibilities in a particular context or for the coming period. In some ministries this is described as a provider-producer split where the agency solves a specific task at departmental request. An alternative to this flexible, but potentially tight command and control procedure is the department's exhaustive listing of the cases in which the departmental minister delegates decision-making authority according to the legislation to a particular agency. These decrees can be changed from day to day, and even if they do not always contain call-in clauses the minister and the department on a selective basis can request any specific decision referred to the minister. Still the distinction between the command and control solution described above and this general delegation solution is important. In this latter situation there is much more certainty as to the tasks and responsibilities of the agency, and the precise listing of delegated tasks signals to for example regulated business and citizens that the decision is an administrative rather than a political matter.

The two governance instruments described above are important in both the minister's perspective and in the perspective of the agency. For the minister the issue is whether these fairly general

instruments minimize the agency problem. For the agency the issue is whether delegation within the general framework described above protects the agency and the agency head against ex post opportunism. This may happen if the minister, the government or the department reacts critically on agency decisions that turn out to be politically controversial even if decision-making authority was delegated to the agency. The critical reaction may range from public denouncement of the agency head to discretionary replacement of her or him (Miller 2000; Hood 2001).

[Table 2 about here]

Table 2 shows that the budget only rarely places constraints on agency heads, although there is some variation for agencies belonging to ministries applying one or the other of the three departmental models set out above. While agencies within the narrow department model never are met with quantitative cost efficiency or policy related goals in the general comments to the agency budget 16-17 per cent of agencies under the broad and differentiated departmental models are met with either quantitative cost efficiency demands or a combination of quantitative cost efficiency and policy related demands in the agency budget. Still, the agency budget primarily sets a spending cap leaving agencies largely free to spend their means as the agency heads finds appropriate. This may be the intended state but it may also leave a governance hole to be filled by other instruments.

The situation is quite different for the basis for delegation. Agencies belonging to ministries under the differentiated model normally operate on the basis of either a general delegation decree that list their tasks and responsibilities exhaustively or a law by law decree delegating tasks to them. This is also the case for 58, respectively 63 per cent of agencies operating under the broad or narrow model. Part of this hole may be filled out by the law specifically placing the authority to administer a particular act or part of an act with the agency. But often such clauses are rather vague and indeterminate. Thus considerable space is left to be filled out either by agency practice, ministerial and departmental guidance and intervention, or eventually by negotiations within the departmental hierarchy.

### **Contract specification of performance goals**

As the annual budget only to a very limited extent is used for specifying policy and efficiency related goals to agencies a potential agency problem exists. The question therefore is to what extent performance contracts are used to close this hole. Performance contracts may cover a wide range of different objectives. Demands in contracts can be directed towards increased productivity, goal

achievement, agency restructuring or many other specific activities. Demands can be oriented towards satisfying specific target groups or be primarily internally oriented. Demands can be quantified and the fulfillment of demands easily assessed or they can be formulated vaguely impeding the evaluation of agency performance. This section analyzes the performance demands set up in agency contracts. Specifically, it investigates three aspects of demands. First, the content of the demands in terms of the activity or result required from the agency. Second, demand focus in regard to the target group of demands and third, whether the demand is quantified and/or assessable.

The distribution of performance demands in all 2005 contracts is shown in table 3. Demands are divided into six main categories. The first includes the initiation of different kinds of projects. Such demands account for about a third of all performance demands. Agencies are required to perform analysis and evaluations in specific areas, to draw up different kinds of documents and to initiate campaigns or projects. These types of demands do not specify performance improvements but rather constitute a negotiated working plan for the agency. Even though it might seem rather unambitious to set up demands that can be fulfilled by the writing of a document or the holding of a meeting such demands do entail options for steering agencies. As seen from the point of view of the political executive, agency attention can be focused on areas of political interest through demands of project initiations in such areas. Even though such activities may not lead to immediate effects on agency performance they can be well-suited to demonstrating at least the symbolic attention to particular issues.

