

THE STRATEGIC IMPORTANCE OF PUBLIC PROCUREMENT

MORE

SCHOOLS

MORE

HOSPITALS

MORE

DEVELOPMENT

SAVINGS



Asian Development Bank

ADB

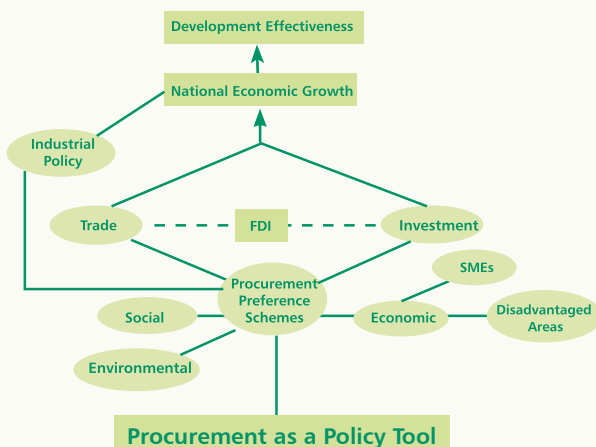
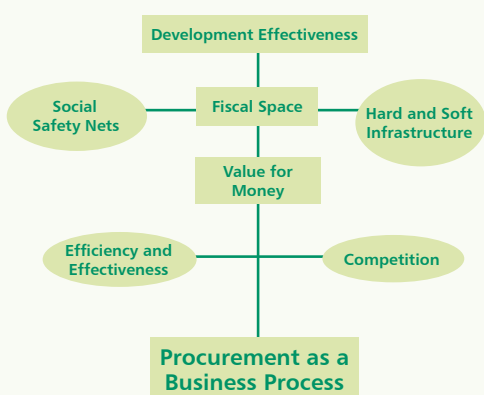
The Strategic Importance of Public Procurement

Governments face uncertain times and difficult decisions in managing their economies and ensuring the security and prosperity of their citizens. The 2008 global financial meltdown slowed trade, reduced revenues, and increased unemployment, provoking a strong countercyclical reaction by many central banks and governments. While these measures were partially successful in many countries, the effects of the recession linger, dampening economic growth and employment.

One way hard-pressed governments can combat the corrosive effects of recession and win badly needed fiscal space is through more efficient and strategic public procurement. Cost-effective value for money in public purchasing is also a valuable policy instrument by which governments can increase employment and target sector growth and industrial policy.

Government expenditure for purchases of goods, services, and works is a key component of national income and well-being. The Organisation for Economic Cooperation and Development (OECD) estimates public procurement globally amounts to approximately 15% of gross domestic product (GDP), a figure that can exceed a staggering 25% in countries such as Viet Nam, India, and the People's Republic of China. Efficient public procurement remains an underutilized tool by many governments, but those which have embraced it have collectively realized billions of dollars in savings.

Procurement – Economic Governance Linkages



FDI = foreign direct investment, SMEs = small and medium sized enterprises
Source: ADB.

How Significant Is Public Procurement?

Public procurement plays a significant role in any economy, as much as 15%–22% of nations' gross domestic product. Most assume the percentage is higher in developing economies and lower in developed economies. Efforts to correlate this data across national and subnational regimes lead to inconsistency, particularly to the extent that data at the subnational level is disaggregated, scarce, and highly unreliable. Comparisons also suffer and likely undercount reality due to governance regimes, norms, definitions, and nomenclature. Some of the most dramatic examples are: (1) defense, which many nations exclude from their "procurement" regimes; (2) health care, which accounts for significant portions of public expenditure in more socialized governments; (3) utilities, which vary widely in terms of source of expenditure and management, whether national, subnational, public-private, and frequently undercount for recurring and sustainment costs; (4) the proliferation of so-called concession contracts and other vehicles through which governments obtain infrastructure or services without direct expenditure of appropriate funds, for example, public-private partnerships (PPPs), build-operate-transfer or build-own-operate-transfer (BOT/BOOTS), and private finance initiative (PFI); and (5) reconciliation of sub-federal government spending.

