The reform of public procurement practices in an era of fiscal restraint

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Optimisation of the performance of national procurement systems should be at a greater premium during an era of fiscal restraint. The degree to which budget cuts result in fewer public services and the like is mitigated by steps that enhance “value for money.” In this article I explore three principles to guide reform initiatives, which may be useful to policy-makers in the EBRD region.

Introduction

While the principle of obtaining the greatest value for money from state expenditures is long-standing, during booms and other eras of excess the pressure to squeeze the most out of state budgets is often relaxed. What is worse, sometimes when agency budgets are expanded quickly, the pressure to “get money out the door” can lead to inefficient public sourcing of goods and services. Eras of fiscal restraint, such as the one that descended over Europe in the first half of 2010, offer an opportunity to revisit public purchasing practices. The purpose of this article is to suggest three principles that might guide the reform of public procurement (PP) practices in an era of fiscal restraint.

Prior experience suggests that the pay-off from PP reform can be substantial. It is not difficult to see why. If a government spends only 5 per cent of national income on goods and services, then a 10 per cent increase in procurement efficiency releases the equivalent of 0.5 per cent of GDP. For developing countries, 0.5 per cent of GDP may well be multiples of the total aid received from abroad. For industrialised countries, 0.5 per cent of GDP would go a long way to meeting internationally agreed aid targets.

While some may be impressed by these potentially large gains (from a macroeconomic point of view), associated improvements can also translate into smaller reductions in the quantity/quality of public services offered should budget cuts follow fiscal austerity. Since both the quality and quantity of public services – such as education, health and transportation – have a direct bearing on the standard of living of poorer groups of society, then PP reform may have indirect consequences for inequality and income distribution. For this reason, the reform of PP policies should not just be a matter for finance officials; development officials, international organisations and non-government organisations ought to be concerned with the operational effectiveness of national procurement systems.

Of course, the aforementioned focus on government procurement systems is somewhat misplaced. In some jurisdictions many of the goods and services purchased by the state are bought by bodies other than the central government. The case for effective public purchasing practices carries over to other public sector agencies as well; likewise, the themes developed here for central government carry over to other levels of the public sector.
The remainder of this article is organised as follows. Each of the following three sections is devoted to articulating a principle that should guide the reform of public purchasing during an era of fiscal restraint. While this article does not claim to be a comprehensive review of the state of procurement reform in transition countries, nevertheless, it is hoped that the focus on a small number of principles to guide reform initiatives might generate debate over the imperatives that ought to drive PP reform in developing and transition economies.

**Principle one: do not overload public purchasing policies with too many objectives**

Governments typically have many different objectives that they seek to accomplish with the plethora of policy instruments available to them. It is not the purpose here to question those objectives, which may well have been decided on via accepted, legitimate means. Instead, the goal here is to ask which objectives should PP practices target.

A review of national procurement legislation and implementing regulations in developing, transition and industrialised countries points to a wide range of objectives that procurement policies are meant to achieve. Attaining “value for money” is on almost every list of government objectives for procurement policy.

The promotion of previously disadvantaged or under-performing groups, firms, industries, and regions find their way onto the goals of most jurisdictions. Considerations of national security, security of supply, as well as public morals, frequently appear to affect the objectives and implementation of PP practices.

No doubt the attraction of using PP policies to advance these interests is that a certain minimum level of demand is guaranteed for producers – typically, but not necessarily, domestic producers – that seek to meet a stated objective. Expanded output and employment may appear to follow from this use of PP policies giving satisfaction to officials seeking “results.” Desired results follow from state action, or so it seems.

**SME sector**

Of course, as far as the optimal design of public policy is concerned, the question arises as to which available policy tools can attain the stated objective at least cost. PP measures may not be the most direct, efficient tool. Frequently they are not. One example will suffice. Many governments seek to promote the commercial success of small and medium-sized enterprises (SMEs) and, as part of their procurement policies, favour tenders from such firms. The first question that should be asked is: what is the evidence that the SME sector is too small? Even if such evidence can be gathered, or a case for expanding the sector made on first (often ethical) principles, then the second question that arises is what available public policy or policies attain that goal at least cost?

