International Public Procurement Agreements – Problems of Implementation in Switzerland

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The Government Procurement Agreement (GPA) of the WTO and the Bilateral Procurement Agreement between Switzerland and the European Union prohibit the discrimination of non-local firms. The Swiss legislation interprets the international obligations in a great variety of ways. This causes uncertainty and high transaction costs both for suppliers and purchasing agencies. Moreover, it gives way for rent-seeking by local firms to the detriment of the local tax payers and foreign firms.

In this article, we shall analyse the Swiss public procurement policy under two aspects: welfare economics and public choice. We want to examine whether a federal law should regulate or harmonise the public procurement procedure in order to ensure efficiency and fairness. Our analysis is purely economic. Legal aspects, though very important, are neglected (see Biaggini 2003a and 2003b, Zufferey and Dubey 2003).

In Switzerland, the total amount of public procurement is approximately 25 percent of total public expenditure and 8 percent of GDP. Before the GPA and the Bilateral Agreement became effective (in 1996 and 2002 respectively) public procurement was considered as an instrument of economic promotion. The local, cantonal or national firms were privileged for two reasons: because they create jobs and because they pay taxes. This has changed. Foreign suppliers may not be discriminated any longer. The rationale behind this reform is: intensification of competition, efficiency gains through division of labour and economies of scale, and stronger incentives for innovation. This requires a harmonisation of the procurement rules. The international procurement agreements give the different countries a certain scope when implementing them. Today, in Switzerland there are 27 different procurement laws, one of the Federal Government and 26 of the cantons. The differences regard the threshold values, the award procedures, the selection and evaluation process, the contract conclusion, the terms and conditions of appeal, and the legal protection.

Welfare Analysis

The main prerequisites for efficiency are: competition, free market entry, low transaction costs, incentives to use economies of scale and to implement innovations. Besides these efficiency conditions in the narrow sense some further aspects have to be taken into account, especially job security, security of supply, social equity, and political acceptance.

Competition and free market entry

Efficient markets require competition, and competition requires free market entry, otherwise scarce resources are wasted, rents are transferred from the consumers to the producers, and innovations are hindered. Whether in reality these disadvantages occur depends on the degree of competition. If a monopoly or cartel exists it must be careful not to attract new suppliers because of high profits (Baumol et al. 1982). Firms prefer to establish or defend a cartelistic situation by bringing government in to protect it. The easiest way to do so is to restrict market entrance for outside competitors by legal measures. In order not to damage their image cartels and the politicians protecting them try to conceal their interests by using good-sounding and already accepted goals such as job security, social and regional equity.

Low transaction costs

The lower the level of information about goods to be provided and firms able to supply them the higher the transaction costs. In the field of public

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The present paper summarises a report on public procurement in Switzerland written for the Federal Government and the Swiss cantons (Frey, Kilchenmann and Krautter 2003 and 2004).

procurement the large variety of rules among cantonal and local jurisdictions leads to legal uncertainty and high transaction costs, not only for the potential suppliers but also for the procurement agencies.

Fully open procurement procedures may raise transaction costs, too. This especially holds for small quantities to be bought. The costs of an open tender can easily exceed its benefits. It is therefore sensible to restrict the international procurement rules to purchases above a certain sum. This limit depends on the kind of goods to be procured (commodity, investment, services, etc.).

With electronic procurement (E-procurement) via Internet transaction costs can be lowered.[1] The online set-up of the complete supply chain should additionally lower the costs (see below). Hence the following conclusion can be drawn: Orders exceeding a certain amount should be subject to a general regulation. Rules trying to satisfy each particular case are not desirable, however. They increase the transaction costs.

Economies of scale

For many goods and services average costs decrease with increasing quantities. In the public sector, production within locally and regionally limited boundaries does not allow the firms to benefit from mass production. When firms are allowed to offer not only in their own jurisdiction costs will be lower.

E-procurement as an innovation

Market rules should be formulated in a way that the firms are permanently forced to search for new and better solutions. The chance that this will be the case increases with the number of competitors.