In short, procurement spending represents staggering sums and accounts for a significant portion of all states' economies—€1.5 billion annually in the EU and over \$500 billion in the United States at the federal level alone. As a result, the potential impact in both monetary terms and in potential to reduce waste, increase efficiency, or achieve better outcomes (value for money) is enormous for all states at the national and subnational and local levels. Of course, these potential savings and/or efficiencies are greatest for developing states.

Importantly, such statistics fail to capture externalities or second-order significance of public procurement. Public procurement regimes can enhance or detract from the effectiveness or pace of economic development, public service delivery, evolution of governance systems, and growth of private sector capacity. Most dramatically, corrupt or unaccountable public procurement regimes suffer the most. These can bleed as much as 50% of their investment to fraud, waste, or abuse with World Bank or OECD estimates at 20%–70% of spending. The 2009 Global Corruption Report published by Transparency International estimates that corruption increased public purchasing costs by approximately 10%, resulting in global loss of \$300 billion to \$500 billion.

Source: Steven L. Schooner. 2011. ADB Briefing Notes.

“I'm announcing that part of this deficit reduction will include reforms in how government does business, which will save the American people up to \$40 billion each year. It starts with reforming our broken system of government contracting. There is a fundamental public trust that we must uphold. The American people's money must be spent to advance their priorities—not to line the pockets of contractors or to maintain projects that don't work... ”

US President Barack Obama, March 2009

What Is Public Procurement?

Public procurement is the process by which national and local public administrations

- Establish and determine the needs for which procurement is required
- Formulate the appropriate procurement strategy to meet needs
- Solicit competitive bids from qualified suppliers as a means of determining best value and price
- Select the best bid according to preestablished criteria
- Award contracts and ensure the availability of a formal challenge mechanism
- Ensure contract administration focuses on performance, cost, and timeliness

Procurement can contribute to government policies and program outcomes indirectly, for example, buying office supplies or building schools and health clinics. In other cases, the actual development or delivery of the policy outcome is procured, such as a public–private partnership (PPP) involving the design, construction, and operation of a hospital.

Effective public procurement requires the strategic management of the cost of purchases by the public sector and the way the supply of the private sector is shaped, thus posing three equally relevant questions for policy makers: how to buy, what to buy, and who to buy from.



How to Buy: Procurement as a Business Process

In many ways, the purchase of goods, services, and works by the public sector are best compared to the equivalent process within private sector firms. Just as procurement is a strategic asset contributing to a private firm's competitiveness in a globalized world, a well performing public procurement system strengthens good governance.

	Price Range	% Variation
Toner cartridge (per cartridge)	£41 to £89	117
Electricity (day rate kWh)	4.8p to 8.3p	73
Box of 5x500 sheet A4 (80g/m ²)	£6.95 to £14.95	115
Post-it notes (pack of 12)	£4.41 to £10.55	139

Source: National Audit Office.

Over the last decade, data show governments have yet to take full advantage of significant potential savings embedded in strategic procurement. The United Kingdom audit office, for example, shows wide differences between the highest and lowest prices for the same goods purchased by 121 public bodies.

Some of these vast price differences might be justified by variance in quality, location, and size of the purchase, but waste and inefficiency are also likely culprits. A recent study documented waste in Italian purchases of goods and services for a large and statistically significant sample of public contracting authorities. The results of this study point to large inefficiencies in procurement. The study concluded that if all Italian public bodies paid the same best prices savings would range from 1.6% to 2.1% of GDP.¹ In emerging and developed countries alike, such enormous savings could allow governments to lower taxes or increase targeted social investments.

