Public Disclosure Authorized

Public Disclosure Authorized

76625

Using International Institutions to Improve Public Procurement

Bernard Hoekman

The World Trade Organization's voluntary rules on government procurement are a useful mechanism for ensuring that public procurement procedures are efficient. They also provide an opportunity to reduce the uncertainty of participants by increasing transparency and accountability. Yet most developing countries have chosen not to subject their procurement policies to international disciplines and multilateral surveillance. Their reasons may include an unfamiliarity with the government procurement agreement (GPA); a perception that the potential payoffs are small; a desire to discriminate in favor of domestic firms; or the successful opposition of groups that benefit from the current regimes. Although the economic rationales for abstaining from the GPA are not compelling, a quid pro quo for accession may be needed to overcome opposition by special interests. Developing country procurement markets are large enough that governments may be able to make accession to the GPA conditional on temporary exceptions to multilateral disciplines or on better access to export markets.

All over the world government agencies purchase the goods and services necessary to provide the public with education, defense, utilities, infrastructure, public health, and so forth. The public procurement associated with these expenditures often represents a significant share of a country's gross domestic product. To maximize the use of scarce financial resources, governments have developed procedures and mechanisms to ensure that public entities procure these collective goods and services at least cost and in a fair and transparent manner. Some countries have addressed the issue of procurement efficiency head-on; South Africa, for example, wrote a section on procurement principles into its 1994 constitution requiring the government to pursue a fair, public, and competitive procurement process under the direction of independent and impartial tender boards that are obligated to record decisions and make them available to interested parties (Transparency International 1997).

The World Bank Research Observer, vol. 13, no. 2 (August 1998), pp. 249–69
© 1998 The International Bank for Reconstruction and Development / THE WORLD BANK

Many procurement systems attempt to mimic the workings of the market by requiring that public entities seek competitive bids from potential suppliers of goods and services. Over time, an increasing number of governments have also pursued more far-reaching efforts to subject production units directly to competitive forces by privatizing state-owned enterprises, encouraging competitive entry into sectors traditionally reserved for the state (for instance, utilities), and by contracting out activities to the private sector. In a survey of the empirical literature on the impact of competitive tendering and outsourcing, Domberger, Hall, and Lee (1995) conclude that savings on the order of 20 percent are common and do not come at the expense of quality.

In the late 1970s several high-income countries negotiated an agreement on government procurement under the auspices of the General Agreement on Tariffs and Trade (GATT). The Government Procurement Agreement (GPA) extends the basic principles of the GATT—nondiscrimination, national treatment, and transparency—to the tendering procedures of specified government entities. Members of the GPA are Canada, the European Union, Hong Kong, Israel, Japan, Republic of Korea, Norway, Singapore, Switzerland, and the United States. Although many developing country governments have made efforts to reduce the cost of providing public services, they have refrained from signing the GPA. This is surprising, because the GPA appears to be a useful mechanism for ensuring that government procurement procedures maximize value for money. The benefits are likely to include not only a reduction in procurement costs but, perhaps more important, positive spillover effects that result from transparency and accountability.

This article examines multilateral government procurement regulations from a developing country perspective. It assumes that governments are interested in achieving and maintaining efficient, transparent, and accountable procurement procedures and asks why developing countries have not signed on to the GPA. This is an important topic because the multilateral rules of the game must be consistent with "best practices." If there are good reasons to question the economics of the GPA from a development and growth perspective, the rules should be revised. If not, the issue becomes one of political economy. Efforts must then be directed at identifying and overcoming the resistance to membership by those groups in society that benefit from the status quo at the expense of the community at large.

Developing countries can expect to face increasing pressure on the subject of government procurement in bilateral trade relations with industrial nations. The United States has played a leading role in this connection, making public procurement practices a priority and linking them to the broader issue of combating corruption. In April 1996, largely at the initiative of the United States, members of the Organisation for Economic Co-operation and Development (OECD) agreed that firms would not be permitted to write off bribes against tax obligations; in May 1997 they recommended classifying bribery of foreign officials as a criminal offense under national

legislation (World Bank 1997). At the December 1996 meeting of the World Trade Organization (WTO) in Singapore, a working group was created to conduct a study on transparency in government procurement practices and develop "elements for inclusion in an appropriate agreement" (WTO 1996, p.7). Although the GPA is not mentioned, the most straightforward way for developing countries to deal with procurement-related concerns is to join the GPA. As far as the United States is concerned, this is clearly the ultimate objective; in the meantime, an interim agreement on transparency, openness, and due process is seen as "an important step toward a more comprehensive multilateral agreement in the WTO" (USTR 1997, p. 4).

The WTO Agreement on Government Procurement

The GPA applies to laws, regulations, procedures, and practices pertaining to any government procurement, including purchases, rentals, leases, and lease-purchase agreements, with or without the option to buy. The procurement agreement covers only entities listed by each signatory in three categories: central government; subnational entities; and others (these are primarily utilities that may be partially or wholly privately owned). Procurement is subject to the GPA as long as its value exceeds certain specified thresholds and the goods or services in question are not exempt from the Agreement. The threshold for central governments is generally Special Drawing Rights (SDR) 130,000; for local governments SDR 200,000; and for other entities usually SDR 400,000. For most members, construction contracts are covered only if they exceed SDR 5 million. (In 1997 one SDR was equivalent to $1.35.)

All procurement of goods is covered unless otherwise specified. (In most instances military procurement is the exception.) In the case of services, only those products that are explicitly listed by each member country are subject to the GPA's rules. In practice these commitments closely parallel those of the World Trade Organization members under the General Agreement on Trade in Services (GATS), which liberalizes access to service markets generally (see Hoekman and Kostecki 1995 for an introduction to the GATS and references to the literature).

