

THE PUBLIC PROCUREMENT SYSTEM IN RUSSIA: ROAD TOWARD A NEW QUALITY¹

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Abstract

This paper examines main principles forming the basis of the Law on placement of orders for government procurements (94-FL) in its current version. We outline a whole set of positive changes as well as negative developments following this legal practice. We pay special attention to discussion of problems and imperfections in the system singled out by real participants in the procurements. We formulate a range of challenges and tasks to be solved in a new version of the Law on government procurements, and offer an indispensable set of conditions to be allowed for solution of these tasks.

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Introduction

Public procurement sector plays an important role in countries with developed market institutions as well as in transitional and developing economies. An indispensable condition for development of the public procurement sector and the economy as a whole is creation of discrete and transparent conditions of interaction between potential parties in the process, prevention of corruption and establishment of a competitive environment.

Meanwhile, creation of an effectively acting institution of public procurements is an extremely difficult task for a number of countries - either because the very system of such relations per se was non-existent for a long period (for instance, in the countries with planned socialist economies), or because they have deep-rooted weak institutions liable to manipulating and corruption and existing under suppressed competition⁵.

In this case, Russia is no exception: the Russian field of government procurements has undergone successive stages from absence of this sector per se, through practice of extremely disordered relations between suppliers and purchasers, to enactment of the Law on government procurements which is now in force.

The Federal Law "On placing orders to supply of products, production performance, rendering services to satisfy public and municipal needs" (94-FL) has become effective four years ago. One of the most radical reforms in the second half of the first decade of the millennium has a profound impact on many economic agents both in public and private sectors.

One of the certain positive results of the reform is that **public procurements established themselves as an institution**: the system of rules that regulate the behavior of actors on public procurement markets accompanied with a mechanism of their enforcement. While before 2005 the only operative instruments in the area were declarative normative acts that set no limitations to arbitrary decisions of public customers, the 94-FL introduced a system of public procurement regulating standards, together with mechanisms of sanctions for violating the norms. The enforcement practice in 2006-2009 (sometimes contradictory judging by consequences) proves the necessity to make public procurements

⁵ See, for instance, Trybus (2005) about the importance of higher efficiency of legislation on government procurement in the context of expansion of the European Union; Gelleri and Csaki (2004) and Gozel (2005) on specific experience gained in Hungary and Turkey, respectively. Difficulties in reforming this sphere, typical of developing economies, are the object of detailed discussion in this Hunja (2003).

more adequate and to move the whole public procurement system to a new level of development. To make such progressive steps, one first needs to analyze the reform key ideas and its principal results in an objective and unbiased way.

The experience of creation of a market for public procurements, formation of its institutions and regulation in Russia enables us to assess the basic difficulties and risks related to design of institutional rules in the market in the countries with transitional and developing economies, and also to draw a number of lessons that may be useful for the economists who are engaged in the design of the respective rules. This paper is devoted to discussing these difficulties and risks.

The paper is structured in the following way: Section 1 describes basic principles underlying the current legislation on government procurements. Section 2 summarizes main results and problems related to operation of this piece of legislation singled out by real participants in the procurements. Section 3 gives a description of these problems following from the basic principles of legislative requirements, as well as arising from the practice of enforcement. Part 4 discusses challenges and challenges and tasks in the context of further reforming of legislation on government procurements.

1. The public procurement reform in Russia: underlying assumptions and main idea

Radical changes in the public procurement legislation in 2005-2006 were of objective nature: at the beginning of the decade public procurements grew (visibly faster than GDP) against the practice of inefficient regulatory mechanisms in the sector – the legislation rather provided some general framework no sanctions for poor performance and opportunism. It resulted in growing corruption in the public procurement system⁶ and growing concern on the side of the Government.

Adoption of the new version of Federal Law (FL-94) in 2005 was a reaction to the existing problems. Its design has been based on the idea that following key elements should be provided by the new legislation:

Conditions for competition. To ensure competition, all economic agents were to be guaranteed free access to in participation to procurements, small and medium enterprises (SMEs) in the first place. To ensure access for new participants it was prohibited to set

⁶ Enlarged scale of corruption was indirectly confirmed by reduced average number of applications at public procurement bids, increased share of public contracts placed with one bidder and other similar indicators.

qualification demands when assessing and selecting applications; suppliers' "quality" features (such that qualifications and business reputation of potential performers) were brought to a minimum⁷. To foster SME entrance to the public procurement sector the 94-FL set very low thresholds to make competition purchase procedures for public customers obligatory (60 thousand rubles in 2006-2007, 100 thousand rubles till present⁸).

High degree of procurement transparency. Prior to the 94-FL tender information might be published at a local newspaper almost without any standards to be met. Under new law all the procurement information was unified and placed at a common official Internet-site <http://www.zakupki.gov.ru/>. Another extremely important feature of the new law which aimed way to make public procurements more transparent and limit bid manipulations by public customers, was an adoption of a "minimum price criterion" according to which the winner is selected among eligible participants on the price basis only.

Instruments for preventing and controlling corruption. Corruption in time of the 94-FL development and adoption was viewed as a key problem for public procurement sector. To prevent corruption and decrease opportunities for opportunistic behavior of all participants an approach under which any freedom of choice by public consumers has been minimized or eliminated. This has been achieved by an adoption of formal and unified approach to all procurement procedures with drastic limitation of public customer's abilities – and its procurement-responsible employees.

