REGULATING PROCUREMENT IN COMMERCIALPUBLIC ENTITIES - MERITS AND DEMERITS

Reginald G. Mamiro*

ABSTRACT. Regulating public procurement is seen as inevitable across many social groups. Performance of public procurement systems is frequently used to measure the integrity of governments in power. Efficient public procurement systems enable governments to discharge their obligations towards implementation of economic projects and delivery of social services for their citizens.

However, given their multiple and sometimes incompatible objectives, regulated public procurement systems are frequently under attack for frustrating professionalism and innovation of the individual manager and the overall enterprise performance. Regulatory frameworks in developing countries are taming managers of commercial public entities with fit-for-all rules and regulations, ignoring the dynamics of the procurement supply markets and other realities on the ground. In this practitioner's paper the author discusses the extent to which the above advances are real or otherwise, and whether public procurement regulatory measures are reducing managers of commercial public enterprises to mere 'administrators' as they dance to the whims of the regulator, with specific reference to Tanzania.

---

* *Reginald G. Mamiro - MBA, CPA is the former Finance and Administration Director of the Institute of Accountancy Arusha, Tanzania. Currently he lectures in public procurement and on several occasions he has been engaged by the Public Procurement Regulatory Authority (PPRA) as a trainer for the dissemination of different modules of a course on the Public Procurement Reforms going on in the country. He has also served as a member in tender boards of various public firms in Tanzania. His teaching and working interests are in public procurement and financial management reforms.*

INTRODUCTION

The need to regulate the modus operandi of public entities is founded on the agency theory whereby conflicting interests frequently arise between the firm's owners (principal) and the individual interests of the firm's managers (agent) i.e. profit maximization versus management remuneration. It is assumed that the principal and agent do not share the same level of information, and as such the agent can opportunistically take advantage of the situation, sometimes to the detriment of the principal. (Mccue et al, 2008). The owners of the firm usually have little detailed knowledge of exactly how the firm is operating on day to day basis and depend on periodical reports prepared by the management and audit reports on which the management can exert influence, the consequences of which are detrimental to the firm's prosperity (Enron Corporation Bankruptcy, 2001)*. In most cases managers exploit the situation by justifying for and rewarding themselves higher pay in terms of salaries and exit perks. They concentrate in pursuing their own objectives even if it means decreasing profits and therefore dividends to owners and ultimately decrease in stock value. To resolve this principal - agent problem most (private) firms today have introduced performance contracts the targets of which must be attained by managers i.e. remuneration pegged to performance, also issuing some shares to managers as a way to motivate them pursue profits. There is some evidence that such schemes give managers an incentive to promote the firm's profits and act in accord with the owners' interests (Mansfield, 1990). These are of course measures besides government regulation particularly on publicly traded corporations.

Enron Corporation, a firm that had specialized in the energy sector, commanding a quarter of the energy trading market, appeared spectacularly highly successful before crashing in 2001. In August 2000 (just about a year before its collapse) Enron was valued at $ 77 billion making it the seventh largest corporation in the United States at that time. However, towards the end of 2001, Enron came crashing down. In October 2001, Enron announced a third quarter loss of $

618 million attributing it to ‘accounting mistakes’. The United States Securities and Exchange Commission (SEC) then engaged in a formal investigation of the firm’s financial dealings with partnerships led by its former finance chief. It became clear that Enron was engaged in a complex set of transactions by which it was keeping substantial amount of debt and financial contracts off its balance sheet. These transactions enabled Enron to hide its financial difficulties. Despite securing as much as $ 1.5 billion being new financing from J.P.Morgan Chase and Citigroup, the company was forced to declare bankruptcy in December 2001, the largest bankruptcy in the U.S. history until then.