General Provisions of the GPA

The primary obligations imposed by the GPA are transparency and nondiscrimination. This policy extends not only to imports but also to goods and services provided by local subsidiaries of foreign firms. Preferential prices, offsets (measures, such as domestic content requirements and technology licensing, that encourage local development), and similar policies that discriminate in favor of domestic firms are in principle prohibited; competitive tendering procedures are encouraged. These include open tendering, where any supplier may respond to a published call for ten-

ders, or selective tendering, where bids are restricted to prequalified suppliers who have demonstrated that they meet technical competence norms. Limited tendering, under which potential suppliers are directly solicited to bid by the procuring entity, may be used in only three circumstances: situations in which no responses have been received to an open or selective call for tenders, cases of urgency, and orders for additional deliveries by an original supplier.

Calls for open tenders must be published in all cases, stating the mode of procurement, its nature and quantity, dates of delivery, economic and technical requirements, amounts and terms of payment, and so on. Individual suppliers may not be given information that could have the effect of precluding competition. Entities are obliged to award contracts to the tenderer who "has been determined to be fully capable of undertaking the contract" and who is either the lowest cost or most advantageous supplier, according to the evaluation criteria set forth in the notices. Because an evaluation of which tender comes closest to satisfying the criteria is open to a considerable degree of discretion, much depends on how the criteria in the notices or tender documentation are worded. It is a violation of the procurement agreement to determine that a tender is the most advantageous on the basis of criteria that are not specified.

The nature of procurement is such that unless rapid remedial action can be taken to intervene in the procurement process, firms are unlikely to contest perceived violations of the rules. A unique feature of the GPA is that it requires members to establish bid protest or challenge procedures, under which bidders can correct breaches of the GPA in order to preserve commercial opportunities. Such measures may involve suspension of the procurement process, reopening of the tender procedure, or the award of compensation for loss or damages. This is a key dimension of the GPA because it gives firms an incentive to defend their interests. The domestic challenge mechanism is complemented by the WTO's multilateral dispute settlement process. To ensure transparency and facilitate the application of these procedures, procuring entities must provide information explaining why a supplier's application to qualify was rejected; why an existing qualification was terminated; and why a tender was not selected. They must also identify the winning bidder and clarify the characteristics and relative advantages of the tender selected.

Developing Country Provisions

Although in principle the GPA prohibits signatories from discriminating in favor of domestic firms, developing countries may negotiate mutually acceptable exclusions from the rules on national treatment for certain entities, products, or services (Article V). Such negotiations may also be initiated after signing the procurement agreement. That option, however, is limited to *certain* entities, products or services, and the scope to pursue such policies is therefore inherently limited by the relative nego-

tiating power of the country seeking to apply them. Developing countries may also, at the time of accession, negotiate conditions for the use of offsets. Although offset requirements explicitly allow for de facto discrimination against foreign suppliers, the requirements may be used only to qualify for the procurement process and not as criteria for awarding contracts. Thus, if a firm offers local content that greatly exceeds the minimum requirements, that aspect of the offer may not be a factor in awarding a contract.

Economic Issues

The major substantive disciplines imposed by the GPA are nondiscrimination, competitive tendering, and transparency, complemented by the domestic and multilateral enforcement mechanisms. What is the economic rationale for these rules? Are there reasons to conclude that they may not be in the interest of developing countries? There are two potential sources of concern: first, discrimination may be needed to ensure least-cost procurement; and second, the net economic payoffs associated with the rules may be too small.

Is Nondiscrimination Always Optimal?

Intuitively the nondiscrimination rule appears to be unambiguously beneficial because it should intensify competition and thereby minimize the costs of procurement. As is often the case in economics, this proposition is not necessarily true. Discrimination may be necessary to minimize average procurement costs. Discriminating against foreign bidders may be welfare improving *if* domestic firms are at a competitive disadvantage in certain areas (that is, if they are higher-cost producers) and only a limited number of firms (foreign and domestic) bid for a contract. In such situations, foreign firms may exploit their cost advantage by bidding just below the amount they expect domestic firms to bid (McAfee and McMillan 1989). Although the foreign firm will be the lowest bidder, the bid may be substantially above the firm's actual cost. A policy that gives preferences to domestic firms may then induce foreign firms to lower their bids by the extent of the preference margin. If so, procurement favoritism increases national welfare. Even if the cost structure of domestic and foreign firms are identical and account is taken of the social cost of distortionary taxation, discrimination may be rational simply because foreign profits do not contribute to domestic welfare (Branco 1994). Thus favoritism can be used as a rational profit-shifting strategy whenever there is imperfect competition. Shifting demand to domestic firms may also reduce price-cost margins as domestic output expands (Chen 1995).

Even when there are many potential suppliers for a contract, which should guarantee the lowest costs, discrimination may be beneficial in other ways. If, for in-

stance, the products to be procured are intangible or if enforcing contract compliance is a problem, public agencies may need to grant excess profits to contractors to get them to deliver (Laffont and Tirole 1991; Rothenberg 1993). Moreover, if there is an incentive to pay a premium over the suppliers' cost to ensure contract performance, the required premium may increase as the number of potential bidders rises (because each supplier will take into account the higher probability of not getting repeat business) (Breton and Salmon 1995). Minimizing the costs of procurement in such settings may require limiting the number of potential suppliers. If so, governments can be expected to favor domestic over foreign suppliers. The sourcing costs will not be affected, while political benefits may arise because domestic firms are part of their constituencies. Such situations are more likely in the case of service procurement, because of their intangible nature. Services are often the largest category of government purchases—increasingly so in countries that have been pursuing outsourcing and contracting strategies. In the United States, for example, most federal nondefense procurement is for services (Francois, Nelson, and Palmeter 1997).