No doubt, all these elements are interrelated to some degree. For instance, the importance to ensure competition as one of the factors in prevention of corruption is mentioned, for example, in Soreide (2002). The role of transparency as a basic condition for prevention of corruption with regard to transitional economies is discussed in DeAses (2004).

Enforcement mechanisms. To make the set of formal rules which limit and structure activities and abilities work efficiently, a system of sanctions is needed for violation of these rules, a system of compulsion that allows minimizing risks of opportunistic behavior of in the process.

So a set of sanctions stipulated in the Code for Administrative Violations has been introduced. If the 94-FL rules

⁷ About successful experience in Chili in attracting small and middle-sized enterprises to the market for public procurements and mechanisms used for elimination of related barriers, see Escobar (2008).

⁸ Which is about 3000 USD.

were not obeyed, the Federal Antimonopoly Service and its territorial bodies might cancel bid results and impose fines on procurement-responsible officials in public customer organizations. Later the 94-FL was treated as a part of antimonopoly legislation and aligned with the Federal law “On protection of competition” (135-FL). Sanctions for breaking the 94-FL were expanded to the level of criminal liability. Complaints of suppliers whose interests suffered in the bid process were reason enough to start a case and impose sanctions. In case of arguments controlling bodies based their actions on presumption of supplier’s good will and customer’s unfairness.

2. Certain results

The 94-FL was approved in July 2005 and became effective since 2006. The law received notable political support and was accompanied by sufficiently increased scope of public procurements: their volumes were doubled between 2006 and 2008, from 1922 bln rubles to 3981 bln rubles. Rate of growth of public procurements in the post 94-FL period visibly bypassed dynamics of GDP.

However enforcement problems started to appear almost from the moment when law became effective. Thus, according to data of monitoring conducted by the HSE Institute for public procurements almost 80% of tenders in year 2006 were accompanied with violations of the 94-FL. In 2007 the indicator went down to 60% and stayed almost unchanged till present.

The widespread procedural violations by different parties were given numerous explanations. Public customers mentioned difficult 94-FL procedures, lack of specialists, Budget Code limitations. The legislators however stated that procedural violations came from unfair competition and public customers’ preferential treatment of certain suppliers.

At the same time, practice of public tenders under the 94-FL, revealed numerous objective problems that make hard for public customer organizations to perform their key functions⁹.

At the stage of tender preparation among the most severe problems are:

Detailed performance specification is not enough to guarantee proper quality of procurement. In cases of mass standard products such a problem doesn’t arise. However the problem is extremely important for products/works/services, whose quality may be

⁹ The list of the problem has been compiled on the basis of the survey of public customers and number of in-depth case-studies conducted in the framework of HSE research project “Functional analysis of the public procurements system and proposals to improve it”.

assessed only in the process of operation/use of a procurement object or even after its use.

No credible base for objective assessment of contract starting prices. Customers complain that no methodology guidelines related to determination of contract starting prices are currently available. Information on prices for similar products is inaccessible as well. Theoretically an Internet-site www.zakupki.gov.ru might be such a source for public customers, but currently it is interfaced to satisfy needs of a regulator instead of considering demands of the market players. Absence of publicly available information on prices in similar procurement contracts and absence of methods to determine prices brings about conflict situations¹⁰.

At the stage of order placement most respondents mention time-consuming nature of open competitions/auctions procedures, which hindered normal activity of customer organizations, especially in the absence of applications. Also, documental support of an application is considered as procedurally imperfect (including inability to get data, supporting and substantiating information that is contained in supplier's application).

Other problems are usually attributed to: risks of suppliers' opportunistic behavior (deliberate price cutting by agency firms to catch a contract from real suppliers and later get from them or from a customer compensation money for refusal to sign a contract) and inability to prevent such a behavior; inability to secure interaction with the same supplier who made good impression in time of past supplies (it is especially important when you need to serve previously supplied equipment, IT-systems etc.); necessity to use auction procedures to make unique procurements (the market has only one real supplier, capable of insuring good quality of products, works or services).

As to the performance stage these problems include:

Inability to modify contract conditions in order to adapt to changing outside conditions. In many cases public contracts are signed under high uncertainty caused by a number of external factors. It is mostly typical for large procurements with long fulfillment periods. Prohibition (in the time of a placement) to make any changes into contract terms may seriously impact the public contract execution. For instance, such a limitation may influence contract

¹⁰ One of the respondents referred to a participating company which in the course of a bid cut its starting price for computer-supply contract by 49%. The customer organization was reprimanded by controlling bodies for excessive starting price of the contract. As a result the contract was executed, but the supplied equipment was different from that expected by the customer, with different starting price – it was a lower quality “equivalent”.

results for design works. In the process of implementing design contracts, especially in the historic city area, initial conditions may change due to pre-design stage results with high degree of probability. Prohibition to introduce changes into public contracts, set at the order placement stage, may cause the design contract to be suspended or terminated.

For example, IT equipment supplies with its quick technological changes pretty often face similar problems. If the contract execution takes longer than 6 months, some models of computer equipment may be put out of production, but a supplier is usually ready to supply newer and better model for the same price. At the same time public customers, having no right to introduce changes into specifications of the procured equipment, should say no to supply of newer and more modern computers. They are also devoid of right to lower prices for outdated and objectively cheaper models. As a solution the so-called “frame performance specification” and “frame contracts with sliding conditions” may be used specifying only procurement cost and approximate range, as well as rules and procedures for adjustment.