What public officials need to learn is what factors are holding the SME sector back and what policy tools are available that have the most effective leverage over the restraining factors. It may well be the case, for example, that the most important factor holding back SME growth is access to finance and working capital. In which case, governments should consider policies that encourage appropriate lending to SMEs by banks or others. Giving SMEs additional orders for goods and services is a very indirect, and therefore almost certainly inefficient, method for overcoming the obstacles in question.

A critical reader might well argue that banks are more willing to lend to SMEs if the latters’ order books are fuller and, therefore, public purchasing from SMEs has a positive knock-on effect. There is no denying the fact that, in principle, such a knock-on effect might exist (although the assumption should be checked that order book size is the key constraint and not access to credit.) Even if order book size really is that important to securing credit, it does not follow that government purchasing policies should be implicated. After all, consideration should be given as to whether a state subsidy to private sector purchases might trigger more orders for the SMEs in question.

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2. The phrase “may appear to follow” in the last sentence was deliberately used as the effectiveness of many public procurement measures that “set aside” or reserve certain state orders for favoured groups has been contested.

3. This takes into account other legitimate factors, such as quality and so on. The emphasis on cost in the text is not meant to imply that the budgetary cost is the only legitimate criterion determining sourcing decisions. More generally, economists refer typically to meeting an objective at least cost and to meeting a target using the most efficient method synonymously.

4. The favouritism can take many forms. What matters is that the government actively discriminates in favour of one group of bidders. Of course, reserving certain government contracts solely for one class of commercial bidder is tantamount to banning bids from non-favoured firms. Discrimination can involve inducements, penalties, and outright bans.
Hidden costs

Many of the considerations raised above – which are central to the optimal design of policies – tend to get quickly pushed under the carpet in the rush to design measures to “help” this or that constituency. The consequence of poor procurement policy design, including taking on objectives that can be better served elsewhere, is that the prices paid by state agencies for certain goods and services are higher than they need to be. Moreover, all too often the quality of service experienced by users of state-funded services is lower than it should be. It is important to appreciate that these costs are often “hidden” in the sense that rarely do governments report line items in budgets for the incremental costs associated with meeting objectives other than “value for money”.

While the costs of PP favouritism may be hidden, the corporate beneficiaries are well aware of their state-supported largesse. As is so often the case with resource-distorting public policies, typically there are a small number of beneficiaries of favouritism while the costs are spread across the nation’s taxpayers and users of public services. Each of the latter tends to lose little from each act of favouritism and so has few incentives to campaign for reform. This is why an external shock is often needed – such as acute budgetary pressures brought about (say) by a collapse in tax revenues following a severe economic downturn – to induce reform initiatives.

Cost of favouritism

An era of fiscal restraint provides an excellent opportunity for governments serious about improving the effectiveness of their procurement regimes to re-examine the rationale and effectiveness of existing practices. An independent audit could examine both the ends and means of existing procurement policies. The auditors should identify those public objectives that can best be served by government purchasing policies; other public goals should be taken care of more effectively with other state measures.

Defenders of the status quo would have to provide information publicly as to the costs of procurement favouritism and to demonstrate that no alternative policy better meets the state’s chosen goals. It would be important to stress that the purpose of the audit is not to argue that the government must abandon this or that objective; rather, the auditors would identify which government objectives can best be attained using PP policies and not some other form of state intervention.

Investigations such as these, therefore, would be evidence-led. Once established, governments should get into the habit of occasionally reviewing the costs and benefits of existing PP practices (not just the objectives pursued.) Potential innovations in procurement methods do arise over time and it makes sense also to compare various means for attaining a given government goal.

The government evidence-led assessments of PP policies therefore should be encouraged. If such a step is regarded as too costly, then the support of international development organisations and donors could be sought either to establish such a project or to fund the conduct of assessments of procurement policies.

Value-for-money

By and large, governments try to accomplish too much with PP policies. The implementation of such policies is often confused and made more complicated by the adoption of too many goals. Costs paid by state agencies are higher than they need to be and the quality of services supplied worse than the best tenderer could provide. The harsh reality is that the pursuit of many non-value-for-money objectives comes at the cost of attaining value-for-money.