Buying Efficiently

To achieve efficiency, procurers must manage several variables. Expertise and knowledge of the markets where the contracting authority sources suppliers are essential. Expertise is also critical in identifying the best way to solicit an offer: negotiation vs. open competition; fixed price vs. cost-plus methods; price only vs. quality-weighted tenders, base price, number and types of lots, allowing temporary consortia, and contract duration; sealed-bid vs. e-auctioning; and centralizing vs. localizing. No one size fits all, but much is now known on what procurement criteria form the best fit for a specific market situation.²

¹ Bandiera, O., A. Prat, and T. Valletti. 2009. Active and Passive Waste in Government Spending: Evidence from a Policy Experiment. *American Economic Review*.

² Dimitri, N., G. Piga, and G. Spagnolo, eds. 2006. *Handbook of Procurement*.

While most of these tools are designed to boost participation and competition, other tools can do so over time and structurally. Examples include effective set-aside or preference schemes for small firms or local employment in public procurement and coordinated approaches by procurement and antitrust regulating authorities. Both of these approaches—at a transactional level promoting preferences or set-asides in tendering and, at a structural level, in regulation over procurement markets—if optimally implemented generate welfare gains in addition to fiscal space for governments.

Eliminating Procurement Waste

Waste is often thought to be due to either incompetence or corruption on the part of the public procurer. Bandiera, Pret, and Valletti (2009) argue that 82% of their data on documented waste in Italian contracting authorities are due to incompetence rather than corruption. One likely feeds the other and it is difficult to differentiate their impact: corruption makes investing in competence less worthwhile, while incompetence favors corruption. Investing in professionalism in procurement, emphasizing compliance with the rule of law, and promoting market and organizational knowledge all fight waste, but other tools are available, such as centralizing part of the public demand. In Italy, for example, public bodies that switched to centralized procurement through the services of the Italian procurement agency, Consip, have realized savings approximating 30% of the prices originally paid prior to such demand aggregation. In India, for example, assuming a 2% increase in procurement, efficiency would result in savings annually that would approximate, if not exceed, current average lending levels by multilateral development banks.

The Brazilian Ministry of Planning, Budget and Management reported Brazil's savings with the use of e-procurement between 2002 and 2010 amounted to almost \$14 billion.

Ensuring Effectiveness

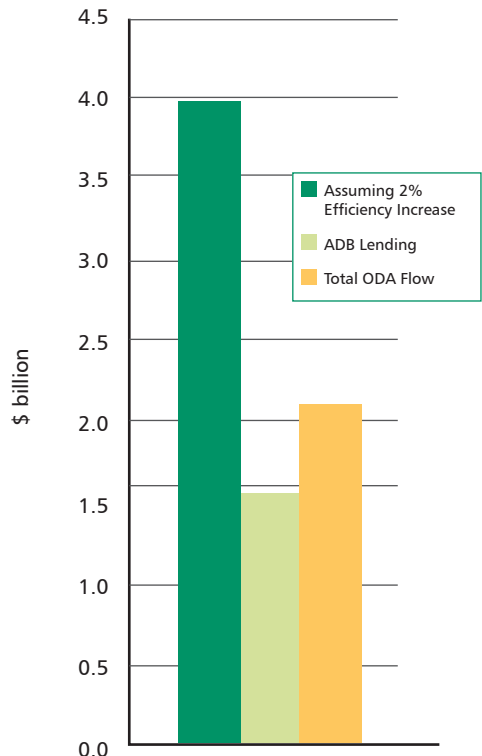
While efficiency during tendering is particularly important, overall effectiveness is dependent on documenting the promised quality by winning firms of goods, services, and performance level. Verifying effectiveness is difficult as the life of the contract is often long and checking quality standards and monitoring is costly. To ensure quality, procurement authorities need to strive for methods similar to the private sector that include using the reputation and past performance of suppliers as a benchmark in selection and award processes, while ensuring that competition and long-term participation are preserved. Shifting to an effective procurement process requires a strong team of properly rewarded professional contract administrators able to identify reputable firms and reject inefficient ones.