An innovation that will revolutionise government procurement is E-procurement. According to the Commission of the European Union 25 percent of all submissions could be treated electronically (Bovis 2001). This means that the entire procurement chain should be processed electronically: the clarification of the demand by the administration departments who plan to place orders with the procurement agency, the call for bids, the positioning of the tender offers, the process of tendering, the composition of the contracts, the contracting, the delivery of the goods and services, the invoicing, the payment, the inventory, and the statistical computation and evaluation. In order to realise efficiency gains from E-procurement, rules and procedures must be harmonised. The local autonomy of the decision makers is not restricted by such a form of technical rationalisation.

The advantages of E-procurement for the different partners is summarised in the following table.

Other goals

In the field of public procurement the advocates of locally and regionally limited submission practices sometimes argue that privileging domestic firms is associated with positive pecuniary externalities. As known from welfare economics externalities of this type do not lead to market failure and cannot justify government intervention (Scitovsky 1954). Much more, other goals are addressed as well, such as job security (full employment), the promotion of the local and regional firms (economic growth), the promotion of education and R&D (innovation), equal provision of public services to all groups and regions, social equity, or environmental protection.

At first sight, these arguments seem to be convincing. They involve the danger of high efficiency and growth losses, however. As will be shown in the next section, they often open the floodgates to

Advantages of E-procurement

Advantages for		
firms	*procurement agencies*	*the government*
Higher transparency	Saving of time	Easier surveillance of the procurement procedures
Cost reductions, benefiting from economies of scale	Cost reductions	Improvement of statistics
Less discrimination of SME	Bundling of demand in view of lower prices	Easier detection of protectionist practices

Source: Bovis 2001, with own additional arguments.

[1] In Switzerland an E-procurement platform already exists (SIMAP, Système d'information sur les marchés publics en Suisse, www.simap.ch). It can be used by federal, cantonal and local public agencies as well as public enterprises.

rent-seeking. The taxpayers have to bear higher charges, whereas the local suppliers benefit from higher sales and profits. In most cases it would be much cheaper to directly subsidise local firms for contributing to one of the public concerns mentioned. Government procurement policy should not be used as an instrument of social, regional or industrial policy.

The international public procurement agreements give every single country a guarantee that all other countries open their markets, too. The winners of such a liberalisation step are the taxpayers and the firms benefiting from mass production. Is this conclusion still correct if some countries do not follow the international procurement rules? In this case the firms cannot fully benefit from economies of scale and long-term innovations. The taxpayers, however, still get a greater return for their contributions.

A policy of retorsion would run counter to the official Swiss position in international relations. Switzerland, as is well known, is very reluctant to accept new binding international agreements. But once they are approved, it is willing to correctly follow all obligations (Hart and Sauvé 1997). It would be a bad example to discriminate foreign competitors, but at the same time to demand open access to foreign markets.

Competition between jurisdictions

In democratic societies and market-economies the individual preferences matter. They differ not only between individuals, but also between groups and regions. The same holds for the production costs. Should the local and cantonal governments therefore be autonomous in their procurement decisions in order to take account of the local and regional specialities? The answer is positive as far as it concerns the specifications of procurement – as long as they apply for all competitors. The procurement rules, however, should not be set by the jurisdictions individually. The danger is too great that the politicians discriminate in favour of their own firms.

Our reasoning presupposes that there already exist international public procurement agreements and that they are accepted. If this were not yet the case it would be reasonable to find out the best rules in a kind of interregional or international competition. New solutions could be tested in a single region. If they prove to lead to good results they can be copied by other regions. If they do not, not all regions would have to suffer from the losses.[2]

Social equity and political acceptance

Countries which strongly favour efficiency often show large social, sectoral and regional disparities. Not all persons, industries and regions are capable of efficient struggling under conditions of economic competition. There exists a conflict between efficiency and equity. A certain degree of redistribution and/or regulation is necessary, be it for ethical reasons or to make the market system politically acceptable for the majority of the citizens. The question is whether a protectionist procurement policy is a good measure to generate acceptance. It is not. There exist instruments associated with lower efficiency costs.