Enron’s accounting firm - Arthur Andersen which was also one of the so called Big Five accounting firms, was then indicted and finally convicted in June 2002 for ‘obstruction of justice for impeding the SEC’s investigation of the Enron collapse.’ This conviction – the first ever against a major accounting firm meant that Andersen could no longer conduct audits of publicly traded firms, a development leading to its demise.
Enron’s incredibly rapid collapse, combined with revelations of faulty accounting information from then other publicly traded firms (e.g. World Com, which overstated its earnings by nearly $ 4 billion in 2001 and 2002), has raised concern that disclosure and accounting regulations may be inadequate for firms that are involved in complicated financial transactions, and that accounting firms may not have the proper incentives to make sure that the accounting numbers are accurate. Registering a typical case of asymmetric information which characterizes the principal – agent problem, the scandals at Enron, Arthur Andersen and other corporations resulted in the passage of legislation that is intended to make future Enrons less likely. The law established an independent oversight board for the accounting profession, prohibited auditors from offering certain consulting services to their clients, increased criminal penalties for corporate fraud and required corporate chief executive officers and chief financial officers to certify financial reports.

The Enron collapse largely illustrates that government intervention (regulation) is necessary for lessening asymmetric information problems, but can not eliminate them. Managers have tremendous incentives to hide their companies' problems, making it hard for investors to know the true value of the firm (Mishkin, 2004).

For state owned firms to which this paper addresses, many governments (principals) are introducing legal mechanisms to regulate the behavior of managers and whoever is entrusted with dealing with contracts to serve the public. Such mechanisms include enactment of laws to govern among others, procurement of goods, works and services for the government and all state enterprises. Institutional frameworks are put in place to support operationalization of the regulated systems and enforcement of public procurement legislations while instruments are developed to monitor and evaluate compliance of state enterprises subjected to procurement regulation. Apparently significant emphasis is with respect to legal compliance as featuring in the regulators' periodical and annual monitoring and evaluation reports. These 'fit-for-all' uniform legal and regulatory measures are imposed as well on state enterprises that are commercial in the sense that they do not receive subsidy from the government and as such they are expected to operate and behave in a strict commercial manner as they compete in the same market with non-public (non regulated) enterprises. They are supposed to generate profit and pay taxes and dividends to the government. Subjecting such entities to the often rigid procurement legislations generates a hybrid or a secondary level asymmetric information problem between the regulator and the regulatee. The regulator lacks sufficient information on the regulatee's procurement supply market and the overall business environment yet he/she proceeds with whims to enforce compliance of the law while the regulatee foregoes his/her otherwise rational and informed decisions as he/she follows suit for fear of breaching the rules. The situation is further complicated by the (in most cases) fixed remuneration earned by the managers which is in most cases not pegged to performance and therefore would not motivate them to continue pulling strings with the regulator or strive to perform to optimum levels, instead they easily give in.

THE NEED FOR REGULATORY MEASURES IN DEVELOPING COUNTRIES

Added to the principal-agent problem, there is a unique situation with most economies in developing countries in that they are characterized by among others, imperfect markets and a number of problems associated with asymmetric information giving rise to lack of competition, cartels and corruption. We have in some of these countries very few firms commanding a large sector of the procurement supplier market. There is also the existence of a relatively large irregular sector in economies of developing countries which needs to be captured, systematically managed and ultimately reduced. These undesirable and counter- productive features are compelling governments to introduce regulatory measures as a mitigating factor. *In this discussion the regulatory measures will refer to those relating to public procurement i.e. public procurement legislation while public firms or entities will refer to all commercial public institutions in which the state has a majority stake.*