While obtaining the lowest possible purchase price is a prime objective in any procurement transaction, it is not the only consideration. Life-cycle costing, the summation of cost estimates from inception to disposal for both equipment and projects (including its cost of acquisition, operation, maintenance, conversion, and/or decommission) should in appropriate cases help determine the choice of supplier. Together with this, demand management and reorganization of processes helps consolidate total savings and contributes to higher performance. Spend management—an integrated approach to spending—avoids the risk of price savings gained by efficient and well-built procurement procedures being squandered on unnecessary additional materials or services.

Spend Management through E-procurement

A key element of spend management is e-procurement which can expedite the decision-making process. E-procurement allows users to fully extract the value

Potential Savings from Procurement Efficiency Gains in India
(Average 2007–2009)



ADB = Asian Development Bank, ODA = Official Development Assistance
Source: ADB staff estimates.

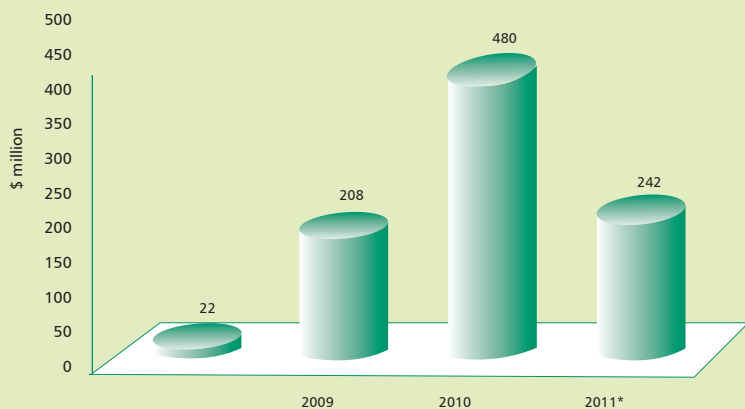
of advanced payment systems, such as procurement cards for small purchases. By encouraging the creation of larger electronic markets, interoperability with other platforms and the costless sharing of information with citizens, it also drives efficiency and effectiveness. E-procurement is an expensive, long-term investment best utilized by procurement organizations possessing the scale, budget, know-how, and the determination to fully exploit its benefits.

Central purchasing bodies that aggregate demand have often been the most efficient implementers of e-procurement. The Republic of Korea has the world's largest e-procurement system and a public procurement market value of \$104 billion in 2008. The Republic of Korea's Public Procurement Service (PPS) operates the national electronic platform KONEPS. PPS also contracts for construction services, stockpiles raw materials such as aluminum and copper, and manages government-owned properties. E-bidding, e-contracting, e-payment, and an online shopping mall are features of KONEPS which handles more than 60% of public procurement and currently has 210,000 registered suppliers. Virtually all of these suppliers are small and medium-sized enterprises (SMEs). The PPS estimates savings from using KONEPS between 2004 and 2009 amounted to the equivalent of between \$6 billion to \$8 billion annually, with increased transaction volumes and the large number of bidders the main reasons for these cost savings.

Impact of the Implementation of New E-Procurement in Ecuador

“...Since August 2008, the Government has achieved a budget reduction of \$950 million.

To achieve this, the Government has only invested \$15 million...”



Source: INCOP.

* The information is current as of September 2011.

What to Buy: Procurement as a Policy Tool

Promoting Demand

The scale of the public procurement market can encourage the development of new, innovative products by generating sustained demand to ensure that a sufficient number of public purchases cover the costs of needed innovation. Stimulating demand through mandating the application of new “green” standards in public purchases and aggregating demand (and tendering) through a central purchasing body, for example, presents opportunities that would be otherwise absent if left to smaller, discreet procurement authorities or exclusively to private sector–led demand growth.

Besides the size effect, standardizing demand toward green characteristics, among others, can lead to substantial diffusion in the economy of new green dimensions. Introducing a life-cycle costing approach to evaluating offers would improve the net green effect of public purchases by raising the incentives for firms to provide products with better environmental qualities, such as recycling capacity of materials and ease of disposal. More broadly, environmental issues play an increasingly important role in defining sustainable policies and have created a new role for government in public procurement.