Procurement agencies can privilege local firms openly or covertly – openly by abandoning an open tender, covertly by formulating requirements which favour local firms and constrain market access of non-local suppliers. Familiarity with the language and the local circumstances, the knowledge of technical and other standards, and the compliance with regional or national rules fall in this category of requirements.

The local collective labour agreements are an example for such requirements. Must foreign competitors sign them? The same question applies for the compliance with industrial safety regulations. An argument in favour of enforcing domestic rules is that the "exploitation" of labour via low wages must be prevented, especially if otherwise local firms are thrown out of the market. The counter-argument runs as follows: Procurement orders to foreign firms imply an import of goods. Many other goods are imported, however, without the foreign producers being forced to sign Swiss collective labour agreements.[3]

Compliance with collective labour agreements is politically highly delicate: When considering the

[2] In the early 1980s, in the United States a contract appeal agency got new rules, The General Services Board of Contract Appeals (GSBCA) got into competition with the older General Accounting Office (GAO). The effect was that the GAO took the appealing firms more seriously and checked the complaints more thoroughly than before. The firms now enjoy a larger palette of legal remedies (Kovacic 1995, 494ss.).

[3] By the way, it can not be ignored that – like Switzerland fights wage dumping – other countries resent the advantage of the low interest rates for Swiss firms compared to companies from other countries.

different arguments, it is reasonable to demand that foreign firms erecting buildings on the Swiss territory comply with the same regulations as Swiss firms do. However, this can not and should not be required of suppliers of other goods and services. There are minimum standards of corporate behaviour which have to be complied with by foreign suppliers, too. The UN Global Compact is such a set of principles to be adopted in public procurement. They concern human rights, labour conditions (the right to be a member of a union, the interdiction of compulsory and child labour, the prevention of discrimination with respect to race, sex, religion, etc.) as well as environmental protection (compare: www.unglobalcompact.org). It can be assumed that the majority of the Swiss population would forbear from buying products which are produced under unacceptable conditions in favour of more expensive products.

Public Choice Analysis

Why have liberal procurement rules not been implemented in the past when so many strong points speak against privileging local firms? Public choice theory gives an answer. It assumes that a behaviour based on maximising individual utility is not only characteristic of economic agents (producers, consumers, workers, employers) but also of politicians, bureaucrats, managers of public and private enterprises and representatives of associations. As an analogy to maximising profits by private firms it is spoken of the politicians (and parties) maximising their votes, of the public servants maximising the budget of their agencies, of the public managers maximising their salaries and of the lobbies maximising the rents of their pressure groups (rent-seeking). That does not mean that self-interest prevails at all time. In the following the politico-economic approach (see e.g. Frey and Kirchgässner 2002) will be briefly discussed and applied to public procurement.

Principal-agent problems and bureaucratic behaviour

According to the principal agent theory a basic problem with contracts is information asymmetry. The citizens are not able to issue concrete orders to the elected members of parliament and government, and they cannot exactly control whether their orders are carried out exactly according to their will. The same problem occurs in the relation between government and administration.[4]

Whereas citizens and taxpayers have an interest in a good cost-performance ratio, the awarding agencies do not want to be exposed to the risk of contracting with companies whose reputation they cannot judge with the same accuracy as the local competitors. Local companies are often believed to be more reliable. As a consequence, objective aspects (e.g. price or quality) are not always the crucial criteria in the selection of contractors. Procurement agencies are usually risk averse; favouring local suppliers reduces the risk of being accused later of having done a bad job in the case of inadequate delivery or cost explosion (Bohan and Redonnet 1997). Besides this so called "buy-local"-instinct the awarding agencies do not want to jeopardise a good relationship with the local firms simply because of a one-time profit. Risk aversion can also be explained with the presumption that local companies left out are more likely to take legal actions (Bohan and Redonnet 1997, 154). On the other hand, it can be assumed that firms are often reluctant to criticise the procurement agencies. By doing so they would endanger future orders (Arrowsmith 1996).