Problems of asymmetric information may also reinforce the decision to choose local suppliers in order to reduce monitoring costs. Such proximity incentives make it more difficult for foreign firms to bid successfully, even when they are not faced with formal discrimination, and may encourage them to contest procurement markets by investing directly in developing countries. This incentive is, of course, not procurement-specific but applies in all instances where buyers prefer to deal with "local" suppliers. The policy issues then are how to decide whether suppliers are local "enough" and what—if any—barriers exist against foreign direct investment.

Although discriminatory procurement may lower procurement costs in some situations, studies suggest that the net welfare benefits are likely to be modest at best; increased prices will tend to offset any cost savings (Deltas and Evenett 1997). The net welfare impact depends on the government's objective function, particularly the relative importance given to domestic industry profits as opposed to expected procurement costs. The latter will generally be a multiple of the former. In many situations the information required to determine whether discrimination is beneficial is not likely to be available. Even if it is, the wording of general regulations calling for discrimination—for instance, a universal price preference of 15 percent—is too rigid. In many cases markets will be competitive and products will be relatively homogenous, so these considerations do not arise.

Nonetheless, in principle there is a potential tradeoff between the GPA's nondiscrimination rules and economic efficiency. One way to address this tension would be to give governments the discretion to apply a "rule of reason" and require them to rationalize their decisions. This approach, however, introduces the potential for arbitrary decisions and makes it difficult—if not impossible—to apply the GPA's enforcement and dispute settlement provisions.

Experience with competitive procurement regimes indicates that in most situations competition is the best rule of thumb; competitive and transparent procurement regimes generate substantial cost savings. For example, Transparency International (1997) notes that noncompetitive procedures may increase procurement costs as much as 30 percent. Estimates of the cost savings associated with international competitive bids for World Bank loans are in the same range. In the case of a recent balance of payments loan to the Russian Federation financed by the World Bank, procurement costs under competitive bidding procedures were on average 30 to 40 percent below the costs of identical items acquired in the past without such bidding and as much as 75 percent less for certain pharmaceutical products (World Bank 1994).

In practice discrimination may be motivated not by considerations of cost or contract compliance but by a desire to promote domestic industry. Much has been written about the pros and cons of protecting infant industries. What matters in the current context is not whether there are rationales for intervention on infant industry grounds, but that procurement favoritism is unlikely to be the optimal policy to use in pursuit of this objective. In effect, it is equivalent to a subsidy financed by domestic taxpayers, because government purchasing costs increase and must be financed. But it is less transparent than a direct subsidy from the budget and as a result provides greater potential for rent-seeking and corruption. Debroy and Pursell (1997) provide an interesting review of India's use of procurement regimes to support infant industry policies—a policy the government recently has begun to reverse.

Costs and Benefits

Even if it is accepted that nondiscrimination is the best rule of thumb and that it will produce significant cost savings, the net benefits may be minor because of the costs incurred. These costs can be substantial, as entities must satisfy many procedural requirements to ensure due process and transparency. These procedures are undoubtedly burdensome, but they have advantages as well. Nondiscrimination, transparency, and accountability provisions may constrain rent-seeking activities. Allowing procuring entities to discriminate may facilitate bribery of procurement officials. Although the issue of corruption extends beyond procurement, rent-seeking in the public purchasing context is particularly prominent because the amounts involved are significant and foreign interests are frequently affected. Case studies have demonstrated that corruption can increase the costs of a project by as much as 25 to 50 percent (Wade 1982; Rose-Ackerman 1995a). Corruption and rent-seeking reduce economic growth, distort resource allocation, and result in higher taxes or, more commonly, deficit financing (Mauro 1995; Murphy, Schleifer, and Vishny 1993; Schleifer and Vishny 1993; Bardhan 1997).

Abstracting from differences in cultural norms across countries, effective anticorruption strategies must reduce the magnitude of the benefits that can be granted by officials, increase the costs of bribery for the private sector, and limit the market power of officials (Rose-Ackerman 1995a, 1995b; Bardhan 1997). Of the various strategies and suggestions offered in the literature, the following are particularly relevant for procurement: effective deterrents through ex post punishments that exceed the gains realized (including banning firms caught in attempts to engage in bribery from bidding for contracts for a number of years); the creation of external monitoring devices and institutions (including encouragement and protection of "whistleblowers"); public transparency mechanisms (published audits by independent auditors, a free press); privatization and hard budget constraints; requiring the use of standardized products and goods that have well-established market positions; the use of general retail-wholesale market prices for goods similar to those to be procured as comparators; and the use of incentives to encourage bidders to complain if they suspect corruption.

Although the GPA lacks an explicit corruption standard or norm, it is consistent with—or embodies many of—these principles. Of particular importance are the challenge procedures that allow firms to protest before the decision process is completed, as well as thereafter. Multilateral monitoring and the threat of WTO dispute settlement procedures will also help to ensure that entities abide by the GPA's substantive and procedural disciplines. Alam (1995) argues that the opportunities for losers to take countervailing actions can constrain rent-seeking activities. In the context of procurement, the set of losers is usually small. In discretionary, nontransparent procurement systems, firms that lose out have little incentive to protest irregularities because they fear being blacklisted. The GPA's rules are designed to maximize the incentives to obtain and use information concerning possible violations, but given the sunk costs of participating in the bidding process, such a protest is only viable if the expected returns outweigh the costs of protesting. Ensuring that this is the case may be difficult.

Operation of the GPA

The GPA requires signatories to report annual procurement statistics to the WTO Committee on Government Procurement, which provides oversight for the GPA. This committee, which comprises representatives from all member countries, meets periodically in Geneva. Signatories began reporting statistics for the year 1983. Because the latest year available for some countries is 1992, the analysis here is restricted to that period—a time during which the GPA applied only to the procurement of goods by central government entities. As a result, most procurement activities were excluded. In the case of the United States, for example, Francois, Nelson,

and Palmeter (1997) note that in 1993 goods accounted for less than 5 percent of total federal nondefense-related purchases.