Governments should also examine specifications that are not necessarily tied to performance but deal with the production process, such as fair trade requirements or the use of recyclable inputs, and monitor that these features are correctly used and taken advantage of by both public and private purchasers.

Focusing on using the magnitude of public purchasing to promote innovation, whether in the context of environmental sustainability or otherwise, also has the potential to regenerate local economies in urban and rural areas through a targeted “multiplier” effect on local demand. Procurement spend analysis is critical to understanding the local impact of government contracting. It is often not the quantity, but the way in which money circulates in the local economy, through targeted public purchases promoting local employment and “add on” spending, that matters most for sustainable local development.

From Whom to Buy: Procurement as a Distributive Tool

Buying from Small Firms

Another important policy use of procurement relates to small firms. Discrimination in procurement against small firms can occur for a variety of reasons. They may be discriminated against in credit markets for no other reason than the risk aversion of bank officers. Discrimination may arise from sources such as corruption and risk aversion by procurers. Risk aversion that discriminates against SMEs also arises from routines that are costly to change, for example, the minimum size of corporate revenues set down in standardized bid qualification criteria.

Procurement activity is stranded with fixed costs for most public purchasers that generally disproportionately impact the unitary costs of small firms, thus hampering their competitiveness from the outset against large firms. While some of the hurdles that arise in procurement are common to all firms, others have a greater effect on small and micro firms, such as administrative burdens due to onerous bid submission requirements, long delays in payment post contract award, disproportionate financial criteria that favor large turnover and higher cash flows, and unfair evaluation of bids that often impose higher costs to smaller firms in exercising contract dispute resolution procedures that are more manageable by larger corporates. In particular, large contract values can affect small and micro firms far more than large firms. Unless preventative measures are in place, the growing trend of centralization, pushed by information technology developments and the growth of e-procurement tools, brings the risk of steadily rising asymmetric treatment against small firms.

While most countries have introduced policies or regulations aimed at reducing red-tape in procurement that disproportionately affects small firms and their likelihood of being awarded public contracts, some have instituted a more proactive approach which mandates that specific set-asides or preferences must be adopted to ensure the long-run competitiveness of their industry. Preferences do not inevitably lead to contracts being awarded to small firms, but rather push large, non-targeted, firms to bid more aggressively, to the advantage of taxpayers. The United States, South Africa, and Brazil have the most comprehensive preference programs aimed to

protect smaller firms through targeted public procurement, with preferences also granted to minority- and veteran-owned firms.

Public Procurement for the Disadvantaged

Social use of public procurement is best known for its affirmative action content during specific moments of social change with governments using it to help achieve greater equality for targeted disadvantaged groups. In the United States in the late 1960s, affirmative action requirements were extended to benefit businesses owned by women and racial minorities. Procurement has been used to give preferences to indigenous people in Malaysia, Canada, and South Africa. Earlier use of procurement preferences, in the United Kingdom for example, has promoted participation by people with disabilities.

Governments should be cautious when using procurement to achieve social goals. Possible increased monetary cost (including the additional bureaucratic transaction costs) should be factored in to any decision when adopting this approach. The management decision should include action to counter perceptions of lower transparency and unfair favoritism. Engaging stakeholders (e.g., firms, business networks, consumer groups, and investors) in the planning and monitoring phases could prove extremely useful, but should not be allowed to become a veto exercise by actors that do not desire progressive social change driven by governments.

Public Procurement Favoring Better Labor Standards

Core labor standards can also be positively affected by procurement. A recently completed study on the social aspects of construction surveyed the application of nine International Labour Organisation labor standards over a 4-year period, with the objective of improving conditions for construction workers in Ghana, India, and Zambia. That study argues that incorporating social clauses in the construction contract offers a mechanism for protecting the labor rights of workers. In such cases, preferred social and labor policy can be implemented through contractual provisions to extend mandated labor and social standards to difficult-to-reach temporary and casual workers. In order to become effective, however, voluntary buy-in by employers and ensuring proper compliance through comprehensive monitoring is critical.

