Summary in English

Rules and practice in public procurement

The regulatory framework pertaining to public procurement is under constant discussion. Representatives of procuring entities often criticise it for being complicated and for encumbering procurement procedures, thereby making them costly and dysfunctional. Suppliers are often critical of the way the regulatory framework is applied and sometimes put forward accusations of arbitrariness in the choice of suppliers or even corruption. The supervising authority – the Swedish Competition Authority – claims that the respect for rules and regulations is weak and that the repertoire of sanctions has to be developed.

All the above points of criticism are well taken. Current rules are supposed to cover a very wide range of situations, even though Sweden now has three different acts in place for different areas of application, and it is unavoidable that they will be perceived as complicated by certain users. The risk of arbitrariness or corruption is always latent, although it may be difficult to prove in practice that such abuse has actually occurred. It is also a fact that violations have occurred, sometimes conspicuously so. Any particular design of the regulatory framework will therefore necessarily represent a compromise between partly conflicting aims. For instance, whatever threshold for procurement rules ("low value") is chosen, there will be cases where the gains reaped from formal procurement do not cover the administrative costs, and vice versa. The possibility of filing an appeal against a procurement decision is necessary to prevent arbitrariness, but the appeal alternative will sometimes be abused.

A reasonable requirement is that established rules and practice as far as possible have a solid empirical basis. Unfortunately, this is currently not the case. Neither EU directives nor national

legislation have based their respective choices of threshold values on analyses of potential gains and transaction costs. There exists a number of studies on the gains from competition, but these often refer to more fundamental reforms, such as the transition in-house production to outsourcing preceded by formal procurement, and they may therefore be difficult to use in discussions on specific aspects of public procurement regulations.

The present study has been carried out in order to remedy partly this situation. A number of actual procurement operations in central and local government have been analysed at a relatively detailed level in order to find out what are the actual gains at different levels of competition. These gains have been confronted with actual transaction costs associated with more or less formalised procurement procedure alternatives. The sample is admittedly limited, but in certain respects the conclusions are so sharp that they can be expected to survive when the empirical basis is extended in future studies.

Issues investigated

A number of related questions have been asked in the investigation:

- *Transactions costs:* What are the transaction costs for different parties involved, primarily procuring entities and suppliers?
- *Expected gains from procurement:* What gains can typically be expected from a formal procurement subject to competition, as compared to direct procurement not preceded by formal exposure to competition?
- *Threshold values:* The answers to the two preceding questions provided a basis for judging what are reasonable threshold levels for the application of formal procurement procedures rather than direct procurement. A necessary requirement is that expected gains on average should cover transaction costs for procuring entities, but this is normally not considered sufficient; margins are required to ensure that transaction costs are covered in a qualified majority of cases. The costs for suppliers should also somehow be acknowledged, but there are different opinions as to their direct effect on the threshold values chosen.

- *Quality versus price*: What is the relationship between quality and price in actual procurement operations? If currently used methods for trading quality versus price are considered unsatisfactory, what alternatives are available?
- *Framework agreements:* Framework agreements are subject to regulation in the most recent version of the public procurement act. Following a rather intensive debate on the pros and cons of this regulation, it has been considered appropriate to collect some experiences and opinions on such agreements.
- *Legal framework:* Is there a risk that the complexity of the regulatory framework gives legal experts too much influence at the expense of experts in the field affected by the procurement in question? What legal instruments are required in order to maintain due respect for the legal framework?
- *Potential for simplifications:* The basic aim of the study has been investigate whether current rules and regulations can be simplified without sacrificing the main goals – economic efficiency in the wide sense.

Results from the empirical investigations

One result from the investigation, perhaps surprising to some, is that there is generally no significant correlation between quality and price in the procurement operations studied. In some operations quality increases with price, in others it decreases, and in the majority of cases there is no significant correlation at all. A conclusion is that price cannot be used as an indicator of quality, and that quality must therefore be examined separately in any procurement where it is considered important. This is an important observation to procuring entities, given that large and well established suppliers often try to use their brand as a signal of quality and to charge a higher price.

A second observation is that the fear that small and medium-sized enterprises should be excluded from competition seems exaggerated. Many companies never participate in public procurement, but the number of participating appears large enough to ensure competition in general. Naturally, some procurement operations are so large that only large companies are able to participate, but this is not unique to public procurement.

The main conclusion from the study is that the potential gains from procurement are substantial. Gains naturally vary from procurement to procurement, but the average gain as defined here is between 20 and 25 per cent of the value of the procurement, when the price reached is compared to the average price of the bids supplied. This is relatively high but does not deviate radically from what certain previous studies have identified. A reason for this is that the price and quality dimensions have been studied separately; given that that quality and price vary independently, the variance in these two dimensions will be added.

A second observation of some importance is that the cost of formalised procurement operations are generally lower than is often pretended in the public debate. The difference may stem from the fact that the standard arguments do not differ between costs that are associated with any form of procurement and costs that are specific to current procurement regulations. Terms of reference have to be produced irrespective of the procedure, and the same holds for the verification that the bid provided by the supplier conforms to restrictions laid down in the terms of reference. The additional cost arises because of a higher degree of formalisation and a higher expected number of suppliers.

The costs to the suppliers vary strongly with the procurement and the degree of standardisation of the goods or services in demand. Typically they would be around 1 per cent of the value of the procurement, but in complicated operations they may be as high as between 5 and 10 per cent of the value. The latter case obviously occurs only when the supplier perceives his own probability of getting the contact as rather high.