THE DECISION PUZZLE

Public procurement rules put a lot of emphasis on competition, thus depending on or assuming a supportive competitive market which is unfortunately lacking in most developing countries; yet it is absence of a competitive supplier market environment which justifies instituting procurement rules and procedures to ensure value for money and equitable settlement of public interest obligations-a ‘catch 22’ sort of. Again procurement rules can themselves generate significant market distortions on an already competitive market as they attempt to isolate a part of the market, artificially creating a public (sub) market that becomes highly regulated by public procurement rules (Graells 2010). Greater scrutiny of tax payers and competing vendors have reduced public procurement to be perceived as an area of waste and corruption.(Thai, 2008). When translated in economic values, the regulatory burden frequently outweighs economic benefits which constitute the primary objectives of most public procurement reforms. Too rigid public procurement systems often limits the public buyer from obtaining the best value for money as there is no assurance of buying at effective market price. But suppose we do not regulate, how are we going to control the manager's behavior or that of the public buyer from possible abuse? Should regulation be applied selectively, that is, should commercial public procurement be subjected to a set of procurement rules that is different from the rest? This is a question open for discussion.

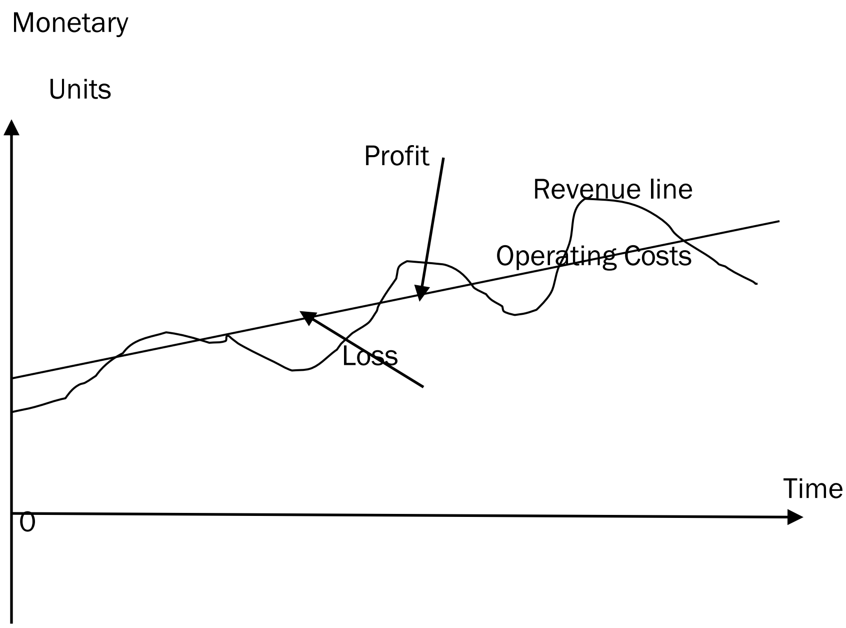
EXISTING LITERATURE

While regulating public procurement practices is perceived by many as one way to usher in transparency, accountability, economy, and integrity in the use of public funds, there is limited literature on the other side regarding studies on possible undesirable outcomes running parallel with public procurement reforms taking place particularly in developing countries. The study by Csaba Csaki (2008) though not strictly on commercial public authorities but rather commercial operating public procurement environment raised a number of issues concerning what he referred to as 'private mind set vs. public rules'. Csaki did a comparative study on the public and private sector procurement processes in Hungary following the subjection of certain companies operating in the energy and utilities sectors to the European Union's Public Procurement Directives of 2004. He studied the decision making processes of private organizations before and after the regulatory changes to observe how the introduced public procurement rules would affect suppliers relationships. Indeed, the 2004 EU directives and Hungary's national Act on public procurement together witnessed customer-supplier relationships changing from 'relational' to 'transactional'. The fact that the new rules disallowed for instance requirements containing references to product brands or makes other than in the context of 'equivalency' also increased the number of machinery and parts types therefore the need for more training, warehousing and also more documentation. Quality of supplies was also put on test since suppliers would compromise with quality to compensate themselves for the increased cost of doing business which was now 'eating' up their profit margins. Time required for executing a public procurement compliant transaction prohibited the fulfillment of request on short notice while going for 'speedy' processes would raise the risk for legal challenges.