[Table 3 about here]

The next main category consists of demands related to organizational adaptation. These are internally oriented and include for example changes in procedures and organizational structure and matters related to employees. Together they account for 21 percent of all performance demands. In particular, performance contracts seem to be a popular place to specify ambitions of increased IT use as such demands alone make up almost eight percent of all demands. This demonstrates that contracts are to a large degree oriented towards agency modernization and adaptation and used to set up ambitions for the introduction of new agency procedures, steering systems and other organizational changes.

Of particular interest from a theoretical viewpoint are attempts to use contracts to specify demands for increased agency performance on matters related to policy effectiveness. Such demands are included in the two categories of policy demands and production demands. Following

political transaction costs theory there is clear expectation for political executives to be actively concerned about policy effectiveness. Even if formal law is the main basis for stating the policy goals to be achieved there is considerable room for political and administrative discretion. Such discretion can be used ad hoc by referring specific cases to the minister and department but performance contracts can in addition be tailored to specify general performance demands directed against agency level administrative practice, for example quality and service standards, scheduled time for case processing, client and end user satisfaction. If incumbent ministers are held accountable for their general performance it is only natural to expect them to be concerned and performance contracts should be expected to include demands in this regard.

It turns out that about 17 percent of performance demands are directed towards policy and another 15 percent of demands concern agency production. On average, this corresponds to each contract containing more than ten demands related to either policy or production. Specific demands concerning case work time alone accounts for 7.6 percent of demands, while other types of quality and service demands account for 5.7. Agency users as well as the general public are very likely to be concerned about long times for handling cases and other aspects of agency quality, service and production. The presence of these types of demands therefore indicates that contracts are indeed used to make agency deliver on areas that concern their political executives.

While production demands focus only on the actual production of agencies, productivity demands specifically relate the production to the resources used. In this category we also find attempts to decrease sick leave for example by X days per employee and specific demands concerning the economic results. All of these must be interpreted as directed towards increasing productivity. The theory is more ambiguous as to the political focus on efficiency goals. If we follow the Moe-logic laid out above their concern for costs and cost efficiency is expected to be low. Consequently, efficiency and cost related demands are not expected to be included in the performance contracts to a very large degree. The findings correspond well to this expectation as productivity demands make up only five percent of all performance demands.

Lastly, a number of other types of demands have been lumped together in the 'other' category. Of interest here is noting that demands concerning assistance to the minister or department make up less than two percent of all demands. These typically concern the quality and timeliness of assistance to the minister and the low percentage demonstrate that contracts are used more to direct agencies behavior towards focusing on specific areas and delivering in regard to policy and

production than to set up demands for servicing the minister directly. In a typical ministry it is probably not necessary to specify the latter in performance contracts.

As discussed so far both policy and production related demands constitute an integral part of agency contracts, but they do not stand alone. What is more, different types of demands have a different focus in another sense. For some of them focus is directed towards a well-specified target group where a target group is defined as the group for which the fulfillment or non-fulfillment of a particular performance demand is estimated to be particularly important. The existence of such a target group tends to increase positive and negative political transaction costs. But for some performance demands focus is unclear so that it is not possible to pick out the existence of a relatively well defined target group. In this case transaction costs and in particular positive political gains from specifying demands to agencies are less specific. Therefore we expect them to be of little political and departmental concern.

Some agencies have an important interface with a clientele consisting of citizens and business firms while for other agencies this interface is indirect because local and regional governments are responsible for the handling of end users. In the former case we consider citizens and business firms as the target group, in the latter local government. Table 4 shows that performance contracts to a very high extent are used to specify demands with citizens and private business as their target group as 37.2 percent of all demands can be identified as having users or citizens as their target group. These demands typically concern policy performance or the initiation of projects that are targeted towards end users. By relating the performance demands to their target group it is thus established that project initiation often is externally directed and therefore might be well-suited to demonstrating to agency surroundings that the bureaucracy is actively engaged in areas of concern to agency target groups.