High risks of poor quality products. A customer who prepares performance specification understands perfectly that participants would agree to all quality demands regardless of their real possibilities, while the actual quality may be assessed only when products are delivered. Thus, references were made to design and survey works – a customer is totally unprotected from the bids of small organizations, which at a later stage may prove themselves incapable of executing a contract fully and properly. The point is that it is not possible to assess the contractor quality in advance in line with the current legislation (prohibition to apply qualification demands to participants). But customer’s expenses for construction-assembly works, maintenance and servicing of the project seriously depend on quality of design and survey works made by a contractor. In case of IT-products low quality of procured components for periphery equipment (toners, cartridges etc.) bring about malfunctions and even complete incapacitation of costly IT-equipment. There were instances of unscrupulous suppliers offering half-price for products and readily agreeing to provide services to repair failing parts. Technical components of low quality are used for such repairs with repaired parts working for about 2-3 months and then failing again. As a result total customer’s losses dramatically exceed savings from purchase of cheaper components offered by unscrupulous suppliers.

Untimely supplies. Facing untimely supplies by the end of a calendar year, public customers have to choose whether to keep back from a supplier the last tranche (meaning to return money to the budget and stay without required products, works and services) or

make “a deal” that payment would be made in an accounting business period, and supply would come later. The first option is in line with spirit and letter of the 94-FL, but hinders normal activity of a customer organization. Therefore usually customers choose the second option and enter an informal zone of relations with their suppliers.

Limited capacities for bringing an abusive supplier to order. Under the 94-FL provision to register public contract violators in a special list of abusive suppliers is possible only in two cases – refusal to sign a contract; its termination by court ruling. However numerous precedents do not fall within these borders. Besides, the measure may have effect only on good will real companies, but cannot intimidate fly-by-night companies set specifically for “one time” participation in a bid. Similarly, possible compensation of losses through courts or insurance of contract non-performance risks or mechanisms of bank guarantees cannot resolve customer problems, which affect customer’s main activity in case of supply of poor products, services or untimely supply.

Manifestation of these and other problems in time of implementing new system of supplies brought about numerous minor amendments to the 94-FL. 19 packages of amendments were made in the period of 2005–2009. The legislation activity was increasing with time: 2005-2006 saw only 2 packages of amendments to the 94-FL, 2007-2008 – 7, in 2009 the law was amended 10 times.

The legislation activity was dictated by the desire to put the 94-FL in line with real life practices and reflected the situation in the public procurement institution. However such a development had internal contradictions.

On the one hand, significant part of the 94-FL amendments was in line with the law main ideas. A striking example relates to electronic auction standards. It is a definite plus in case of simple standardized products. On the other hand, the legislators were to respond to problems manifest in the process of the 94-FL implementation, especially in dealing with complicated/unique procurements. But the legislators failed to typify such problems and secure proper development of procurement instruments. Instead they took the approach of implementing individual solutions for individual cases – mostly by relieving certain procurements from the 94-FL competition procedures (see Box 1).

Box1. Exemption of procurements from 94-FL competition procedures

A list of instances related to placing orders with one supplier (performer, contractor) is specified by article 55 of 94-FL. The article was amended 7 times and expanded 3 times due to an extended number of cases added to the initial version of the law. In addition, 20 new items and articles 55.1 and 55.2 were introduced. Initially these exceptional cases dealt with local objects (for example, “order placement to visit zoo, theatre, movie house, concert, circus, exhibition, sporting event” – amendment dt. July 24, 2007), but they later came to cover large blocks of public procurements. In May 2009 amendments were introduced in anticipation of the Vladivostok Asian-Pacific Economic Cooperation summit in 2012 and dramatically relieved purchases from 94-FL regulations in order to secure the summit. In the long run, article 55 on placing orders with one supplier came to unite various cases of placing orders without bids, including: a) a supplier being truly unique, for instance, in the case of placing orders to supply armament and military equipment that have no Russian analogues and are manufactured by a single manufacturer; b) the inadvisability to hold auctions, for instance, in the case of required business trips (booking air tickets and hotel rooms); c) permission for customers and suppliers to place orders without bids, for instance, if a supplier (performer, contractor) is specified by a decree or a command from the RF President or the RF government.

One of the consequences of such an approach to the procurement legislation amounted to the following: despite its initial simplicity the 94-FL turned to be an extremely complicated and internally inconsistent normative act. The law expanded more than 3 times (from 47 to 147 pages). Many of its norms leave room for interpretation, practical enforcement and control body directions collided with the Civil Code norms.

The law was characteristically treated by the Federal Antimonopoly Service and Courts of Arbitration in a different way. Particularly, Courts of Arbitration, in line with the Civil Code norms, considered specific cases and took the following decisions: it is proper to change a cost of the construction work contract if a contractor makes his argumentation convincing; it is proper to set demands in performance specifications related to describing technology of works, employees and equipment to be used as well as other requirements which precondition successful quality performance; it is possible to set rights of a public customer to terminate a contract unilaterally in the project documents, it is possible to change terms of a contract without changing a legal nature of a contract object.