Coverage

In 1992 the total procurement of goods by the entities covered by the GPA was about $62 billion. Average annual purchases that year by the United States, the largest procurement market, were some $29 billion (table 1). This compares to total purchases of $16 billion by the European Union (EU)-12 entities, $9.2 billion by Japan, and $1.6 billion by Canada. For the purposes of cross-country comparisons, it is helpful to relate these numbers to total central government expenditures on nondefense-related goods and services and to capital expenditures by the central government. Relative to total central government expenditures on goods and services—which includes items such as wages—purchases under the GPA by large countries such as France, Germany, Italy, Japan, and the United Kingdom tend to be below average; the United States and the Nordic countries are above average. On both measures, Germany and Italy have the lowest ratios, suggesting they may have sought to limit the coverage of their GPA obligations. Israel and Singapore have scheduled substantially fewer procuring entities than the OECD countries.

For a number of reasons it is difficult to estimate how much additional procurement was brought under the GPA's umbrella in 1996, when it was extended to cover services and subnational entities. First, it is not always clear whether specific services are covered or whether the nondiscrimination rule applies to all services. (Many countries made their commitments conditional upon reciprocity.) Second, no information on the size of the average contract and the types of goods and services purchased is available. The best estimates of central government nondefense expenditures by GPA signatories puts the total at about $2.1 trillion (table 1); subnational government bodies add at least another $1 trillion (IMF 1996). Not all of this procurement is available for international competition. In particular, the average subnational government contract is likely to be smaller than those of central government entities. If it is assumed that one-third of total outlays by central and subnational governments could be subjected to GPA rules, the total potential market would be close to $1 trillion a year. Applying the historical GPA rate of 50 percent for the share of procurement of goods that falls below the threshold value, some $500 billion could be open to international competitive bidding (table 2). This is likely to be an overestimate, however, as threshold values for subnational government entities and services contracts are significantly higher than those that apply to central government entities. Because the thresholds for any construction contracts are at least SDR 5 million, and as much as SDR 15 million in Korea and Japan, $300 billion is a more realistic figure.

Table 1. *GDP and Central Government Expenditures, 1992*
(millions of dollars)

Country	*Gross domestic product*	*Total government expenditure (A)*	*Total nondefense expenditures (B)*	*Capital expenditures (C)*	*Value of total contracts under GPA*[a]	*Value of total contracts relative to*		
						(A)	*(B)*	*(C)*
Austria	185,235	40,282	29,842	4,750	433	1.08	1.45	9.12
Belgium[b]	218,836	64,197	44,540	4,973	407	0.63	0.91	8.19
Canada	493,602	128,155	96,959	1,965	2,399	1.87	2.47	122.12
Denmark	123,546	47,219	35,782	1,539	1,646	3.49	4.60	106.92
Finland	93,869	30,020	23,045	1,912	834	2.78	3.62	43.58
France[b]	1,319,883	256,711	178,104	19,273	3,279	1.28	1.84	17.02
Germany[b]	1,789,261	215,669	149,629	35,832	2,055	0.95	1.37	5.74
Ireland	43,294	16,986	13,236	1,269	208	1.23	1.58	16.43
Israel	69,762	25,270	13,001	3,500	68	0.27	0.53	1.95
Italy[b]	1,222,962	335,439	232,725	17,983	1,994	0.59	0.86	11.09
Japan[b]	3,670,979	479,158	332,436	58,360	9,507	1.98	2.86	16.29
Luxembourg	12,638	2,394	1,784	364	34	1.43	1.92	9.44
Netherlands	320,290	92,698	75,644	6,505	1,281	1.38	1.69	19.70
Norway	112,906	25,399	19,276	1,255	775	3.05	4.02	61.76
Singapore	46,025	8,889	3,424	2,272	30	0.34	0.89	1.34
Sweden	220,834	75,172	61,158	3,386	1,162	1.55	1.90	34.31
Switzerland (1984)	90,649	8,973	5,784	1,096	252	2.81	4.36	22.99
United Kingdom	903,126	338,259	211,108	33,755	5,740	1.70	2.72	17.00
United States	5,920,199	1,037,354	631,924	56,354	29,120	2.81	4.61	51.67
Total		3,228,246	2,159,399	256,343	61,227			
Unweighted average						1.64	2.60	30.35

a. Average 1991 and 1992.
b. Estimated: Switzerland, 1984; Hong Kong has been excluded because of data inconsistencies.
Source: WTO (1984–94); IMF (1996).

Table 2. *Indicators of GPA Performance, 1983–92*
(millions of dollars)