Rent-seeking and lobbyism

Even without alleging favouritism, the government, the civil service and the procurement agencies tend to equate their welfare with that of the local firms. They feel bound to maintain local jobs, to foster local technology or to ameliorate the trade balance (Martin and Hartley 1997).

If regional firms can be confident of receiving all orders of their jurisdiction this gives rise to the risk of collusion. This is facilitated by the fact that most of the local entrepreneurs and managers know each others. They can either hamper the entrance of new competitors or cooperate with them in view of higher prices and a handsome producer surplus. Until recently, the Swiss anti-trust law did not allow to combate bidder cartels effectively. Such cartels are typically "ad hoc cartels", whereas anti-trust regulation only applied to recurrence. Meanwhile, a new law has been enacted. It will be interesting to see whether it will have an effect on public procurement, too.

[4] The first economists who dealt with that so called "Principle-Agent-Problem" were Jensen and Meckling (1976). A good survey of the status quo is provided by Barberis, Shleifer and Vishny (1998).

According to Olson (1965) and other scholars of public choice it is much easier for the producers to organise their interests in a powerful way than for the consumers, the taxpayers or the citizens. This is due to the fact that the number of suppliers of a certain commodity is small and their interests are relatively homogeneous. Not so for the consumers, taxpayers and citizens. Their interests are heterogeneous. The single person is only marginally affected by protectionist measures. There is little incentive to form a countervailing power to the suppliers' interests.

Another problem, which does not directly affect the bureaucracy and the interest groups, but rather the democratic process as such, is the restriction of re-election, which the parties and politicians are subjected to. Particularly in small political jurisdictions the entrepreneurs, their relatives and employees account for a decisive part of the entire voting public. Politicians and parties increase their political power by privileging the local firms and restricting the number of competitors in the government procurement process.

Conclusions for the Swiss Procurement Policy

We know from economic theory that good rules are essential to guarantee that the great number of economic decisions taken independently leads to an efficient use of scarce resources. This also holds for public procurement. Here the following rules are important (Mattoo 1996, Bohan and Redonnet 1997, Anechiarico and Jacobs 1995, Kovacic 1995):

- Public contracts have to be advertised internationally for bids exceeding a certain amount.
- The specifications have to be transparent.
- Discrimination of non-local suppliers is improper.
- The submission has to make clear all requirements potential suppliers have to meet.
- The suppliers must have some scope to introduce new solutions.
- Discretion regarding sensitive information has to be granted.
- The rules of procurement have to be enforced, and loopholes must be avoided.
- Firms that want to take legal action must have access to an impartial judge.

Our analysis of Swiss public procurement policy has shown that efficiency and welfare losses can turn up in two fields: in connection with the procurement law and in connection with the procurement practice, i.e. the application of the legal regulations.

Procurement law

In Switzerland, the reasons for efficiency losses on the legal level are mainly twofold:

(1) The great variety of rules and regulations lowers transparency and increases the information and transaction costs. The correct application of the law and its supervision become difficult. These problems regard much more the procurement agencies than the firms. The awarding agencies have a tough time negotiating their way through the jungle of today's regulatory diversity, conducting correct submissions and preventing complaints against their decisions. If they neglect the details they risk to get into trouble when, afterwards, the losing competitors oppose the final decision. The clearer the submission prescriptions formulated by the procurement agencies the easier the job for the offering firms. These prefer uniform forms (paper version) and input masks (Internet version).

(2) Legal rules and regulations cannot be formulated explicitly enough to be applicable to each case. This is especially true for orders which cannot be standardised. Too much detail in rules and guidelines may create rigidities and impede innovations.

The revision of the procurement law should take into account the following points:

- *Threshold values*: The observed variety of threshold values is confusing both for procurement agencies and firms. Threshold values should reflect the fix cost associated with an open tender which is approximately the same across jurisdictions, but not different levels of preferential treatment of local suppliers. Harmonisation or minimal standards (i.e. maximal values) are desirable.
- *Award procedures*: The leeway for applying open, selective and limited procedures should be narrowly defined by law.
  Submission and publication: The existing rules already allow public submissions to be carried out via Internet. On a long-term basis, a legal harmonisation would facilitate E-Procurement, too.