Further discussion of a systemic improvement of the legislation on public and municipal procurements needs to be based on a systemic analysis of arbitration practices as well. Presently the Supreme Arbitration Court has gained notable experience in the area of the legislation on public procurements. It should be understood that the fact itself of court litigation against orders of control bodies would bring about – with high degree of probability – a reciprocal attention of the bodies to operations of a litigating public customer. In this respect legal actions are considered by the majority of public customers as a last resort, and rulings of the Supreme Arbitration Court are meaningful both in quantitative and qualitative ways – as an important indicator of the public procurement legislation efficiency. The 94-FL inconsistency was, probably, the key reason why the public procurement reforms failed to reach its goals. Thus, according to Rosstat data, costs of bid contracts in 2006 were three times as big as public orders placed with a single supplier. These indicators were almost equal in 2008, and in January-September 2009 government spent in single source contracts already more than in bid procurements. Importantly, the dramatic growth should be attributed not only to exceptions for certain products or categories of customers, another reason being “frustrated bids” with only one participant admitted or no participants at all. Mass nature of such situations seems to be illustrative of the fact, that the 94-FL requirements often create problems for non-opportunistic public customers and fail to secure good encouragement to attract non-opportunistic suppliers.

The U-HSE came to similar conclusions in the framework of large survey (encompassing 957 manufacturing firms) organized on orders from the Ministry of Economic Development in February-June 2009. Heads of enterprises were asked to assess the general consequences of the changes made to the law on procurements. For each question, respondents were allowed to select any number of responses from a large set of options – like ‘greater opportunities to participate in public procurements’, ‘improved competition and transparency in public order distribution’, ‘additional complications of bid procedures’, ‘more rigorous demands on suppliers’, etc.

According to Table 1, companies performing public orders in 2008 cited the additional complications in public procurement participation procedures as the most serious problem (34% of respondents). The next most frequent complaints pertained to increased bid competition (26%), increased costs of public procurement bid participation (26%), increased demands from public customers (24%), and more room for dumping by unscrupulous suppliers (23%). However, only 12% of respondents made reference to the increased transparency of public procurements.

The U-HSE questionnaire included questions on “kickbacks” in the public procurement system and on the participation of companies in public order supplies. Since the same questions were asked by the World Bank for a similar sampling during the first round of this monitoring project in 2005, we had a unique opportunity to compare the situation before and after the changes to the law on procurement. In both cases the questions related to preceding periods; our comparison concerned the years 2004 and 2008.

In answer to the question, “How often do enterprises of your industry have to give bribes or ‘kickbacks’ to receive public or municipal orders?”, 17% of the 2009 respondents chose the response “practically always” or “often”; 22.5% of the companies said “sometimes” (see Table 2). The corresponding figures for 2005 were 20% and 14%.

Table 1. Heads of enterprises responded to the question: “How did changes in the public procurement regulation in 2006-2007 impact enterprise activity?” (% of respondents; spring-summer 2009; any number of answers permitted)

	Total sampling	Small firms (below 250 employees)	Big firms (over 1000 employees)	Firms receiving public orders
1. New opportunities to participate in public procurements	10.8	10.0	12.4	17.9
2. Increased competition among suppliers	16.1	15.5	18.2	25.6
3. Public procurement system became more transparent	7.5	5.8	8.0	12.3
4. Public customers raised general demands for suppliers	14.2	11.8	17.5	23.8
5. Reduced requirements relating to suppliers' experience and qualifications	7.4	8.6	2.2	11.5
6. Document preparation to participate in public procurement bids grew more complicated	20.3	20.6	23.4	33.8
7. Increased expenses for participation in public procurement bids (preparation of bid documents, provision of collaterals, etc.)	15.3	14.4	19.7	25.6
8. Participation in public procurements became less profitable	11.8	13.0	13.1	22.0

9. New possibilities for dumping by unscrupulous bidders	14.3	14.2	14.6	23.0
10. Other	2.9	3.3	2.2	2.3
11. No principal changes	28.2	29.2	24.8	21.0
12. Hard to respond	30.1	29.3	30.7	13.8
Number of firms	957	431	137	391

Table 2. Heads of enterprises in the manufacturing industry responded to the question: “How often do enterprises of your industry have to give bribes or ‘kickbacks’ to receive public or municipal orders?”

	2005		2009	
	Number of firms	Sampling share (%)	Number of firms	Sampling share (%)
Practically always	87	8.7	60	6.3
Often	117	11.7	104	10.9
Sometimes	142	14.2	215	22.5
Never	366	36.5	338	35.3
Hard to respond	290	28.9	240	25.1
Total	1002	100	957	100

In other words, before the system of public procurements was reformed, “kickbacks” were mentioned by 34% of the companies surveyed; three years later, the figure climbed to 40%. On the positive side, the share of enterprises that considered “kickbacks” to be a mass phenomenon declined by 3%. The proportions remained the same for the companies performing public order supplies in 2004 and 2008.

Thus, the U-HSE analysis of the processing industry demonstrates the high costs of bid participation for suppliers and makes it clear that the passage of 94-FL had very little effect on corruption levels.

We have to stress again here: the 94-FL enforcement problems are different at different markets. Obvious positive results in case of buying simple standard products are accompanied by losses, when it comes to buying technically complicated products and services¹¹. As a result non-opportunistic public customers were

¹¹ Structure of risks related to supply of goods of improper quality and costs of evaluation of the quality differ depending on the category a given good belongs to – whether it is an inspection, experimental or credence good, - and depending on what institutions for independent evaluation of quality

seriously encouraged to pull their procurements out of rigorous formal frames of the 94-FL. Consequences were different depending on “political weight” of corresponding agents. For instance, the Ministry of Emergency Situations and the Ministry of Defense even at the initial stage of the law preparation managed to introduce pre-qualification of suppliers for procurements in their ministries. As far as we know, the 94-FL problems in relation to buying complicated products and services, at a certain stage contributed to a common decision to pull public corporations outside the borders of the 94-FL. As to less influential agencies, they managed to mitigate the 94-FL demands only partially – like in case of price limits in procuring R&D or obtaining permissions to conduct pre-qualification for large-scale construction projects.