An era of fiscal restraint allows for a cold, hard look at what governments can really accomplish with PP policies. Put bluntly, mindsets change when austerity beckons. Policy-makers must not fall into the trap – or be led to do so by interested parties – of assuming that reformulating procurement practices is the cheapest or most effective way to attain a specific government goal.
The information which makes the case about alternative ways to attain government goals should be collected, made public, and interested parties forced to defend the status quo. While it would be naive to suppose that credible information alone will be enough to tip the balance in favour of reform (there will be more on reform in the section which details principle three), trying to make the case without such information and the associated change in policy-making mindset is much more difficult.

**Principle two: promote competition and, whenever possible, treat tenderers equally**

In effect there is more than one way to squeeze the most out of a limited agency’s budget. On the one hand, procurement practices can be put in place so as to encourage – for a given quality level – tenderers to offer lower prices to supply the agency.

Alternatively, tenderers can be encouraged to offer more goods and services for a contract of a given monetary value. In either case, competition between independent tenderers has been shown to enhance value-for-money for state agencies. Competition, therefore, is not just over price; firms can compete on delivery times, reliability, and the introduction of new processes, goods and services and so on. Innovation can thus be spurred by competition between tenderers for public contracts.  

These are not just theoretical considerations. Over the past 20 years analysts have simulated the effect on procurement tendering systems of factors that enhance the competition between tenderers, such as increasing the number of potential tenderers.

Quite remarkably a number of these studies show the same qualitative finding: namely, that the cost to the state falls markedly as the number of (relatively equally matched) tenderers rises. It appears that costs tend to fall very quickly as the number of tenderers rises to five. From then on, costs per unit fall more slowly.  

As a general rule, however, encouraging as many appropriately qualified firms to tender is very much in the interests of government purchasers.  

While the principle may be easy to articulate, it is worth recalling that there are many features in the operation of government purchasing regimes that can stifle competition. First, tenderers must know about the procurement opportunity and have time to be able to respond. Second, tenderers must have confidence that the government evaluator is not biased against their tenders. Third, the cost of completing a tender and the information needed to put together an effective tender must be relatively inexpensive.

**Transparency**

These three factors refer to what is commonly known as the “transparency” of the PP regime. Improvements in transparency reduce the uncertainty associated with tendering, lower tender preparation costs, and provide assurance of equal treatment. Such improvements typically encourage the application of tenderers – both domestic and foreign – for public contracts. Evidence from southern Europe suggests that SMEs are particularly susceptible to improvements in transparency.  

Other evidence points to cost savings for state bodies that promoted transparency and, in so doing, elicited more tenderers or better-qualified tenderers for public contracts.  

**Restrictions on tendering**

Sometimes the restrictions on tendering for public contracts are explicit. For example, large firms may be banned from tendering for certain government contracts that are “reserved” for SMEs. Limiting the number of tenderers almost always raises the cost paid per unit by public agencies. In this model, the condition of competition between tenderers will always be distorted by explicit procurement rules. Adding a so-called price preference of (say) 20 per cent to foreign tenderers for government contracts alters the conditions of competition, typically making the foreign firms lower their tenders (by less than 20 per cent), domestic firms raise their tenders (by less than 20 per cent), and all too often the state ends up paying more per unit bought.
In other cases the impact on the conditions of competition is more subtle. For instance, the costs of certain tenderers can be raised more than others so as to meet certain requirements laid out in the tender documentation. Such cost-raising interventions typically raise tenders across the board, reducing the amount of goods and services a government can afford to buy from a fixed budget. The point here is two-fold. First, state buyers should not be too prescriptive in specifying how tenderers should meet certain requirements, such as health, safety and environmental standards. What matters is that the standards are met, not how they are met. Firms have strong incentives to meet those standards without waste and this helps keep costs down for governments.

The second point is to be wary of requirements that by design or effect are detrimental to any one class of tenderers. For instance, insisting that foreign tenderers meet certain domestic requirements when there is a perfectly acceptable foreign standard being met is often a means of affording domestic tenderers some protection from international competition.

Greater use of mutual recognition procedures, especially by countries in established trade blocs such as the European Union, should be encouraged. During an era of austerity, hard questions should be asked about the standards embedded in many procurement codes; again, the purpose is not to eliminate those standards but to ensure they are in line with best practice and do not impose unnecessary costs on classes of tenderers.