In the Netherlands, for example, several larger municipal governments used public procurement to increase the labor participation of long-term unemployed, demonstrating that public procurement can assist poverty and unemployment alleviation, essential for promoting more inclusive growth.

Political Trust: Transparency, Integrity, and Accountability

A competitive and transparent procurement process can reduce opportunities for corruption and collusion. Recently, an empirical study of European Union tenders³ showed that in terms of transparency, publishing an invitation to tender “is most beneficial as it is associated with benefits roughly equivalent to a 1% reduction in award value compared to the base estimated value.” Open competitive tenders are also considered a tool to obtain transparency and savings, and to stimulate participation. The study found that an open procedure is the most effective in attracting more bidders, with significant increases in bid contestability (in some case well over 40%).



The case of a local government in Japan is illustrative. A 2009 study documented the effects of increased transparency and principled bid qualification and evaluation criteria on the ultimate cost of goods that were publicly procured. Public works bidding data from the local government of Mie Prefecture from March 2001 to March 2004 were reviewed. During this period, the Mie Prefecture government replaced the previously opaque and discretionary procedure of qualifying bidders with a transparent and rule-based one. In the new procedure, suppliers were allowed to bid as long as they satisfied minimum financial and technical requirements specified by the government. The study concluded that the effects of improved transparency were estimated to have reduced public procurement costs by up to 8%.

³ *Europe Economics*. 2011. Estimating the Benefits from the Procurement Directives—A Report for DG Internal Market.

Compliance and Performance Indicators

Audits, whether internal or external, require the creation of appropriate performance indicators. Such indicators have already been included in the OECD Development Assistance Committee Methodology for Assessment of Procurement Systems (MAPS) as compliance and performance indicators (CPIs). Experience has been mixed thus far, as only some countries have tried to apply them in a comprehensive way; even in those cases, however, there is still a need for political commitment and ownership of the process at the highest levels to make the CPIs contemplated under MAPS fully operational.

CPIs take a snapshot of what is happening on the ground by examining a sample of procurement transactions and other relevant information that is representative of the performance of the system. CPIs, by pushing administrations to adopt correct, objective, and unambiguous standards of performance, raise accountability and incentives to perform for contracting authorities around well-established targets. CPIs can help in reorganizing the governance and processes of procurement offices to enable them to more accurately meet a given target of operational and performance improvement.

CPIs have potential to increase accountability of governments by increasing the level of transparency about performance of the procurement system and awareness of the need for remedial action in the case of documented performance gaps. CPIs are not only a key strategic tool for change management but also an enabling method for enlarging and embracing the community of stakeholders of procurement: the private sector, civil society, taxpayers, and citizens.

Actions for Policy Makers

- Push for Procurement Performance
 - a. Structure national and local action plans for output-based performance measurement of contracting authorities;
 - b. Aggregate demand in those sectors where clear economies of scale are available; and
 - c. Fight cartels in public procurement through cooperation between procurement, anticorruption, and antitrust authorities.
- Procurement-Related Data Collection and Monitoring
 - a. Mandate the collection of procurement data in a central repository system;

- b. Support contracting authorities by publishing updated procurement benchmarks; and
- c. Establish publicly available repositories of information on contract performance.

- Committed and Sustained Procurement Reform

Country-owned reorganization of procurement policies and procedures around effective business processes. Necessary next steps are:

- Increasing procurement professionalism through competency-based training and accreditation, and corresponding incentives;
- Identifying and applying objectively measurable procurement performance indicators and improving audit capacity; and
- Leveraging information technology through use of e-procurement, including establishing data collection and monitoring systems.

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Note:

In this publication, “\$” refers to US dollars.

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About the Asian Development Bank

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two-thirds of the world's poor: 1.8 billion people who live on less than \$2 a day, with 903 million struggling on less than \$1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

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