- *Selection criteria*: The freedom of the local and cantonal jurisdictions to formulate specific conditions regarding the qualification of the suppliers and the services offered should be restricted. They can easily be misused for protection purposes.
- *Contract conditions*: The guiding principle of imposed conditions must be equal treatment of all suppliers, local and foreign.

Procurement procedures

In Switzerland, the main problem of public procurement consists in the persistence of "old habits". It is a widely held view that local firms as employers and taxpayers must be protected against foreign competitors. Therefore, it is not surprising that the WTO-rules are still not implemented as they should. This is not so much a problem of the procurement law as such, but rather of its application. Consequently, the emphasis should be on a better implementation of the national and cantonal procurement rules. This requires a simplification of the procurement rules in order to increase transparency and create adequate surveillance mechanisms.

- *Monitoring*: The surveillance of the formal compliance with the international and national procurement rules and their interpretation in the sense of competition, transparency, non-discrimination and efficient use of resources must be cost-effective and fast. It must also have a preventive effect. It is up to the lawyers to find adequate ways and means to ensure the correct application of the law. From the economic point of view the creeping development of a big bureaucracy must be avoided and innovations must be encouraged.
  Possible solutions are:
  – formal judicial control, spot-checks by administrative and financial control agencies, the surveillance by the monopoly commission etc.
  – public announcement of "sinners".
  – disclosure of procurement facts (e.g. statistics) so that third parties (media, researchers etc.) can reveal grievances. The E-procurement platform SIMAP could operate in the same direction as it publishes not only the invitations to bid but also the awards of bids.
  – installation of an ombudsman. He or she could collect notifications of infringement or unequal treatment and try to create a counterbalance to the interests of the local suppliers.
- *Incentives to comply with efficiency*: The efficient behaviour must be made advantageous to all parties involved in the procurement process. Good results have been realised by general contractors who, instead of government agencies, are responsible for the submission and the evaluation of the tender. General contractors can accumulate a specific knowledge and they are less subject to political pressure. Last but not least, blunders and misuse are penalised by insolvency whereas government agencies do not have to worry about their existence.
- *Rights of appeal and complaint*: Firms (and persons) experiencing severe losses because of an incorrect application of legal norms should have the possibility to take legal action. The problem is that the citizens and taxpayers as aggrieved parties are not conscious of their losses and are not authorised to complaint today. Furthermore, even for firms the cost-benefit ratio of a formal opposition is often negative. A simpler, faster and less costly procedure is needed.
- *Control of effectiveness and efficiency*: As in other policy areas, a systematic review of the procurement activities on all levels of government should be organised from time to time. The results could serve as a background for further improvement of the government procurement policy and practice.

How much harmonisation?

At the moment, the federal government and the cantons are preparing a reform of the public procurement law. Four reform models are being evaluated (Biaggini 2003a):

- The revision of the existing *intercantonal treaty* (Konkordat) does not go far enough. It leaves too wide a scope to the cantons and to the local jurisdictions for discrimination against foreign competitors. And it takes too much time, making the quick realisation of efficiency gains from E-procurement unrealistic.
- A new *federal law formulating guidelines* (Bundesrahmengesetz) for the subnational legislation cannot solve the problems detected, either. The deficiencies are not primarily due to lacking legal norms but to their application in practice. The opening of the markets and the equal treatment of all competitors must be enforced.
- A *partial harmonisation* of the procurement policy in a new federal law would be the best solu-

tion. It would allow the harmonisation of the technical aspects necessary for E-procurement and could enforce the factual opening of the procurement markets without intervening too much into the local autonomy apt to take into consideration specific local circumstances.

- The *complete harmonisation of the procurement law* via a new federal law is not necessary. Such a solution would infringe the principle of subsidiarity and provoke a strong opposition by the cantons.

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