[Table 4 about here]

Alternatively, when the interface is to local authorities, contracts rather are used to negotiate projects to be initiated by the agency during the contract period. Almost sixty percent of demands, where the target group is local authorities, concern project initiation and the same pattern is found when it comes to demands targeting the minister or department. This could reflect that many projects are initiated in cooperation with either the department or local authorities.

While many demands have clearly defined target groups, for others it is not possible to point to a specific target groups. These have been divided into demands focusing on production and resources

on the one hand and on internal matters on the other. Not surprisingly most demands in the first category concern specific activities or goals related to production and productivity, while many of the demands with a focus of internal matters entail organizational adaptation or the initiation of different kinds of projects with an agency internal focus.

Based on this discussion, a first conclusion is that departments often enter performance contracts with their agencies to initiate projects with a clear ministerial or local government focus or to meet the presumed concerns of the agency clientele in business and society. A second conclusion is that performance demands often suffer from a diffuse focus, not having a clear target group. Such demands very often are directed towards intra-agency business or different aspects of agency production with the important addition that cost efficiency receives scant attention.

Among the prime causes of delegation problem is information asymmetry. The literature argues that important information and action will be hidden from the political executive impeding the control of agencies. If setting up performance demands is to remedy this problem a precondition must be that it is possible to monitor whether agencies in fact fulfill the requirements set up in contracts. Demands can of course be formulated so performance is easily monitored but they might also be stated so vaguely that executives have no real way of determining whether demands have actually be met. Table 5 presents an overview of the character of demands in terms of assessability of performance. It also shows how the character varies across type of performance demand.

[Table 5 here]

Performance demands have been coded according to two criteria. First, it was registered whether demands are quantified. This is the case with for example a numerically specified reduction of case work time or a set target for an increase in user satisfaction. If demands are quantified it is by implication also possible to assess whether they have been met. Second, the remainder of demands has been coded depending on whether it would be possible to determine that the demand had been fulfilled. For example it can easily be assessed if a specific conference has been held or a document drawn up, while a demand to “work with policy area X” is so vague that it is not possible for an observer to determine whether the agency has actually delivered on the demand.

It turns out that a very low share of performance demands is non-assessable. More than 95 percent of demands have been drafted in a way that enables agency performance to be assessed. Contracts are therefore well-suited to enable the monitoring of agency behavior – at least on the areas covered in contracts. Further, it is interesting to note the significant degree of variation across

demand type. Performance demand targeting policy and productivity are to a very large degree quantified. In fact, more than 70 percent of demands in these categories include numerical targets for agency performance. Production demands are also more likely to be quantified than the average demand. This gives further support to the proposition that contracts are used to steer agency behavior in areas that are important for the political executive. Contracts are to a large degree targeted towards agency effectiveness in regard to policy and production and in these areas demands are often formulated in a way that maximizes the potential for monitoring agency behavior.

### **Ministerial organization, task specification and contract differentiation**

Even though all agencies share many traits, there are also important differences among agencies. This section investigates to what extent performance contracts reflect such differences. If contracts are used as a tool to handle agency problems it can be expected that the content of contracts is tailored to meet the task of steering specific agencies. In other words, systematic variation across agencies should be expected. Alternatively, if contracts do not vary depending on agency type and ministerial organization a more likely interpretation would be that contracts are used more as a symbolic instrument than as an instrument fine-tuned to meet the challenges of handling agency problems.

Of particular interest here is the degree of differentiation of the tasks handled by agencies. As discussed above, the line of distinction between agencies and ministerial departments differ. In ministries characterized by a broad departmental model, agencies are primarily implementation bodies while policy work is handled by departments with relatively large staff. In ministries with a narrow model, departments concentrate on coordination and servicing of the minister. Table 6 displays the average percentage of performance goals of different types in agencies integrated in ministries with a broad, a narrow model and a differentiated departmental model combining elements of the broad and narrow model.