Country	*Value of covered procurement*		*Share of limited tendering*		*Share of procurement covered domestically*		*Share of procurement that falls above SDR threshold*	
	1983–85	*1990–92*	*1983–85*	*1990–92*	*1983–85*	*1990–92*	*1983–85*	*1990–92*
Austria	179.4	403.9	43.2	43.2	51.3	1.5	46.9	43.5
Belgium[a]	129.9	407.2	10.3	8.6	100.0	100.0	40.0	57.5
Canada	968.5	2,163.9	9.7	7.4	92.3	77.4	42.9	46.0
Denmark[a]	447.9	1,651.7	4.0	1.4	95.6	79.8	5.8	12.6
Finland	256.3	800.8	0.3	0.1	95.7	69.1	39.4	18.1
France[a]	937.9	3,089.5	33.3	29.6	97.6	97.2	35.1	85.5
Germany[a]	845.6	2,029.3	13.3	24.0	97.2	99.1	24.9	61.7
Hong Kong	154.5	348.6	22.1	28.2	5.8	3.2	67.7	71.2
Ireland[a]	47.8	185.8	1.8	5.6	100.0	84.8	20.6	29.1
Israel	30.1	67.9	5.0	3.3	13.7	25.6	84.0	91.1
Italy[a]	382.4	1,937.5	1.0	5.9	99.2	97.8	5.0	60.5
Japan	3,379.4	9,274.1	12.3	21.0	86.1	85.5	37.4	43.7
Luxembourg[a]	14.9	35.8	39.8	23.9	100.0	97.8	30.9	28.4
Netherlands[a]	547.1	1,407.7	16.8	13.5	98.7	86.4	12.1	37.7
Norway	384.7	721.4	7.1	8.3	48.6	40.4	44.5	58.9
Singapore	48.5	31.0	0.0	0.0	45.1	67.3	57.9	51.1
Sweden	624.4	1,200.5	4.0	4.8	43.7	43.6	27.9	36.9
Switzerland	265.0	806.2	25.1	27.7	35.7	38.3	43.8	39.8
United Kingdom[a]	1,329.7	5,375.0	13.7	6.6	99.4	98.2	29.3	49.0
United States	24,080.8	28,891.2	11.5	9.6	86.3	90.4	80.1	66.8
Memo: EU countries	7,967.2	16,119.4	19.0	15.0	98.3	94.9	21.2	54.1
Average unweighted			13.1	13.0	74.6	71.2	38.8	49.5
Average weighted by value of procurement			13.3	14.1	86.1	87.3	59.7	57.4

a. Average of 1984–85.
Source: WTO (1984–94).

Foreign Sourcing

Smaller countries tend to procure more goods and services on international markets than do large countries. If Canada, the European Union, Japan, and the United States are excluded, about 60 percent of the purchases of goods by central government entities under the GPA are from national suppliers, compared with more than 90 percent for the large players. Unfortunately, EU statistics define "domestic" as within the European Union, thus skewing self-sufficiency ratios (see table 2). In interpreting these statistics, note that no distinction is made between domestic firms and foreign firms that have established a local presence. As long as the share of foreign direct investment is the same in large countries as in smaller ones, cross-country comparisons should not be affected.

In Japan, the United States, and the EU countries, the share of total procurement from domestic firms was virtually unchanged during 1983–92. The average weighted share across all GPA members is relatively constant; the unweighted average fell by 3 percentage points, from 74.6 percent to 71.2 percent (see table 2). Among smaller countries, however (with the exception of Singapore and Switzerland), the share of procurement from domestic sources has declined over time. Although such changes cannot be attributed solely to the GPA because other developments—such as the North American Free Trade Agreement, the EU procurement liberalization, and unilateral deregulation and privatization policies—also played a role, the finding appears to be robust. But for most of the large players there has been no change.

This conclusion is supported by the few empirical studies on government procurement practices in OECD countries. These use a methodology suggested by Baldwin (1970) and Baldwin and Richardson (1972), which assumes that in the absence of discriminatory policy, government entities would behave in the same way as do private firms. Thus, government imports of a good as a share of total consumption would equal that of the private sector as a whole. The difference between the private sector import propensity and the actual import share of total government consumption can be called a preference margin. (A positive preference margin implies that the government share is lower than the private share.) Baldwin (1970) estimated that the preference margin in the United States was some 20 percent in 1958. After adjusting for the fact that certain large import items such as oil were not subject to discriminatory policies, the margin for the residual set of covered goods increased to some 40 percent. More recent estimates (1992) show the U.S. preference margin was 16.3 percent (Francois, Nelson, and Palmeter 1997). On a sectoral level, positive margins in OECD countries may be as high as 50 percent (table 3). Margins are invariably the highest for procurement of services.

The Baldwin-Richardson methodology is obviously sensitive to the assumption that, other things being equal, the government would import the same share of a

Table 3. *Estimated Preference Margins for Core Government Purchasing, 1992*
(Baldwin-Richardson 1972 Approach)

Country or region	*Machinery*	*Other goods*	*Trade, transport, communication*	*Utilities*	*Other services*
Canada	—	—	—	—	39.6
United States	18.4	17.9	—	18.8	42.6
Western Europe	—	9.2	13.7	14.9	48.3
Japan	—	32.0	26.2	34.0	46.6
Australia	49.8	49.7	—	—	41.5
New Zealand	13.9	19.7	49.8	—	50.0
Korea, Republic of	30.6	20.8	—	—	48.2

— Less than or equal to zero.
Source: Francois, Palmeter, and Nelson (1997).

good as the private sector, and that all differences can be attributed to formal or informal preference policies. One source of bias that arises in this connection is that private sector imports may be distorted because of tariffs and other trade policies. Alternatively, private sector demand for certain products may be very low or even zero because government is the dominant supplier of output that embodies particular products (defense, utilities, certain types of transport services, and so on).

Limited Tendering

Limited tendering procedures (which involve an entity contacting and negotiating with potential suppliers individually) are permissible only under certain conditions. The use of limited tendering varies across signatories, from a reported low of zero (Singapore) to a high of more than 30 percent on average for France, Hong Kong, Italy, and Switzerland (see table 2). Across all signatories the average share of limited tendering was about 13 percent. This practice has been falling over time in the EU-12 (by about 7 percent a year on average during 1983–92), but rising in the United States. By 1992 limited tendering in the EU and in the United States stood at 10 percent, largely as a result of a significant decline in this practice by France and Germany during the 1980s. Japan's limited tendering rose from around 12 percent during 1983–85 to 21 percent during 1990–92. Hong Kong and Switzerland make even more intensive use of such procurement mechanisms.

