

SNS Economic Policy Council Report 2022: *Public Procurement*

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Summary

THE TOTAL VALUE of public procurement is significant, and it concerns delivering essential goods and services such as healthcare services. Statistics from 2018 show that public procurement in Sweden amounted to more than SEK 780 billion or 18.3 percent of GDP. In many markets, the public sector is an important buyer with an impact on the supply side through its purchases. This implies that the organization and realization of public procurement not only have implications for the beneficiaries of public services but also influence the supply side of the market, in some cases even influencing the firm survival rate.

Although the main focus of this report is an economic analysis of challenges in public procurement, we also touch upon the legal framework governing public procurement. We address issues such as: Why do procurements become more expensive or lower in quality than planned? Why do public authorities purchase goods and services they should produce inhouse? Why is public procurement perceived as complicated? The short answers to these questions involve uncertainty or, more precisely, incomplete and asymmetric information and how this is addressed in the three stages of the procurement process: the preparatory stage, the tender stage and the contract management stage. Uncertainty with respect to demand conditions, production environment and delivery is unavoidable and has implications in terms of both quality and costs.

It seems natural that a supplier knows more about these issues than the procuring party and that different suppliers also have access to different information on the subject matter of the contract to be procured. This information asymmetry makes it difficult to evaluate bids, select the best supplier and draft a contract that ensures the best possible result. Suppliers may feel obliged to take shortcuts to be awarded a contract or

the procurement authority may feel obliged to give the contract to the “wrong” firm. To obtain the best value for money, not only procurement practices but also the rules governing public procurement must be improved.

Not everything should be procured

It would be prohibitively costly for the public sector to produce everything it needs inhouse. It seems obvious that public authorities should purchase standardized goods such as office supplies, foods and IT hardware. However, it is less straightforward that everything outside the core competence of the public institution should be provided externally via procurement. A guiding principle is that if transaction costs are too high or if the economies of scale from buying a product are low, it may be wiser to produce the item inhouse rather than turning to external suppliers.

Pros and cons of joint procurements

Other strategically important considerations concern whether or not to organize a joint procurement (i.e., to combine the procurement process and call for tenders for two or more contracting authorities), the choice of tender procedures, the choice of supplier selection models, the choice of opting to negotiate and the importance of engaging in a dialogue with potential suppliers. It is easy to imagine that small or medium-sized municipalities operate under significantly different conditions compared to large municipalities and regions.

One way of addressing limited resources is to organize a joint procurement together with other municipalities. Collaboration and the benefits of becoming a large, and thus more attractive, buyer comes at the cost of having to agree upon procurement specifications that fit the needs of all parties. This may imply an indirect cost in terms of a reduced match with respect to the preferences of the individual municipality. However, transaction costs are low when each call-off in a framework agreement is small and the products are similar. On the contrary, the costs may be larger than the benefits when each call-off is large or the products are sufficiently differentiated. In such a case, separate tender processes are preferable. Extensive collaboration may also affect the market structure in a way over time leading to a reduction in the number of suppliers and thus less competition for future public contracts.

The format of a procurement matters

Despite being relatively detailed, the legal framework leaves considerable strategic leeway for public authorities when it comes to the actual tender processes. Examples where the law offers strategic flexibility in the procurement process include division into lots, division into separate tender processes, details of the contract, evaluation criteria and supplier selection method, use of reserve prices and use of subcontractors.

The above-mentioned examples also illustrate factors that may influence who decides to participate in a tender process and the offers they submit. Who is awarded a contract may, in turn, influence the contract performance. A serious provider will strive to supply a high-quality product, while a less serious supplier may lack the ability or interest in providing quality.

The quality of the delivered goods or services also depends on contract terms and contract management. From an economic perspective, there should be a clear link between elements of the tender process and the content of the signed contract and the subsequent contract management. Real-world examples indicate that contracts tend to end up becoming cost-plus contracts covering all the realized costs of the supplier regardless of the details in the actual bid in the tender stage.

There are also strategic approaches that do not seem to be in use in public procurement in Sweden. One such approach is to award contracts based on past performance. Two additional strategic approaches that may make public procurement more attractive for firms that would otherwise abstain from participating in such processes are (1) bid-preference programs and (2) set-asides. Set-asides could, for instance, be implemented by reserving some parts of a contract for new firms (entrants) or for firms below a certain size. An alternative is that the public authority limits the number of lots that can be awarded to a single firm. A further reason to split contracts into smaller lots is that it allows for combinatorial procurement, which in certain circumstances may benefit the public sector.

Sustainable public procurement – objectives and possibility to follow up

Public procurement as a means to increase employment and accessibility has as of late been included in what is known as sustainability concerns or secondary objectives. Other examples involve ambitions to include small and medium-sized enterprises, environmental concerns, social criteria and innovation. When considering secondary objectives, it is important to distinguish between the organization-specific perspective, procurement as an instrument of public policy and the welfare

perspective. The latter concerns correcting for negative externalities (e.g., environmental) or stimulating positive external effects (innovations) at the lowest cost possible for society as a whole. In the organization-specific perspective, the focus is on the efficient use of public funds within one specific organization without considering possible externalities.