The limitation of literature is even more pronounced when it comes to procurement regulation on commercial or for-profit public entities. One of the few studies carried out in a developing country is that by M.Ogot, M.Mulinge and R.Muriuki (2010) where they studied the impact of public procurement law on profit oriented public corporations in Kenya. Findings from the study explained that regulating procurement in profit oriented public corporations had significantly promoted transparency, quality and value for money (though quality is supposed to be an element of value for money) in procurement carried out. However the study also revealed that ability by the public enterprises to bargain with suppliers for the best deal and speedy response to business opportunities were some of the areas adversely impacted by the law. What the study would not tell is what impact that the inability to bargain with suppliers and failure of speedy response to business opportunities had on the firms' profitability and growth; for the accountability for firms' profit generation and growth cannot be alienated from the managers' discretion to control cost of inputs i.e. procurement. In other words one fails to see the rationale to task managers of regulated firms for failure to generate profits if they are denied control over costs. The managers' denial of discretion and control over operating costs may have significant adverse effect on business planning and the overall firms' performance.

Figure 1 below graphically explains a likely unpredictable trend or flow which the operating costs of a regulated state owned commercial entity might take when the fit-for-all procurement rules are allowed to dictate. . Despite the fairly stable revenue performance which may be enjoyed by the firm over time, the volatility of the operating costs caused by denial of managers to have full control over input costs frequently offsets the would be profits, a pattern detrimental for the prosperity of the firm.

Figure 1: *Where the firm's manager has no full control over procurement of inputs.*



Some critics are accusing governments of trying to accomplish too much using public procurement policies and implementation of such policies being often confused and made more complicated by adoption of too many goals, some of them political. Though seemingly backed with many good intensions, regulating public procurement is also said to be notorious for under-delivering and poses a question on whether developing countries should include public procurement in their economic policy mix (Kattel et al, 2010). When we have elections approaching there will often be a rush to implement social services projects even if the latter were not planned for, compelling the government to deviate funds from other planned projects.

Following the rules does not seem to assure the public buyer getting the best out of the exchanged value even if the opportunity to get the best was there save for the rules . More often than not, costs paid by government agencies are higher than they need to be and the quality of services supplied worse than the best bidder could provide and that the pursuit for many non-value-for-money objectives comes at the cost of attaining value for money (S.Evenett, 2010).

OPENING UP PROCUREMENT MARKETS

Public procurement in developing countries is said to account for up to 25% of their gross domestic product (GDP) (Arrowsmith, 2010). For a number of years the rate in industrialized countries has remained at around 10%. Though in absolute terms the procurement market trade volume in developing countries may not be significant the relative higher ratio it has on total GDP is an incentive big enough for formation of any economic alliance which most international trade organizations would not afford to easily let go. This is besides also the political impact it may pose. The pressure to join the organizations will in real sense be coming from the industrialized countries in their endeavour to ‘recruit’ members from developing countries rather than the latter ‘lobbying’ for membership.

Development of international public procurement rules appears to be guided by many of the same values that guide the broader efforts to create a global administrative law. (McCrudden et al, 2006).

For quite some time WTO’s Government Procurement Agreement (GPA) has been ‘encouraging’ developing countries to open up procurement markets to international trade by instituting measures that will improve foreign access to their procurement markets. The exposure of developing countries’ procurement markets to international trade in this context is more of a deliberate attempt by the industrialised countries that form the majority membership in GPA to expand their supply markets while it is known that there is a significant trade imbalance between the two blocks. Chances that suppliers from developing countries will compete for and win contracts in foreign procurement markets are bleak and therefore will remain net recipients of foreign supplies and services. It is well stipulated in GPA’s policy whereby the agreement prohibits discrimination against foreign industry. WTO’s GPA seems to have nothing in store for developing countries and it is no where closer to assist them in promoting their domestic industry. Equally, the UNCITRAL model law the template from which most developing countries have been developing their procurement rules is not that much in their favour since it provides for a rule against discriminating foreign suppliers possibly to facilitate implementation of the policy to open up procurement markets to foreign suppliers (Article 8(i)). Although the model law works as an off shelf standard product, relieving governments of the necessity to re invent the wheel, it is also designed to offer a framework which will reduce the threat to international trade in procurement. (Trepte,2004). For, a country subscribing to the GPA rules or adopting the UNCITRAL model law can not prohibit discriminating foreign suppliers and at the same time nurture its small and infant domestic industries, a feature characterizing most developing countries.