Value-for-money objective

Existing analysis provides some further information to guide reform initiatives. In contrast to measures that alter the conditions of competition between an existing set of tenderers (such as price preferences and regulation-induced asymmetric cost increases), by and large those measures that reduce the number of tenderers raise unit procurement costs the most. Unnecessary state-created cost increases raise unit costs as well, but by less. The smallest increases in unit costs are engendered by price preferences that do not discourage disadvantaged firms from tendering in the first place (Evenett and Hoekman, 2007).

These findings would imply that the value-for-money objective is best served by a PP regime that:

(i) places few restrictions on tendering in the first place
(ii) imposes standards on outcomes (such as safety levels) and not on processes

(iv) reserves any discrimination between tenderers to price preferences, which are transparent and the consequences of which can be taken on board by all tenderers. Such a regime would target the principle state-created constraints to competition in PP.10

While state restrictions on tendering for public contracts are a concern, so are private attempts to circumvent the competitive process. So-called “big rigging” can take many forms. Sophisticated procurement regimes and law enforcement officials have become well-versed in such techniques and guard against them.11

Here procurement officials may need to cooperate with national competition authorities, as tender-rigging is often a violation of national competition statutes. Making public examples of firms that engage in tender-rigging is one option available to officials.

In summary, there are both private sector as well as (perhaps unintended) government threats to the competitive process in PP systems. Both need to be tackled. Improvements in the transparency of national procurement regimes ought to accompany a rethink as to the merits of discriminating in favour of or against any class of tenderer for public contracts. To the extent that discrimination must be used, then it should be the most transparent form of discrimination.
Principle three: combine procurement reform initiatives with other governance reforms

Identifying the required reforms is one matter; getting them implemented is another. There could well be many vested interests – not just firms and their employees but also public officials – that garner rents from the existing PP system and do not want to lose them. Opposition to reform, therefore, should be anticipated. Perhaps it can be countered with a multi-stranded approach.

Information on the inefficiency of current procurement practices can be a useful weapon. Horrendously high estimates of the cost per unit bought by a government have helped discredit existing practices in the past, putting the vested interests on the back foot. Evidence such as this creates the (possibly correct) impression that certain parties have benefited at the expense of the national interest. Indeed, relating additional procurement costs to “lost” or “foregone” hospital beds, nurses, doctors and teachers can provide powerful rhetorical tools.

Complementarities

Still, it may make sense to tie PP reform to other economic governance reforms, in so doing emphasising the connections between improving value for money in state purchasing and the capacity of the state to afford higher quality institutions and infrastructure. In so doing, the goal is to expand the set of interests that perceive benefits from PP reforms. Complementarities certainly exist between reforming PP measures and national competition policy, as alluded to above. Other complementarities exist between measures to fight corruption and related malfeasance and initiatives to improve government purchasing practices. These could be exploited in assembling a reform package.

Free trade agreements

One increasingly popular option is to use the occasion of negotiating a free trade agreement (FTA) to strengthen national PP regulatory institutions. Many such agreements now include chapters on PP matters. Although these chapters vary in content, and some appear to be solely motivated by the desire to gain access to foreign markets, nothing prevents signatories from making commitments concerning the transparency and other features of the PP process. Such chapters could also include provision to allow for periodic reviews, so ensuring that procurement matters retain a higher profile than in the past. There is clearly an element of opportunism here as reformers can structure procurement obligations in FTAs so as to garner support at home from export interests.

In essence the approach recommended here is to bundle PP reforms into or alongside other initiatives that expand the size of the constituency that favours reform. In this manner, appeals to political will (which all too often fall on deaf ears) are complemented – ideally replaced – by appeals to commercial interests. The latter provides a more enduring basis for PP reform.

Conclusion

Many countries have a saying that amounts to the same thing: a crisis is too good an opportunity to miss. The silver lining in the cloud that is fiscal austerity is the opportunity to improve national PP regimes. In this article three principles to guide any reform efforts have been outlined for a situation where governments in Europe and elsewhere find themselves seeking better value for money from their state budgets. While national circumstances will undoubtedly influence potential reforms, there is enough common experience across countries to guide reformers in the months and years ahead.

References


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