This type of data is not available for developing countries. Indeed, little is known about the product composition of procurement across developing countries, the average contract size, or the "import propensity" of government entities. Indeed, one benefit of membership in the GPA would be that data on procurement flows would

have to be collected and reported to the WTO. This information would be valuable for researchers as well as for the governments concerned.

Transparency, Disputes, and the Challenge Mechanism

If procurement procedures are to function efficiently, potential suppliers need to be aware of demand and have sufficient time to respond to calls for tenders. The GPA spells out these requirements, but it does not monitor compliance; that is left to the private sector. As a result, violations may be overlooked. Even in the EU, where procurement opportunities must be published in the *Official Journal of the European Communities* and can be obtained through electronic networks, a recent study found that procuring entities often failed to publish the information or provided insufficient time for responses. Moreover, many potential suppliers did not routinely monitor the *Official Journal* and were thus unaware of the potential market (Gordon, Rimmer, and Arrowsmith 1997). In part these problems result from ambiguities in the wording of the regulations on EU procurement.

The GPA's challenge mechanism is untested as yet, because it only came into force in 1996. The key requirement for these procedures to be effective is that participants can either obtain very rapid intervention by a judicial or administrative body or have the opportunity to obtain significant financial compensation after the fact for violations of procurement disciplines. (Once a tender has been closed and a contract awarded, reopening the proceedings may be difficult.) A concern with this process is its potential to give rise to problems of moral hazard and excessive litigation. Ensuring that firms have access to an effective and speedy mechanism through which they can challenge a procurement process or award is therefore very important. A recent evaluation of EU procedures and disciplines—which were an important model for much of the GPA—suggests that EU suppliers have not used the challenge mechanism to great effect because it is perceived as being too slow (Gordon, Rimmer, and Arrowsmith 1997).

Negotiating Accession: Considerations of Political Economy

As noted earlier, membership in the GPA did not alter the sourcing patterns of large countries, but small countries purchased more from foreign suppliers over time. These findings are consistent with economic theory. The larger the country, the greater the number of potential domestic suppliers and the higher the probability that domestic firms attain minimum efficient scale. Thus, large countries can be expected to continue to buy predominantly from national suppliers even if they abide fully by the GPA. Small countries, in contrast, will generally have fewer national firms that can provide the goods needed by the government at least cost, especially specialized,

capital-intensive items where scale economies are important (such as telecommunications, transport, or power-generating equipment).

The economic rationale for refusing to join the GPA is weak and may in large part be driven by political economy factors. The issue then is to seek to offset the opposition of groups that would like to maintain the status quo. The problem is similar to that facing trade reformers: incumbent industries and procurement officials have more of an individual incentive to oppose reform than losers from the status quo (taxpayers, consumers) have to push for it. In the context of trade liberalization, the problem arising from the asymmetric distribution of costs and benefits can be addressed by providing those who stand to gain from reform a greater incentive to engage in the political process in pursuit of their interests. One way to mobilize support for liberalization is to promise exporters better access to foreign markets, something that the government can demand as a quid pro quo from its trading partners for liberalizing the domestic market. But such access will not have much of an impact in increasing developing countries' share of OECD procurement markets. Although some countries may have a comparative advantage in providing certain services, service industries are much more subject to restrictive regulations than goods markets. There is no formal constraint on demanding other concessions, however. Developing countries could bargain for access to markets that are of interest to them. Although trade barriers are relatively low in industrial countries, a significant amount of tariff escalation remains. Tariffs and other trade barriers tend to be substantially higher on labor-intensive products such as footwear or clothing than on other types of manufactures. Achieving reductions in these barriers is difficult. Linking membership in the GPA to reductions in trade barriers by OECD countries may help mobilize support for domestic liberalization of procurement markets.

Another way to attenuate opposition is to change the rules of the game in a manner that meets some of the concerns associated with the implementation of the GPA. For example, developing countries could be allowed to apply price preferences that favor procurement from national suppliers. Although a strong presumption exists that the GPA's nondiscrimination, transparency, and enforcement provisions will benefit developing countries, many nations have procurement regimes that provide preferences for domestic firms. Such provisions may be motivated by infant industry arguments; they may reflect an attempt to offset the higher input costs of domestic bidders that result from other policies (for example, high import tariffs); or, as noted earlier, they may be a response to imperfect competition or asymmetric information. In principle, the optimal policy to deal with distortions such as tariffs is to eliminate or significantly reduce them, thereby eliminating domestic preferences as well. Some countries have embarked on a such a process, but local content requirements and price preferences continue to prevail in many jurisdictions.

The GPA could be amended to allow developing countries to establish price preferences as long as these are transparent and accountable. Although the case for policies

Table 4. *Government Expenditures and the Role of Official Development Assistance*
(millions of dollars)

Country group	GDP *1992*	*Total nondefense expenditure on goods and services*	*Capital expenditure*	*Multilateral development bank loans, 1992*[a]	*Development Assistance Committee loans, 1992*[b]	*Ratio multilateral development bank loans/total nondefense expenditures*
Average of low-income countries (*N*=46)	23,704	2,053	1,637			
Total low-income countries	1,090,384	94,447	75,296	17,076	32,931	18.1
Average of lower middle-income countries (*N*=42)	31,151	2,237	921			
Total lower middle-income countries	1,308,362	93,960	38,682	13,972	15,337	14.9
Average of upper middle-income countries (*N*=16)	80,384	6,602	1,496			
Total of upper middle-income countries	1,286,158	105,631	23,943	6,135	1,239	5.8

a. Refers to loan approvals.

b. Development Assistance Committee data pertains to net disbursements and includes bilateral assistance.