It should be noted that in 2006 the World Bank experts paid attention to 94-FL inconsistency, when in case of the Ministry of Emergency Situations and the Ministry of Defense suppliers were to be pre-qualified, but it was not the case with procuring medical equipment. Besides, the World Bank stressed the necessity to introduce pre-qualification of suppliers and other “quality selection” procedures for all procurement of “complicated” products and services¹².

The country leadership understood imperfection of the existing system of public procurements and put in item 35 on development of legal acts related to improvement of the public procurements legislation, including procurement of technically complicated products, into the RF public anti-crisis program for 2009. The RF presidential address on 2010–2012 budget policy contained the following instructions: improve mechanisms of public procurements through the use of modern procedures of order placements, client consolidation and comprehensive methods of investment project management. The budget address maintained that the system of public procurements should exclude cases of overpricing and signing contracts with obviously incompetent contractors, as well as procedural delays; public procurements should be used as an instrument to manage structural transformation in the Russian economy, encourage technological modernization and improve competitive edge of efficient manufacturers.

3. FL-94 in practice: main sources of the existing problems

and building of reputation of producers exist in a given market. (See Pivovarova and Yudkevich (2009)).

¹² Country Procurement Assessment Report, Worldbank, 2006

Analysis of the 94-FL basic notions proves that the law ideology was targeted at a specific type of markets, which were close to an ideal model of *perfect competition* between “atomized” companies which manufactured homogenous products and have at their disposal full information about the same products made by their competitors. While such a market type is quite common, but it is not the only one. So, the standard classification of goods into inspection, experimental or credence ones (Darby and Karni (1973), Kuzminov et al (2006)), based on the structure of costs of evaluation of their quality, and a number of typical problems in market deals with each of the above mentioned types that were singled out by economic theory allow to make a conclusion that the problems arising under the existing legislation in the markets of goods differing from the standard inspection ones were quite predictable and expectable. (Pivovarova, Yudkevich (2009)).

Procurement procedures for different types of products, works and services have no practical distinction under current law, so the most important problem for the majority of non-opportunistic public customers is *non-performance risks or poor performance of public contracts* and corresponding *potential losses*. The authors of 94-FL assumed that mechanisms of *future court sanctions* against suppliers for breaking contract conditions are sufficient enough to compensate for all possible losses of public customers and even prevent possible opportunistic behavior of suppliers.

However such an approach does not take into account several important issues. First, monetary compensation does not always make up for losses of time, especially considering the budget process specifics, inevitable for public customers. Second, insufficient quality of creative works (research and design, pieces of art etc.) is hard to prove in court. Third, even if with time you manage to prove poor quality of supplied products, procurement of substandard drugs for medical institutions or supply of substandard equipment for waste disposal plants are fraught with losses, which may significantly exceed the cost of the initial procurement. Finally, products at high technology markets are quickly renewed and cheapened - therefore a requirement to fix all quality characteristics in bid documents with court procedure being the only way to reconsider a contract brings about direct losses in quality and efficiency.

To cut down risks in the process of buying “complicated” products (services, works) you are supposed to take into account

*qualification and reputation of suppliers.*¹³ Foreign texts take the issue for granted and discuss rather proper mechanisms of accounting under different circumstances. Foreign science and experience offer convincing recommendations on the use of special procedures (two-stage bids, competition negotiations etc.), and on *optimizing quality-price ratio criteria* for different types of products and services. The world practice also uses scientifically approved *adaptation mechanisms* of signed contracts to changing external conditions – but changes are to be *transparent*.

Unfortunately, foreign experience was not properly studied in the period of the 94-FL preparation. Moreover, the World Bank' warnings on the law-related risks, later proved to be right, were brushed off without any coherent reasoning¹⁴. The 94-FL permits to use in Russia *less than half of procurement methods* presently used worldwide – the simplest and easiest to control were moved outside the Russian list. Notable part of general ways to make public procurements more efficient was prohibited, which brought about serious problems for non-opportunistic public customers, interested in supply of products and services timely and in line with quality standards. Under such circumstances more influential public customers used their opportunities for “administrative bid” and did their best to pull their procurements outside the 94-FL. Others were doomed to look for “bypass ways” to cut away dishonest (or potentially dishonest) suppliers. But such activity *easily makes room for corruption*. As a result it is very difficult to make a distinction between *honest* and *opportunistic* agents.

We may state that the 94-FL has really encouraged competition (it was previously mentioned by suppliers in the HSE study). But particulars of competition at different markets, including risks of honest competition being pushed out by dishonest one from markets with objective prerequisites for such activities, thoroughly analyzed by the economic theory, were not taken into consideration. Contrary to natural theoretic demands conditions to identify non-opportunistic and competent procurement participants (for instance

¹³ Qualification and reputation checking in the process of procurement have been discussed both in theoretical and practical literature. Theoretical backing of limited number of potential suppliers in case of special quality demands is given, for instance, in Bakos et al. (1992, “When quality matters: information technology and buyer-supplier relationships”). Positive role of pre-qualification in fighting corruption is shown in Calzolari and Spagnolo (2005, “Reputation and Collusion in Procurement”). Automatic pre-qualification procedures are discussed in economy-computer works, for example Ng et al. (1998, “Case-based Reasoning for Contractor Prequalification”).