Perhaps this explains some of the reasons why most developing countries are taking their time to join the WTO's Government Procurement Agreement (GPA)*

PUBLIC PROCUREMENT REFORMS IN TANZANIA

As it is the case for most developing countries, public procurement reforms in Tanzania have largely adopted the United Nation Commission on International Trade Law (UNCITRAL) model law framework template. Tanzania has made a remarkable progress in reforming its public procurement system. During the last two decades there have been significant developments in reforming the country's procurement regime which can be described in three distinct time horizons stretching from the idea in 1992 of

having an all inclusive public procurement law to the current legislation which provides for among others, centralized procurement of common use items and allowing for procurement of used items in some certain circumstances.

*Only 42 WTO members, mostly industrialized, had subscribed to GPA by the end of 2011.

Reforms During 1992 - 2001

Government's efforts to harmonize and regulate the country's public procurement system is traced to way back in 1992 when it commissioned a consultant to undertake the country's public procurement and supply management study. It was concluded from the study that the public procurement system in Tanzania suffered serious weaknesses and that there was an urgent need for reform. It is not quite clear what recommendations were made from the study and whether or not they were acted upon because again in 1996 the government had commissioned another consultant- the British firm Ms Crown Agents, to study the country's procurement system and assess its adequacy. Some of the weaknesses enlisted after the study had included inadequacy and fragmentation of procurement laws i.e. absence of an all inclusive public procurement system covering the central government and all its institutions and also inadequacy of the existing laws to cater for the wider definition which would include procurement of works and services (Nkinga, 2003). Also there was no regulatory body to set standards, regulate and enforce compliance. Out of the 1996 study and recommendations, a new public procurement legislation was enacted – the Public Procurement Act (PPA) No. 3 of 2001 which became operational on 1st July, 2001.

Reforms During 2002 – 2004

In 2002, shortly after becoming operational of the PPA 2001, a further study of the country's public procurement regime was carried out and documented in the 2003 Country Procurement Assessment Report (CPAR). The study suggested further reforms in the procurement system and processes, capacity to conduct procurement and also attempted to address handling of corruption in procurement. The review was able to resolve some of the major bottlenecks which PPA 2001 had failed to address eg. shift from centralized to decentralized procurement system, more authority to accounting officers, abolishing the then Central Tender Board (CTB) which had assumed two conflicting roles of operating both as a tender board and a regulator; and establishment of the Public Procurement Regulatory Authority (PPRA) in its place as an exclusive regulator.

It was the recommendations of the CPAR which culminated into enactment of another law on public procurement in Tanzania i.e. the Public Procurement Act No. 21 of 2004 (PPA, 2004) which became effective on 11th February, 2005. The act also provided for the operation of the Public Procurement Appeals Authority (PPAA) making Tanzania one among countries having the most comprehensive and elaborate procurement complaints review mechanisms in the world (CPAR, 2006).