[Table 6 here]

The results reflect theoretical expectations of differences across departmental models. Agencies in ministries with narrow models exhibit a relatively high share of demands related to project initiation, while performance contracts for agencies under broad models focus more on organizational adaptation, policy demands and productivity. However, due to the low number of cases when analyzing on the agency level only the difference in regard to project initiation is

statistically significant (at the 0.05 level using a Bonferroni test). Substantially, agencies where ministerial departments are broad are more specifically focused on implementation and contracts therefore focus more explicitly on agency performance. Agencies in ministries with narrow departments, to the contrary, have a broader range of responsibilities and are designed to play a much more active role in policy formulation. This is probably reflected in contracts' higher emphasis on project initiations such as analyses, evaluations and document formulation.

Agencies not only differ from each other because their mother departments apply different departmental models. Their interface to society also varies. Some agencies have a strong interface to the economic and societal environment, while other agencies are to a much lesser extent engaged in direct transactions with individual citizens and business firms. This leads to a much higher degree of task discreteness of the former agencies. They have to handle and decide large numbers of individual cases. This is typical of many regulatory agencies; but this is also the case for agencies that handle citizen and business complaints over decisions made at a lower level of government, typically in local or regional government. The latter group of agencies does not to the same extent have the responsibility for individual case processing. Rather policy delivery to end users or beneficiaries is a local and regional government responsibility. This is typical for environmental administration as it is for the delivery of welfare and other public sector services. Agencies in these cases are engaged in providing guidance and information and in overseeing local and regional practice, often lacking authority to interfere in any authoritative way. This raises the issue whether performance contracts are used differently for agencies having a strong, respectively a weak interface to citizens and private business firms. Following transaction cost theory we should expect this to be the case.

[Table 7 here]

Table 7 displays the average number of demands per contract for different types of performance demands. Agencies with a strong interface to citizens and private business handle a large number of similar cases. Such relative standardization both makes it possible to specify performance demands directly related to policy while at the same time making them and their minister vulnerable to critique. From a transaction cost perspective both should lead to a stronger emphasis on policy delivery what also turns out be the case. For agencies with a weak interface to citizens and business the responsibility for policy delivery is placed outside the agency and the instruments for influencing are simultaneously much more indirect. At the same time political accountability is not

anchored in the ministerial hierarchy. Their performance contracts clearly mirror both these traits. Here the average percentage of demands directed towards organizational adaptation doubles that of agencies with a strong interface to citizens and business. Finally, agencies handling business that bring them into regular and routine interaction with individual citizens and business are markedly more likely to have quantified demands in their contracts. **Conclusion**

This paper has investigated the now almost universal use of performance contracts in the Danish central administration. Contracts have been analyzed as a potential solution to governance problems. Negotiations on contracts take place in the shadow of hierarchy and a precursor to analyzing actual contracts was therefore to investigate the nature of the hierarchical organization in to which performance contracts have been introduced. The Danish central government is organized according to a two-layer agency/department model and the question of most interest was therefore where the exact line is drawn between departmental and agency responsibilities. Empirically this is not a question to which a uniform answer could be given. Ministerial models range between a narrow model where departments concentrate on coordination and servicing the minister and a broad model where departments are specialized in ways matching the agency structure.

The main analysis concentrated on the nature of performance contracts. It was evident from the widespread use of contracts that ministerial departments to a large degree use the contract paradigm to negotiate and specify the framework within which agencies operate. Contracts thus set up a set of performance demands that is suited to establish a framework covering a period of one or more years. In terms of the actual performance demands included in contracts two questions were raised as particularly interesting. The first concerned whether contracts reflect attempts to solve problems of goal displacement and information asymmetry. The second question of interest focused on how contracts balance demands for policy effectiveness against demands for cost efficiency. Regarding the last question, contracts were on average much focused on policy effectiveness as policy demands and production demands accounted for a large share of performance demands. Productivity related demands did on the other hand not count very much in contracts. These findings largely support the reasoning found in the political science literature that political executives are more interested in issues of control and power than in matters of economic efficiency.