Source: World Bank, Asian Development Bank, Inter-American Development Bank, African Development Bank and OECD Development Assistance Committee, Annual Reports (various years); IMF (1996).

that discriminate in favor of domestic suppliers is not compelling, such an approach may be a useful transition to encourage membership in the GPA. Multilateral financial institutions, including the World Bank allow such preferences subject to certain conditions and limits. The World Bank permits a maximum price preference of 15 percent for procurement of goods, and 7.5 percent for public works projects. Provisions for the use of price preferences are also included in the Model Law on Procurement of the UN Committee on International Trade Law (Beveglia-Zampetti 1997). An advantage of price preferences over other policies that favor domestic procurement is that they permit the price mechanism to continue to work. As such, they are superior to local content and offset requirements, policies that the GPA currently allows developing countries to apply. One option would be an agreement to convert offset and similar policies into price preferences. This would be akin to the conversion of quotas and related measures to tariffs in the Uruguay Round for agriculture (see Hoekman and Kostecki 1995). Even if this meant that price preferences in some countries were relatively high, they would become the focal point for future multilateral negotiations to reduce discrimination. Of course, the use of such preferences should be optional and should not be used to create a preference margin that exceeds the level currently implied by existing policies. Nor should tariff conversion be considered in instances where preference policies do not already exist.

Potential Negotiating Leverage

What negotiating leverage could developing countries exercise to pursue better access to foreign markets or temporary exceptions to GPA disciplines? Given the mercantilist nature of bargaining in the WTO context, the size of nonmember (developing country) procurement markets is perhaps the best indicator of leverage. Unfortunately, the data on the size of procurement markets are very poor. Total central government expenditures on goods and services by non-OECD countries in the early 1990s was some $300 billion (table 4). This figure includes conservative estimates for several large countries that do not report data, including India, Indonesia, Pakistan, and South Africa.[1] Data on expenditures by subnational government entities in developing countries are even patchier. If it is assumed that the purchases by such entities are equal to central government expenditures, the total will be at least $600 billion. How much of this is available to foreign suppliers depends on the share of contracts that exceeds the GPA's threshold values. These thresholds are likely to have a greater effect in developing countries as the average size of each contract can be expected to be less than in a high-income country.

It is also important to recognize that many expenditures by developing country governments are financed through official development assistance funds, both bilateral and multilateral. Official bilateral development aid is often tied to buying goods and services from the donor country; and the recipient government cannot subject

aid-financed purchases to international competition. Absent an agreement from donors to eliminate tied aid, such projects would be exempt from GPA rules. Conversely, procurement financed through multilateral development assistance usually already is subject to international competitive bidding.

Available data on the relative importance of aid flows as a share of government expenditure suggest that aid finances a significant share of the total purchases of goods and services by developing country governments (equivalent to 35 percent of the total in low-income countries, 16 percent in lower middle-income nations, and 6 percent in upper middle-income economies; see table 4). This suggests that much of the procurement by poor countries either cannot be subjected to the GPA or is already subject to international competitive bidding. In practice, however, the GPA is expected to interest the higher-income developing countries in which aid plays only a minor role. It can also be noted that what matters in the WTO context is not only the actual policy stance of a government, but also the extent to which countries bind (lock in) their policies by making formal commitments not to become more restrictive in the future. Thus, even if countries are already relatively open, this does not mean they have nothing to offer. An agreement to lock in a policy regime that is already nondiscriminatory has value in the WTO setting. Negotiating leverage for developing countries is therefore substantial.

Conclusion

Government procurement is a key interface between the public and private sectors. Not only is public purchasing of fundamental importance in ensuring that government gets the best value for its money, but procurement practices figure prominently in the way potential investors and civil society at large view a country. Many developing countries have adopted procurement legislation and regulations that aim to ensure that public entities purchase goods and services through an open and competitive process. To what extent actual practice is consistent with the formal rules and principles is often difficult to determine, in part because the incentives to contest violations of the formal rules of the game are often small. The GPA provides a unique international mechanism through which governments can credibly commit themselves to a transparent and competitive procurement regime and provide participants with more effective enforcement mechanisms than may be available under the status quo. Enforcement is a necessary condition for any set of rules to be effective. This applies as much to industrialized as to developing countries.[2]

Governments desiring to minimize procurement costs have options that go beyond the adoption of efficient purchasing practices and related procurement regimes. These include the privatization of government operations and private sector participation in markets presently serviced by public entities. The potential benefits of such

initiatives are increasingly recognized. Procurement disciplines may be a second-best option—if not redundant—if market forces can be applied to the activities of public entities. The greater the extent to which public entities operate in a competitive environment and are subject to hard budget constraints, the less likely that inefficient purchasing decisions will be made. Where public entities have a dominant position, however, competition laws and policies are required to ensure that they do not abuse their market power. The same is true of collusion and other restrictive business practices, matters on which the GPA has nothing to say (Wood 1997). This does not imply that procurement regimes will become irrelevant; quite the contrary. Governments will remain important purchasers of goods and services. Indeed, the more activities are contracted out by government agencies, the greater the need for transparent and efficient procedures to allocate contracts.

More research is required to determine the extent to which current procurement regimes in developing countries are compatible with the GPA. Surprisingly little is known about actual practices and their economic impact. Examples include data on the composition of procurement, the import propensity of government entities compared with those of the private sector, the extent to which procurement costs diverge from market price-based comparisons, whether differences in ownership and market structure across countries affect procurement efficiency of similar entities or contracts, and how frequently negotiations are reopened *after* contracts have been awarded.[3]

For developing countries, the main quid pro quo for membership in the GPA is reciprocal access to the procurement markets of existing members. This is not a very compelling incentive. Seeking better access to export markets more generally appears to be the best approach, complemented by efforts to seek transitional periods in which to phase in those aspects of the GPA, such as challenge mechanisms, where institutional strengthening will be required.