Reforms During 2005 – Todate

Reforms during this period have included implementation of the CPAR 2006 recommendations which together with others had insisted on implementation of the PPA 2004 and also new developments mostly initiated by regulator as a follow up on audits and monitoring activities carried out on public entities but also feed back from the procurement supply market and studies undertaken by stakeholders. These have culminated into enactment of a new law on public procurement-the Public Procurement Act, 2011 bringing in changes which include but not limited to:

- Introduction of bid securing declaration for small value bids in lieu of bid security so as to promote SMEs' and other small local firms' access to procurement markets-Section 58.
- Establishment of the Government Procurement Services Agency (GPSA) as the government's procurement arm for common use items and services-Section 50.
- Provision for procurement of used machinery and equipment - Section 66.
- More functional and administrative independency to the head of the procurement management unit (PMU) whereby he now reports directly to the chief executive officer. – Section 37.
- Establishment of the public procurement policy division at the Ministry of Finance, an anomaly whose resolution had been long awaited -Section 5 and
- Establishment in 2009 of an all inclusive procurement and supplies professional body (PSPTB) which had been mentioned in the CPAR 2003 and CPAR 2006 recommendations.

CONFLICTING OBJECTIVES

Developing countries embarking on regulating public procurement are often carrying with them multiple and sometimes conflicting objectives possibly for the desire to accomplish too much within a limited time period. Multiplicity of objectives often leads them to multiple destinations, some of which may have not been predicted. By regulating public procurement, some developing countries aim at fulfilling economic as well as social objectives but they end up achieving one at the expense of another. None of the available models of public procurement principles or practices seems be adequate for their requirements and priorities. Where they apply discriminatory procurement policies as an attempt to fulfill social obligations such as creating employment opportunities (a situation made possible through growth of domestic industry), they risk foregoing economic benefits which are realized from value for money procurement (a situation made possible through opening up their procurement markets to international competition); they also compromise quality and may be good rating as aid recipients. Where they consider succumbing to pressure from the international trade agreements by opening up their procurement markets to foreign suppliers and service providers they are confronted with a number of risks which includes crippling their domestic industry, suppressing innovation and triggering employment crisis.

Though CPAR reports have been ranking Tanzania high in terms of successful public procurement reforms implementation, this could be so perceived because of the fragmented and uncoordinated public procurement regime from which the country emerged a few years back, otherwise the going has been tough and rough, frequently to and fro. This is partially explained by the three legislations on public procurement which the country has had in just a span of a decade i.e. between 2001 and 2011 as discussed above.

Using public procurement as a policy instrument for attainment of economic and social objectives seems to be a long way ahead. For instance though the procurement law carries discriminatory clauses providing for preference to local firms and particularly SMEs, most of these are confronted with obstacles at all stages of procurement processes. They lack access to information on procurement opportunities, cannot formulate business plans or proposals and often fail to comply with standardization and certification requirements especially when they attempt to venture into export markets. Likewise, procuring entities do not appear to support the government's initiatives in using procurement towards attaining the national level economic and social objectives. This argument is supported by the regulator's reports that very few public entities have been applying the preferential schemes in bid evaluation which are entitled to domestic firms and fully provided for in the procurement act. A report on the country's procurement system released by the regulator in 2007 revealed that out of 388 cases which were eligible for national preference only 3% had the preferential treatment applied. It means individual public procuring entities were not ready to give business to local firms by acquiring goods, services or works from them at a slightly higher price and they instead opted for foreign suppliers who had offered more competitive prices. Enforcement of the legal provision to apply preferential schemes in bid evaluation may not be positively received particularly by commercial public entities despite being mandatory (Sec.54 & 55, PP Act, 2011) for, to them there is no incentive to forego a part of their would-be-profit just to support the government's broad policy objective of nurturing domestic firms.

CONCLUSION

Management of businesses entails risk taking and risk hedging as well. Managers running non- government enterprises do take a number of risks through speculating and exploiting market opportunities as they arise in the course of venturing for higher returns and therefore more wealth for their firms or owners. They sometimes take risky loans and invest in risky assets. Their firms through the owners support them and avail them with conducive environment to do what they think is best for wealth maximization motive. Owners of the firm frequently allow managers to acquire a stake therein as an incentive to work beyond fulfilling individual goals at the expense of those of their employer. Think of ventures like mineral or oil prospecting where resources can be committed for years before reaping paybacks or where such ventures end up in total disappointment i.e. unsuccessful. But the managers are motivated to do all these also because they have an interest in the overall performance of their firms through the shares they own, promotion prospects, increased emoluments and other benefits-tangible and intangible. Their counterparts in the public sector lack the incentives and environment to perform, a situation that ends up into generation of sub-optimal outcomes. Using industrial standards government systems should formulate measurable performance targets on which to gauge the performance of managers running commercial public entities and task them for results, not the way they arrive at the results.