The focus on policy effectiveness in contracts also supports the view of contracts as a potential solution to governance problems. Evidently, contracts are used to direct agency behavior in areas such as case work time, quality demands and agency production. Even though actual agency

performance has not been investigated in this paper, the systematic focus on these areas in contracts supports the theoretical proposition that contracts can be analyzed as an instrument used to remedy problems of political control and responsiveness. Further analyses demonstrating that users and citizens are often the target groups of performance demands and that many policy and production demands are quantified lend added support for this interpretation.

A last question of interest concerned the extent to which task differentiation between department and agencies and the degree of discreteness of agency tasks affect the contracts entered. Due to the low number of agencies the conclusions on this must be considered tentative, but the evidence did support the expected differences among agencies. Agencies in ministries with broad departmental models had contracts emphasizing policy, organizational adaptation and productivity while contracts for agencies integrated in ministries with narrow models tended to focus more on project initiation. The latter probably reflects departmental needs to engage these agencies in policy work initiated by minister and department. Contracts with the former agencies to a much higher extent focused on policy effectiveness as their task portfolio is more narrowly focused on implementation and their departments staffed to cope with policy problems.

Another rather fundamental difference appears between agencies with a strong, respectively weak interface to individual citizens and business firms – the former being characterized by a higher degree of task discreteness. Again the finding is that agencies responsible for large numbers of routine decisions are much more likely to have contracts specifying policy related demands than agencies with fewer hands-on responsibilities for individual case-processing. For the latter group of agencies demands directed towards the organization and its procedures played a relatively much more important role.

Overall, the systematic differences across departmental models illustrate that contracts are used as a flexible instrument. Probably, they also demonstrate that the development and implementation of performance contracts has been seen as a pragmatic step to strengthen intra-ministerial governance. This is very much in line with other reforms and long-term changes in Danish central government. But it stands out in quite stark contrast to more radical reformers (Gregory & Christensen 2004; Chapman & Duncan 2007). A country like New Zealand was a frontrunner in launching innovative reforms of public sector governance, but the reforms seem not to have been politically sustainable.

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## Tables

**Table 1. Overview of contracts**

	<i>1995</i>	<i>2000</i>	<i>2005</i>
Total number of agencies	50	56	59
Agencies with performance contracts	9	35	54
Percentage of agencies with performance contracts	18.9	62.5	91.5
Total number of performance demands	179	1,103	1,998
Average number of performance demands	19.9	31.5	37.0

**Table 2. Ministerial governance and contractual management 2005. Percentage of agencies under contract.**

Hierarchical constraints	Departmental model		
	Narrow	Broad	Differentiated
Demands in budget for: <sup>1</sup>			
• Cost efficiency	0	5.6	18.8
• Cost efficiency and policy	0	11.1	0
Legal basis for delegation: <sup>2</sup>			
• General decree	40.0	38.9	62.5
• Specific decrees	20.0	22.2	12.5
• No decrees	40.0	38.9	25.0
N = 100 %	20	18	16

<sup>1</sup> Quantitative specifications of demands cost efficiency demands in general comments to agency budget.

<sup>2</sup> Quantitative specifications of policy related demands in general comments to agency budget operationalized as either expected case processing time or quality and service standards.