Recommendations concerning the regulatory framework: threshold values

When the lowest threshold is to be determined – what is called "low value" in Swedish legislation – it is possible to see the problem either from the perspective of the procuring entity alone or from a wider socio-economic perspective. The threshold value expresses what restrictions the public sector is prepared to impose on itself and could therefore be argued to be a question to be settled from a public-financial perspective only. Suppliers who find it too complicated or costly to put forward a bid always have their

freedom to abstain. Further, also bidding within the private sector requires preparatory work that will sometimes not result in profit to the company. On the other hand, costs incurred in company operations have to be covered in the long run, which is an argument for the socio-economic perspective. The public sector also has an interest in well- functioning competition and therefore should strive at a framework which does not unnecessarily reduce the number of competitors.

When comparing costs and potential gains from the procurer's point of view, it turns out that formal procurement is profitable already at rather low procurement values. The additional costs of formal procurement are typically covered by the expected gains at levels of EUR 5-10 000. If the costs of the suppliers are included, break-even typically occurs at a 20 per cent higher value.

These figures are based on averages. As pointed out above, there will always be cases when formal procurement does not yield a positive payoff. It is therefore reasonable to require that procurement be profitable in a qualified majority of cases, such as two-thirds or three-fourths. This requires a level that is 2 to 2½ times higher.

Two models are possible. In the simplest model, there is only one limit (low value), above which there is a requirement on formal procurement. A somewhat more complex model relies on two thresholds – one lower above which a simplified procedure based on at least 3 suppliers is applied, and one higher above which the openly advertised procedure is applied.

In the first model, a reasonable low value is in the interval EUR 15-20 000, where the higher value gives room for including supplier costs. In the two-step model, reasonable values for the thresholds are EUR 10 000 and 40 000, respectively.

These values are lower than the ones currently used in neighbouring Scandinavian countries. The latter do not seem to be the result of empirically based considerations, however.

Recommendations on the regulatory framework: basis for evaluation

A study of the different sources of complexity in procurement shows that these are often to be found at the procuring entity itself. The procedures for trading quality against price do not only

lack in transparency to observers but also often appear to be incomprehensible to the users themselves. The result of the evaluation may sometimes depend on bids that are uninteresting to the outcome (what is referred to as "dependence on irrelevant alternatives"), and in some procurement operations criteria are used that would indicate that the procuring entity is prepared to pay an infinitely high price – an obvious absurdity. The source of these problems is the relative scales of evaluation normally applied when price and quality are to be weighed together.

The choice of criterion is up to the procuring entity, but the legislative framework should as far as possible eliminate the risk of undesirable or unreasonable outcomes. A requirement that the criteria used should be based only on the individual merits of each bid should therefore be added to the Public Procurement Act.

Recommendations on the regulatory framework: legal instruments

The risk that the regulatory framework becomes too complicated must be taken seriously. On the other hand, it is a fact the current rules and regulations are treated with insufficient respect both in central and local government, and that this leads to higher costs of procurement than necessary. The set of legal instruments should therefore be developed.

There is sometimes disagreement concerning the applicability of the legal framework, in particular when it comes to corporations or funds where central government has a decisive influence. Currently, there are no sanctions against entities that are legally to be considered as procuring entities but that do not apply the rules. The supervisory authority should be granted the power to decide in such cases.

A second category of problems contains cases where rules have not been respected but where there is no party involved that finds it interesting to plead his own case. The supervisory authority should therefore be granted this possibility.

Another instrument that could be considered is the possibility of injunction combined with a fine in the case of neglect. Such a possibility already exists in the area of competition policy.

Yet another possibility to consider is to charge individual civil servants in cases of serious malpractice. The reason for such a change is that other sanction used or considered only target the

procuring entity and may therefore be too blunt. They imply economic consequences for single agencies in central or local government and therefore tend to hit third parties such as tax-payers. Prosecuting individual civil servants is a very strong instrument and should of course be considered only in severe cases of misconduct.

Recommendations to procuring entities

As already pointed out above, many of the problems arising in public procurement have their origin not in the regulatory framework as such but rather in its application, which is within the control of the procuring entity. A general recommendation to procuring entities is consequently not to complicate things unnecessarily but rather to use procedures and criteria that are supported by common-sense considerations.

There is a significant risk that the fear of committing mistakes will lead those who are really in charge of a procurement operation – experts in the field affected – to hand over responsibility to the legal expertise. This may in turn lead to serious errors – that certain suppliers are eliminated because of unimportant formal errors, or that conditions that are expressed in formal legal terms are interpreted by lawyers and so lead to material consequences that lawyers are not competent to decide on. It is therefore crucial to ensure that experts in the field are maintain their influence throughout the procurement process. This holds also for cases where matters are taken to court; the court must make sure that relevant expertise is engaged in judgements that are not purely formal, or may appear formal although they have material consequences.

A second general recommendation to procuring entities is to avoid unnecessary complexity in evaluation criteria. When both quality and price dimensions are used in the evaluation, as is normally the case, many errors are currently committed because the procuring entity uses criteria whose consequences are not obvious to the users – dependence on irrelevant alternatives, or absurd willingness-to-pay for certain alternatives. The best way to avoid these problems is to use criteria that are not relative but depend only on the individual merits of each bid.

The standard criterion suggested in these situations is to use the ratio between quality and price for the alternatives under comparison. This is simple to use and is also supported by the text of the relevant EU directive ("best value for money"). If the procurer wishes to eliminate the risk that low-quality alternatives win the contest by offering very low prices, restrictions on the lowest acceptable quality should be entered into the terms of reference. Such restrictions if used should not affect the zero level of the quality scale used by the procuring entity.