¹⁴ See (Worldbank, 2006)

past market behavior and activity of companies) were not secured; similarly, mechanisms to cut off opportunistic participants were not used (for instance, requirement to justify price and decline an application in case of negative expert assessment of such a justification).

Also, the public procurement participants may be easily *pushed to set informal relations* due to necessity to use procurement procedures for *small procurements*. The 94-FL developers deliberately insisted on binding procedures even for small procurements to fight corruption and barriers for SME participation in public procurements. Thus, in 2006 the law covered all procurements above 60 thousand rubles (the limit was raised in 2007 and reached 100 thousand rubles). Importantly, international practices set any special competition procedures if procurements exceeded 50 thousand dollars. As is seen from the Box 2, much lower “price thresholds” after adoption of the 94-FL brought about visible increase of customer expenses.

Besides, small procurements were characterized by *lack of interest to bid* on the suppliers’ side – due to *high expenses for bid documents* and low final financial result. So in many HSE “instances” public customers were forced to talk potential suppliers into applying for a bid and prepared bid documents themselves. The reason is simple: without formal bid and presence of at least one supplier a public customer had no right to start spending allocated budget funds and perform its main activity. At the same time the selected supplier, using its “monopoly” status, might impose upon the public customer quite unprofitable procurement conditions. So informal relations were set anyway together with additional public customer expenses – thus discrediting the 94-FL in the most direct way, since all the process participants were assured of economic unprofitability of bid procedures.

Box 2. Procurement expenses for contracts of different scale

The HSE 2009 calculations on 750 public contracts, signed by one public customer – a large budgetary organization – produced the following results. Expenses for procurement administration (sum total of salaries of procurement specialists, financial specialists, performance specification specialists, bid committee and corresponding material expenses specialists) constituted about 0.6% of total contractual costs. But the whole amount of analyzed procurements was divided into contracts above 1.5 million rubles (about 50 thousands USD) and below 1.5 million rubles; labor expenses for preparation of such contracts were also taken into consideration. As a result in case of larger contracts averaging 20 million rubles expenses amounted to 0.15-0.20%, but in the second case they went up to 7.5-9.0% (average contract less than 400

thousand rubles). The expenses were actually ‘imputed’ to public customers, regardless of possible reduction (or non-reduction) of procurement price.

Thus, the legislation’s simplified approach to market mechanisms, along with the assumption of *total corruption among public servants* (hence the rigorous formalization of all procurement procedures), actually ended up increasing expenses for *bona fide (non-opportunistic) agents*. The latter were faced with an unpleasant choice: running the risk of procuring a low quality supply or engaging in informal arrangements with suppliers. At the same time it was impossible to impose efficient sanctions for violations (no regulator can impose fines on tens of thousands public customers for missing application assessments or protocol publication deadlines, etc.), which played into the hands of mala fide corruption-prone agents. So instead of encouraging procurement participation and stronger competition, the new system of public procurement regulation generated additional possibilities for establishing informal relations between public customers and suppliers, creating the ideal environment for “latent” corruption.

The model of public procurements implemented through the 94-FL seems to have its positive side – saving budget funds due to reduced procurement prices in the frame of bid procedures. Mass media mentioned aggregated savings of 500 billion rubles directly attributable to the law. To get the bottom line figure the sum of real cost of all signed contracts in Rosstat form “Bid-1” was detracted from the sum of initial prices of all purchases. But, as a matter of fact, initial prices were never controlled and might be extremely high, especially for demonstrating the economy of scale. Besides, for a long time the first part of the Rosstat form (with starting prices) included data on all bids – those that really took place, and those that did not. The second part of the form reflected only bids that really took place. Accordingly, the 94-FL economic effect was automatically increased by the sum of bids that did not take place at all.

Altogether the HSE analysis of data collection of the public procurement results makes it clear that during the four years of the 94-FL the unified system, aimed at monitoring public procurements, did not fall into place. The Federal Anti-Monopoly Service, the Ministry for Economic Development, the Federal Treasury and Rosstat demand big volumes of primary information from public customers, but do not analyze it in practical terms. Moreover, the format of collecting and presenting the data on sites www.zakupki.gov.ru and <http://reestrgek.roskazna.ru/> makes its analysis by public customers and suppliers next to impossible. The situation is quite illustrative of the point made by the Nobel prize

winner Joseph Stiglitz: oversupply of unstructured and non-systematized information is equal to its absence¹⁵. At the same time certain Russian corporations (both private and state) have already formed information systems of their own which function and secure efficient monitoring and control their procurements. This kind of experience needs to be taken into account to develop a monitoring system of public procurements.

We may conclude the theoretical analysis by saying: the 94-FL developers tried to create universal and easily manageable and controllable system of public procurements. One of the understandable motives was to secure all-round control without making the regulator's activity too complicated and expensive. But the management theory tells us: a managing system cannot be simpler than a management object. In this respect it is not surprising that the developers' methods proved to be adequate only in case of simple products and markets. At the same time attempts to squeeze "complicated" procurements into a regulator-convenient set of "simple" procedures caused serious problems and additional expenses for non-opportunistic suppliers and public customers.