**Table 3. Distribution of performance demands. Column percentages**

<b>Type of performance goal</b>	<b>Percentage of all goals</b>
<i>Project initiation</i>	<b>33.1</b>
- Analysis/evaluation	10.0
- Working group	0.9
- Non-binding document	11.2
- Binding document	5.0
- Meeting/conference	1.4
- Project/campaign	4.6
<i>Organizational adaptation</i>	<b>21.0</b>
- IT-use	7.9
- Employee survey	0.4
- Salary issues	0.3
- Organizational change	1.6
- Employee policy	2.4
- Employee composition	0.6
- Procedures	3.3
- Steering systems	3.9
- Management	0.8
<i>Policy demands</i>	<b>16.8</b>
- User survey	3.3
- Case work time	7.6
- Quality and service demands	5.7
- Satisfaction goal	0.2
<i>Production demands</i>	<b>15.0</b>
<i>Productivity demands</i>	<b>5.0</b>
- Reduction of sick leave	0.4
- Productivity demand	1.8
- Economic result	2.8
<i>Other demands</i>	<b>9.2</b>
- Assistance to the minister/department	1.7
- Communication	2.9
- Cooperation	3.8
- Other	0.9
N	1,998

**Table 4. Target group and types of performance demand. Row percentages**

	<i>Project initiation</i>	<i>Organizational adaptation</i>	<i>Policy</i>	<i>Production</i>	<i>Productivity</i>	<i>Other</i>	<i>All</i>	<i>N</i>
<i>Users/citizens</i>	32.1	14.1	33.5	12.1	0.7	7.5	37.2	744
<i>Minister/department</i>	58.9	8.0	6.3	1.1	0	25.7	8.8	175
<i>Other state authorities</i>	39.0	25.3	11.5	7.7	1.1	15.4	9.1	182
<i>Local authorities</i>	58.4	18.2	2.9	5.8	0	14.6	6.9	137
<i>International bodies</i>	35.3	9.8	2.0	23.5	0	29.4	2.6	51
<i>Other surroundings</i>	10.0	10.0	0.0	0	0	80.0	0.5	10
<i>Production/resources</i>	7.6	7.0	3.3	54.8	26.9	0.3	15.1	301
<i>Internal matters</i>	31.7	50.8	9.8	2.3	2.8	2.8	19.9	398
	661	419	335	300	99	184	1,998	

**Table 5. Type of performance demand and performance assessment. Row percentages**

	<i>Quantified</i>	<i>Assessable</i>	<i>Non-assessable</i>	<i>N</i>
<i>Project initiation</i>	3.3	94.3	2.4	661
<i>Organizational adaptation</i>	11.7	83.3	5.0	419
<i>Policy</i>	72.5	26.0	1.5	335
<i>Production</i>	43.7	52.7	3.7	300
<i>Productivity</i>	77.8	20.2	2.0	99
<i>Other</i>	15.2	76.6	8.2	184
<i>All</i>	27.5	69.0	3.5	1,998
	550	1,378	70	

**Table 6. Departmental models and types of performance goals. Average percentage of performance demands. Row percentages**

<i>Departmental model</i>	<i>Project initiation</i>	<i>Organizational adaptation</i>	<i>Policy demands</i>	<i>Production demands</i>	<i>Productivity demands</i>	<i>Other</i>	<i>N</i>
<i>Narrow</i>	37.7	17.7	16.6	14.3	3.0	10.6	20
<i>Differentiated</i>	33.0	22.1	19.2	11.4	6.6	7.7	18
<i>Broad</i>	23.0	24.8	23.7	15.4	6.2	6.9	18
<i>All</i>	31.5	21.4	19.7	13.7	5.2	8.5	56

**Table 7. Task discreteness and type of performance demands . Average percentage of performance demands. Row percentages**

<i>Agency interface to citizens and private business</i>	<i>Project initiation</i>	<i>Organizational adaptation</i>	<i>Policy demands</i>	<i>Production demands</i>	<i>Productivity demands</i>	<i>Average perc. of quantified performance demands</i>
Strong (N=37)	32.21	18.48	22.04	13.52	4.15	33.2
Weak (N=19)	30.05	37.01	15.12	14.14	7.23	24.5
Total mean (N=56)	31.48	21.40	19.69	13.73	5.19	30.3