Problems associated with asymmetric information and the principal-agent relationship are not likely to occur as there is always a government representation in the boards of directors of these entities which serves as a control instrument to regulate the behavior of the managers and to ensure harmonization with government policies and priorities. Authorities and policy makers should also note that the pursuit for economy in public procurement is sometimes distorted by compromise on quality as suppliers, contractors or service providers try to compensate themselves for the lost profit margins caused by rigid and costly procurement rules. There has to be a mechanism to compensate commercial public entities that are ready to comply with the legal requirement of acquiring their supplies and services from domestic firms at prices slightly higher than the ones prevailing across an unrestricted market so as to support the macro level policy objective of growth of the domestic firms and the economy.

REFERENCES

1. Frederic S.Mishkin (2004) "*Economics of Money, Banking and Financial Markets*" 7th Edition – pp 178 Pearson Education International.

2. Cliff Mccue and Eric Prier (2008) "*Using Agency Theory to Model Cooperative Public Purchasing*". IPPC 3

3. Edwin Mansfield (1990) "*Managerial Economics-Theory, Application and Cases*". pp 16 W.W.Norton & Company.

4. *Public Procurement Act, 2011 (Tanzania*) Government Printer, Dar es Salaam.

5. R. Kattel and V. Lember (2010) "*Public Procurement as an Industrial Policy Tool: An Option for Developing Countries?"* Journal of Public Procurement Vol 10 No.3 Fall 2010 pp 368-404.

6. Madara Ogot, Mariana Mulinge and Rita Muriuki (2010) "*Impact of Public Procurement Law on Profit- Oriented State- Owned Corporations in Kenya".* Towards New Horizons in Public Procurement. PrAcademics Press. pp 372-388.

7. Sue Arrowsmith, Steen Treumer, Jens Fejo and Lili Jiang (2010) "*Public Procurement Regulation, an Introduction".* EU-Asia InterUniversity Network for Teaching and Research in Public Procurement Regulation.

8. Simon J. Evenett et at, (2005) *"International Cooperation and the Reform of Public Procurement Policies"* (On line) Available at www.worlbank.org.

9. *Country Procurement Assessment Report- Tanzania 2003* www.ppra.go.tz

10. *Country Procurement Assessment Report-Tanzania 2006* www.ppra.go.tz

11 Nkinga, N.S.D. (2003), "*Public Procurement Reform – The Tanzanian Experience"* Conference paper presented at the *Joint WTO – World Bank Regional Workshop on Procurement Reforms* held in Dar-es-Salaam, Tanzania 14th – 17th January 2003.

12 *UNCITRAL Model Law, 2011*

13 Christopher McCrudden and Stuart G. Gross (2006) "*WTO Government Procurement Rules and the Local Dynamics of*

Procurement Policies-A Malaysian Case Study". European Journal of International Law Vol. 17 No. 1. pp 151-185.

14 Khi V. Thai, (2004) *"Challenges in Public Procurement"* IPPC 1 Book Chapter 1, Boca Raton, FL, USA PrAcademics Press

15 Peter Trepte, 2004 *"Regulating Procurement"* Oxford University Press pp 43

16 Csaba Csaki (2008) *"Irreconcilable Differences of the Best of Two Worlds: Analyzing the Similarities and the Differences between Private and Public Procurement Rules and Practices"* IPPC 3 Conference Proceedings Paper. Available at www.ippa.org