4. Public procurement in Russia: a strong need for further development

Our analysis allows getting a list of important challenges that should be properly addressed in the framework of new procurement legislation.

First, a comprehensive system of risk management in the procurement area is required, at all stages of a procurement cycle. Corruption was considered to be the main risk factor when 94-FL was prepared and adopted. However, experience of the law implementation demonstrated the existence of significant risks of opportunistic behavior and incompetence of suppliers, causing non-performance risks. At the same time, corruption risks were transformed and migrated to other stages of the procurement cycle. The system of severe constraints and prohibitions, instead of curbing corruption and abuses, turned them into other, often latent, forms: collusion between a customer and a supplier through excessive elaboration of contract specifications to be met by concrete suppliers only; increased number of bids with one participant (who eventually sign a contract for a price close to the opening bid); collusion between potential suppliers, which are registered and allowed to take

¹⁵ See Stiglitz J.E. 1985, "Information and Economic Analysis: A Perspective" and other works of the same author. Influence of methods and level of disclosing information on purchase results are also thoroughly discussed in Handbook of Procurement, Dimitri, Piga and Spagnolo.

part in an auction, but do not directly participate in an auction, therefore a contract is signed at a price close to the starting one; disruption of order placement procedures by “grey” participants who make dumping applications or ungrounded complaints on customers’ actions; informal argument settlement due to non-performance, untimely or bad contract performance, caused by a selection of opportunistic suppliers or customers’ incompetent actions.

Both types of risks – corruption and non-execution of a contract – should be minimized. We believe that this goal could be only achieved if a system aimed at satisfaction of the public needs will be considered in a whole – including an order placement stage (the 94-FL main focus), stages of procurement planning and contract execution. Year 2009 saw a renewed discussion of the Federal contract system, which means that the government is well aware of the problem. However, one has to move in the proper direction faster.

In order to resolve the risk management problem in the public procurement area it is necessary, together with covering all stages of a procurement cycle, to build effective and efficient barriers to the public procurement system for opportunistic and incompetent agents – both suppliers and customers – through corresponding mechanisms of selection, incentives and sanctions. Criteria for “non-opportunistic behavior” and “competence” are required and may be defined only in the content of assessing final results: suppliers are to observe and properly perform their obligations as to supply of products, works and services; public customers are to perform their main functions, for which they need public procurements, in the most efficient way.

Second, the above implies another important issue – a strong need to balance regulation goals against final procurement efficiency. Currently legislative activities concern tendering procedures only, and procurement efficiency is considered by controlling agencies purely in view of the 94-FL procedures. However, in reality, the final goal of procurement is to provide for the public needs; the regulation system has to be tuned properly to implement this particular goal. The readjustment and dramatic extension of the regulation system needs efficient monitoring of public procurements. We discuss these principles below.

Third, rights and liabilities of suppliers and public customers are to be harmonized. Before year 2005 the imbalance was in favor of public customers, while under 94-FL it has been shifted toward suppliers. It is time now to restore the balance by finding proper combination of rights and liabilities of suppliers and customers and ensure in both cases a protection of interests of all non-opportunistic participants of the public procurement process.

Following the international experience, development of fair competition in the public procurement area together with

encouragement of good quality of supplied products and services is made by non-discriminatory policy – applied to all procurement participants - of qualification rules, which are to be thoroughly specified, standardized and customized for a particular procurement. The level of competition should not be evaluated only by minimum price criterion; consolidated criteria of competitiveness are to be taken into consideration: procurement economic efficiency for its whole life cycle (including price, quality and reliability).

Fourth, the costs of all participants (both suppliers and public customers) that arise due to 94-FL rules and constraints should be taken into account. So far the regulation system was rather built to simplify administration processes for the regulator. Such approach helped to cut down regulation and control expenses. However, such expenses of both suppliers and customers are also important as in the long run these expenses are always included in the procurement final costs. The supply price is either made absolutely excessive in the absence of sufficient bid competition (which is predetermined by overcomplicated bid procedures and non-attractive conditions for suppliers to participate), or the price goes up indirectly, if supplied products are of low quality. Additional expenses of public customers make them perform their main functions in smaller volumes or with inferior quality.

We believe that challenges described above could be only overcome by the harmonized development of the public procurement system along the following interrelated directions:

- Gradually *curtail the area of non-regulated procurements* (including procurements by public corporations and natural monopolies, whose regulation is presently under discussion by the government)
- *Expansion a spectrum of procurement procedures and creation of possibility to adapt signed contracts to changing external conditions;*
- The expansion of procurement procedures is attributed to the necessity of *expanding public customers' powers* – they require more rights to choose procurement procedures. To prevent the risk of corruptive behavior, it is expedient to give such rights to public customers at a higher level – first of all to the main public fund distributors (MPFD). At later stages, these “qualified public customer” rights may be given to other large organizations – on the basis of the final degree of efficiency of their previous procurements.
- *Creation of multilevel system for monitoring and control*, based on consistent public system procurement information acquisition; the system should constitute ground for assessment of final efficiency of procurement and reveal possible cases of opportunism in the public procurement practice.

To build a *working system for collecting and analyzing information on public procurements* will make a starting point in bringing the public procurement regulation system to a new stage of development – together with controlling obedience of the 94-FL rules, the Government will also be able to see the whole procurement cycle and assess final procurement results.