The inclusion of secondary objectives in the contract management phase may only be possible to a limited extent. First, this is due to the lack of the public statistics required for such an inclusion. Second, the objective of such a tender and subsequent contract may not be clear, which will make it difficult to follow up and evaluate. Hence, one recommendation is to clearly state the objectives of the purchase in the tender documents with regard to innovation, the environment or labor market. Another recommendation is to balance the level of ambition with the complexity this entails in order to prioritize between these objectives. To avoid complexity and reduce the risk of missing the target, not all tenders have to solve all problems.

Managing uncertainty and risk

Even though quality can be ensured through incentive payments and contract management, an important observation is the importance of evaluating the cost structure before making such a decision. If the total cost is highly uncertain or if the supplier cannot easily influence costs, then incentive payments are not recommended. Such payments should only be used if the supplier can have a direct influence on quality or costs. Incentive payments where high quality is rewarded give incentives to reduce costs, but they transfer risk to the supplier as the total payment becomes more uncertain when it depends on the effort of the supplier as well as on external factors. If, on the other hand, the supplier is able to influence the realized cost, then incentive payments may be optimal.

From an economic perspective, cost overruns are not necessarily a bad thing. There are both good and bad cost overruns, depending on the situation and the causes of the cost overrun. Adopting a contract to new and more precise information can result in better performance with a better fit to the users' needs. However, cost overruns that are reasonably within the control of the supplier should not be accepted by the public buyer. Many cost factors can be anticipated – even if they are uncertain – and how to react to these (possibly by not reacting at all) should be decided before signing the initial contract.

Following up with moderation and competence

The right level of contract follow-up stimulates trust between the supplier and the buyer. Follow-up requires resources from the buyer's side and too much follow-up may actually reduce trust in the contracting relation. However, not enough follow-up may hurt the same trust as it becomes too easy to take shortcuts that endanger the level of quality. Cheaters should face a significant risk of detection and face consequences if such shortcuts are detected, as this will send the signal that shortcuts are not acceptable. Furthermore, the absence of follow-up may also amount to a violation of public procurement law.

The right level of contract follow-up presupposes that the buyer has knowledge and skills to detect and follow up deviations from the contract and that a sufficient amount of resources are allocated to this. Here, knowledge and skills are defined in a broad sense and do not only include the knowledge and skills of the specific employee in charge of this task, but also the knowledge and skills of the entire public organization and its ability to use these resources. For instance, knowledge regarding the specific good or service is required but also the knowledge and the skills needed to take proper action when a deviation has been observed. If secondary objectives are included, these demands for knowledge and skills are even more pronounced.

Create rating systems to manage the reputation mechanism

The basic principles of transparency, equal treatment, predictability, openness and proportionality apply to public procurement within the European Union. These five basic principles make it harder to sustain forms of quality that are hard to define, what economists refer to as non-verifiable quality, and which could be described as “soft” aspects of quality. We previously mentioned asymmetric information as one of the fundamental reasons why public procurement may seem complicated. Non-verifiable information goes in the direction of asymmetric information in that low quality may be observable while not enforceable by a third party, such as a court of law. In such cases, deviations from the promised level of quality are more difficult to deter.

The five basic principles leave limited space for discretion, and this makes it harder for a public procurer to favor a local supplier, an acquaintance or a supplier offering a bribe. The monopoly position in which the public sector often finds itself is an argument in favor of less room for discretion in the public sector than in the private sector. A private firm that is

corrupted risk losing business to other firms more focused on efficiency.

At the same time, discretion makes it easier to punish or reward suppliers, depending on how they behave. It enables supplier selection on the basis of reputation and past performance. These mechanisms are regularly used in private procurement and consumer markets to safeguard non-verifiable quality. Consumers and private firms can make choices based on brand names and reputation, which creates incentives for suppliers to deliver high quality even if the buyer cannot enforce the delivery of high quality through the legal system. Instead, the incentive to provide high quality is based on the prospect of future sales that are responsive to current quality standards.

Research in economics points at loyalty and reputation mechanisms as the best instruments for managing non-verifiable quality. Studies show that such mechanisms would increase efficiency in public procurement. The basic idea is to create a rating system with subjective evaluations of quality, similar to what we see online for hotels and taxi services. An important and critical – from a legal perspective – question is how such a rating system deals with new suppliers. Research suggests that in mature markets, it should be possible to establish a system where new suppliers get an entry rating equal to the average rating of incumbent suppliers.

Conclusions

Does public procurement law provide the best basis for competition that stimulates low prices and high quality? In other words, do we get the best value for money from public procurement? The general answer is no – not always.

The most important conclusions of the report are

- › the reputation mechanism could and should be activated in public procurement
- › cost overruns should be managed in the contract
- › the tender price should be reflected in the final price paid to the supplier.

Moreover, procurements tend to become fewer and larger, implying a focus on cutting administrative coordination costs rather than on trying to increase the participation of small and medium-sized enterprises.

The challenges identified in the report are probably based on the objectives of directives and the basic principles to further trade, integration and cohesion between the EU member states, rather than structuring public procurement so as to provide citizens and taxpayers with high-quality, low-cost public services.

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