Notes

Bernard Hoekman is senior economist with the Development Research Group of the World Bank and research fellow at the Centre for Economic Policy Research in London. He would like to thank Marie-Helene Le Manchec and Faten Hatab for excellent research assistance; Annet Blank and Dick Westin for help in obtaining data; and Simon Evenett, Garry Pursell, and Alan Winters for helpful comments.

1. Data reported in IMF (1996) on the average ratio of expenditure on goods and services to total central government expenditures of all the developing countries reporting both variables was used to estimate data for missing countries.

2. In the EU, for example, many members states have been slow to implement European Community directives relating to procurement, and the directives are often violated. In 1994 the Commission of the European Communities initiated some 250 legal actions against members states or entities for inconsistency with procurement rules (*Financial Times*, November 23, 1996).

3. This is potentially a significant loophole in any procurement regime because it may reflect or induce corruption and collusion between the entity and a favored supplier, who will bid low to win

the tender in the knowledge that the contract will be renegotiated ex post. This is alleged to be a prevalent practice in some European countries that belong to the GPA (*Financial Times,* November 23, 1994, p. 2).

References

The word "processed" describes informally reproduced works that may not be commonly available through library systems.

Alam, M. S. 1995. "A Theory of Limits on Corruption and Some Applications." *Kyklos* 48:419–35.

Baldwin, Robert. 1970. *Nontariff Distortions of International Trade.* Washington, D.C.: Brookings Institution.

Baldwin, Robert, and J. David Richardson. 1972. "Government Purchasing Policies, Other NTBs, and the International Monetary Crisis." In H. English and K. Hay, eds. *Obstacles to Trade in the Pacific Area.* Ottawa: Carleton School of International Affairs.

Bardhan, Pranab. 1997. "Corruption and Development: A Review of Issues." *Journal of Economic Literature* 35:1320–46.

Beveglia-Zampetti, Americo. 1997. "The UNCITRAL Model Law on Procurement of Goods, Construction and Services." In Hoekman and Mavroidis, eds.

Branco, Fernando. 1994. "Favoring Domestic Firms in Procurement Contracts." *Journal of International Economics* 37:65–80.

Breton, Albert, and Pierre Salmon. 1995. "Are Discriminatory Procurement Policies Motivated by Protectionism?" *Kyklos* 49:47–68.

Chen, Xiangqun. 1995. "Directing Government Procurement as an Incentive of Production." *Journal of Economic Integration* 10:130–40.

Debroy, Bibek, and Garry Pursell. 1997. "Government Procurement Policies in India." In Hoekman and Mavroidis, eds.

Deltas, George, and Simon Evenett. 1997. "Quantitative Estimates of the Effects of Preference Policies." In Hoekman and Mavroidis, eds.

Domberger, Simon, Christine Hall, and Eric Ah Lik Lee. 1995. "The Determinants of Price and Quality in Competitively Tendered Contracts." *Economic Journal* 105:1454–70.

Francois, Joe, Douglas Nelson, and David Palmeter. 1997. "Government Procurement in the U.S.: A Post-Uruguay Round Analysis." In Hoekman and Mavroidis, eds.

Gordon, Harvey, Shane Rimmer, and Sue Arrowsmith. 1998. "The Economic Impact of the EU Regime on Public Procurement: Lessons for the WTO." *The World Economy* 21(2, March):159–87

Hoekman, Bernard, and Michel Kostecki. 1995. *The Political Economy of the World Trading System.* Oxford: Oxford University Press.

Hoekman, Bernard, and Petros C. Mavroidis, eds. 1997. *Law and Policy in Public Purchasing: The WTO Agreement on Government Procurement.* Ann Arbor: University of Michigan Press.

IMF (International Monetary Fund). 1996. *Government Finance Statistics Yearbook.* Washington, D.C.

Laffont, J. J., and Jean Tirole. 1991. "Auction Design and Favoritism." *International Journal of Industrial Organization* 9:9–42.

Mauro, Paolo. 1995. "Corruption and Growth." *Quarterly Journal of Economics* 109:681–712.

McAfee, R. Preston, and John McMillan. 1989. "Government Procurement and International Trade." *Journal of International Economics* 26:291–308.

Murphy, Kevin, Andrei Schleifer, and Robert Vishny. 1993. "Why is Rent-Seeking So Costly to Growth?" *American Economic Review* 83:409–14.

Rose-Ackerman, Susan. 1995a. "The Political Economy of Corruption." *Viewpoint* 74 (April).

———. 1995b. "Redesigning the State to Fight Corruption." *Viewpoint* 75 (April).

Rothenberg, Julio. 1993. "Comment." In Jim Leitzel and Jean Tirole, eds., *Incentives in Procurement Contracting*. Boulder: Westview Press.

Schleifer, Andrei, and Robert Vishny. 1993. "Corruption." *Quarterly Journal of Economics* 107:599–617.

Transparency International. 1997. *The TI Source Book: Applying the Framework*. Internet address: http://www.transparency.de.

USTR (United States Trade Representative). 1997. "Annual Report on Discrimination in Foreign Government Procurement." April 30. Washington, D.C. www.ustr.gov/reports/special/title7.html.

Wade, Robert. 1982. "The System of Administrative and Political Corruption: Canal Irrigation in South India." *Journal of Development Studies* 18:287–327.

Wood, Diane. 1997. "The WTO Agreement on Government Procurement: An Antitrust Perspective." In Hoekman and Mavroidis, eds.

World Bank. 1994. "Rehabilitation Loan: Preidentified Import Component Distribution Monitoring Report." Russia Department, Washington, D.C. Processed.

———. 1997. *Helping Countries Combat Corruption: The Role of the World Bank*. Washington D.C.

World Trade Organization. 1984–94. "Annual Reports to the Government Procurement Committee." Geneva.

———. 1996. "Singapore Ministerial Declaration." Geneva. Processed.