Certain features should be provided to secure a successful functioning of such a system¹⁶.

First, information flows should be divided for standardized (mass) and non-standardized products and structured for groups of products, works and services (based on approved classifications of products and services). In case of standard (mass) products one should be able to compare prices and other supply conditions for MPFDs, public customers, different modes of procurement etc. Such an approach will also enable MPFDs and controlling bodies to check whether procurement starting prices are sound. For non-standard products direct comparisons of prices and other procurement conditions would be mostly impossible. Still, the accumulation of such information will be important for further analysis of procurement conditions by attracting experts who are not affiliated with a buying customer.

Second, procurement information should be divided as follows:

- Generally accessible information (for citizens, public bodies, potential suppliers, interested public customers, etc.);
- Information for public customers only (on their own supplies and supplies of others in volumes sufficient for normal market analysis, comparison with similar procurements, etc.);
- Information for higher authorities (MPFD in relation to procurements in subordinate organizations);
- Information for controlling bodies (on all procurements).

Generally accessible information on public procurements (via one official portal) should enable an outside user to obtain information on new bids and former bid prices. The closed part of information massive should enable MPFDs and controlling bodies to check on the procurement process at all the stages of a procurement cycle (from planning to contract implementation). Many MPFDs already have such systems at their disposal, so a unified system

¹⁶ The existing system of accumulation and collection of information about procurements, however specified it may be in each contract, is not meant, for instance, for acquisition of data by group of goods that could make a base for calculation of a optimum opening bid of a contact and also give signals that parameters of the contract substantially deviate from average in the market.

should be apportioned and take into consideration specific needs of concrete MPFDs.

Creation of such an information system would mean a new stage in developing control mechanism and constitute a basis for efficient fight with possible opportunism in the public procurement system. It is very important to comprehend a notion of opportunism in the area properly and in full. Opportunism in public procurement, we believe, is more than an act of corruption (when a contract is deliberately assigned to a specific supplier in exchange for a remuneration of a decision-responsible official), it is also a fraud (when a supplier deliberately reduces a bid price, knowing, that he would not be able to secure a supply of proper quality in proper time). The both types of opportunism may be found mostly through registering *notable deviation from the market prices* – up (in case of corruption) and down (in case of fraud). In the first case MPFDs and controlling bodies would pay special attention to any upward price deviation. In the second case special consideration should be given to downward price deviation (for instance, when a starting price is halved). Such deviations do not usually bring about the minimization of budget expenses; they rather imply incompetence of a customer or opportunism of a supplier, which may cause disruption of supplies or serious risks, if products, works and services are underpriced.

We understand that to resolve the above tasks on developing the system of public procurement regulation you need time and get visible results only in mid-term or long-term perspective. Therefore in the same time special measures should be implemented in relation to order placement for technically complicated, innovative and unique products and services (including R&D). The professional community is currently involved in discussing forms and degrees in which the following conditions should be provided:

- qualification demands to participant of order placement, with clear differentiation of qualification demands at the stages of access and assessment of participants' applications;
- similar qualification demands to sub-contractors / co-performers and to products supplied by sub-contractors / co-performers;
- expansion of methods of order placement, including a multi-stage bids with possible qualification demands and bid negotiations;
- right of a customer to ask for explanations and additional information from a participant on a submitted application, check on data presented by participants, decline applications at all stages of their consideration;
- right of a customer to choose methods for attesting supplied products, including checks of product quality and technical compatibility at the stage of participants' access;
- particulars of assessing applications, including selection of a bid winner on the basis of a comprehensive indicator "economically

most profitable”, which should take into account customer-checked data and total cost of ownership, including auxiliary works, maintenance cost, reparability, performance period, etc.;

- Rights to introduce relevant changes to a public contract at the implementation period, including adjustment of performance specifications and cost characteristics.

Optimal combination of the above measures would help to solve the most urgent problems for non-opportunistic public customers and create a sound basis for a constructive dialog on current state and future of the public procurement system.

Conclusions

In this paper, we gave a description of both the basic principles of the present law on government procurements and the main problems which stipulated their priority. In particular, the latter included widespread corruption and lawlessness of customers that were typical of the sphere of government procurements in the first half of the 2000s.

Although the new legislation gives participants in the process of procurement a clear system of rules and mutual expectations – and so allows maintaining that the relevant institution is forming – it is not free from problems. For instance, our paper shows that enforcement of the new legislation has not eliminated corruption, but turned it into different, often latent forms, and displaced it to other stages of the process of procurement.

The need for further measures to improve the legislation is obvious, and they should be focused on creation of effective and transparent informational support. We suppose that transparency of information (which, in particular, can produce incentives for both customers and suppliers to establish their reputation of fair participants of the market) will enable to minimize the risks of wider powers of customers in their choice of optimum procedure of procurement, and to differentiate their approach to different categories of goods they purchase.

At the same time, to avoid blunders and problems caused by adoption of the 94-FL, the process should be based on detailed analysis and generalization of public procurement practices, including international experience and best procurement practices in large private companies, public corporations, specific agencies officially allowed to use other procurement procedures (Rosoboronzakaz, Ministry of Emergency Situations etc.). Finally, all actors of the procurement process should be ready for a dialogue and consistent mutual activities. Giving due to current achievements we have to be aware: those were but the first steps in setting institutions to satisfy effectively and efficiently public needs.

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