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COLLUSION AND CORRUPTION IN PUBLIC PROCUREMENT

Contribution from CUTS

-- Session V --

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1. Introduction

1. According to the Organisation for Economic Co-operation and Development (OECD), “procurement is the process of:

- *Identifying what is needed;*
- *Determining who is the best person or organisation to supply this need; and*
- *Ensuring what is needed is delivered to the right place, at the right time, for the best price and that all this is done in a fair and open manner.”* (OECD, 2006)

2. In yet another definition by Transparency International “Procurement” refers to the acquisition of consumption or investment goods or services, from pencils, bed sheets and aspirin for hospitals, gasoline for government cars, car and truck fleets, equipment for schools and hospitals, machinery for use by government departments, other light or heavy equipment or real estate, to construction, advisory and other services from the construction of a hydroelectric power station or expressway to the hiring of consultants for engineering, financial, legal or other advisory functions.

3. Public procurement refers to the government’s activity of purchasing goods and services needed to carry out its functions - ranging from construction to paper, missiles to street cleaning, information technology to secretarial services, etc. Such procurement is of huge importance to any country including India. Public procurement is a key economic activity of governments, accounting for an estimated 15% of Gross Domestic Product (GDP) worldwide on an average.² Public procurement impacts the economy of any country significantly by generating demand and consumption.

4. Public procurement can be used as a tool for generating social benefits - for example, by way of preferential treatment in procurement, it may be used to promote and support development of backward regions or protection of small scale industries, etc.

5. In most countries characterised by a high incidence of corruption, public procurement remains a key activity of the government suggesting some kind of possible positive association between corruption and the magnitude of public procurement, with the latter driving the former. The public procurement mechanism has been empirically found to have an impact on the integrity of vendors present in the market. An inefficient public procurement system may act as a deterrent to firms maintaining high quality and

¹ This document was written by UDAI S. MEHTA Policy Analyst, PRADEEP S. MEHTA, Secretary General, and SIDDHARTHA MITRA Research Director, from CUTS International, India.

² OECD (2008), “Fighting cartels in public procurement”, Policy Brief, available at <http://www.oecd.org/dataoecd/45/63/41505296.pdf>.

ethical standards. Firms with lesser competence would be able to survive in the market by exploiting the loopholes of the public procurement system.

6. As mentioned, the public procurement system is highly prone to corruption. But is corruption good or bad? Corruption has ancient roots and is a global phenomenon. Corruption is undesirable because it not only results in loss of public trust and faith in the government but also sub-optimal allocation of resources with negative implications for the growth and level of output. It also leads to a skewed distribution of income. As the link between individual effort and individual income is weaker in highly corrupt societies, the aggregate supply of effort is also adversely affected. This again has a negative impact on economic growth.

7. Corruption also results in lessening of innovation. Companies relying on corruption will not spend resources on innovation, and even companies that do not indulge in corruption will feel less inclined to make the necessary investments in innovation, if they are not able to gain access to markets/consumers due to corruption by their competitors. Thus, if a government allows corruption to survive and shortlists bidders not on the basis of their experience and/or ability to execute the project, but on their ability to indulge in corruption in the form of bribery or collusion, the country will soon end up risking losing new investment opportunities. Such loss will adversely affect the country's economic development and without such development poverty alleviation through trickle down or augmentation of government resources will not be possible.

8. A few economists have attempted to measure or theoretically analyse the consequences of corruption for an economy. But, on the other hand, benefits of corruption have also been identified. It is often argued that bribes work as grease in a sluggish economy to keep the wheels moving and thus improves its efficiency. As explained below, it can also pave the way for business to avoid cumbersome rules/regulations, which in most cases act as speed breakers in the path of growth:

*“Interference with the free market usually induces inefficiencies. However, bribes sometimes can partially restore the price mechanism and improve allocative efficiency. Corruption might be viewed as people’s optimal response to market distortions. In this sense, corruption has some beneficial effects to society, but the resulting solution is only second best.”*³

9. However, as mentioned above, there are strong arguments which point to the enormous harm caused by corruption. Many international institutions, such as the World Bank and the International Monetary Fund, have reached the same conclusion. The World Bank believes that corruption is a major factor impeding economic development. Corruption hampers economic growth, disproportionately burdens the poor and undermines the effectiveness of investment and aid.⁴

10. The rest of the paper is structured as follows. Section 2 examines the sources of corruption in public procurement and then evaluates systems of public procurement in India with emphasis on implications for the extent of corruption. This analysis is then used in Section 3 to suggest the way forward i.e. the insights from Section 2 are used to come up with recommendations for the public procurement system/processes in India.

³ Arrowsmith, S. and Davies, A (1998), “Public Procurement – Global Revolution”, Kluwer Law International.

⁴ Zhang H, “Corruption, Economic Growth and Macroeconomic Volatility”, available at http://www.karmayog.org/anticorruption/anticorruption_913.htm.

2. Public Procurement: Impact of Corruption

2.1 Corruption in Public Procurement

11. Corruption has many faces in public procurement. These can range from the most common form of bribery to more sophisticated forms of political corruption or blue collar corruption. Bribes usually are smaller amounts paid to lower level officials to expedite a decision, to induce a decision which has been delayed or to avoid undue delays.

12. The most common and rampant form of corruption in public procurement is the practice of collusion or cartelisation for the purpose of bid rigging. Bidders often form a cartel, which then tries to manipulate the award decision in favour of one of their members, with or without the involvement of a corrupt official. Each of the cartel members thus gets a chance to be a successful bidder through prearranged bidding for several contracts bid for by the same set of firms. This undermines competition in the industry and its price lowering impact. Bidders can eliminate competition in public procurement in many simple ways - for example, a competitor agrees to submit a non-competitive bid that is too high to be accepted or contains terms that are unacceptable to the buyer; a competitor agrees not to bid or withdraws a bid from consideration; a competitor agrees to submit bids only for certain geographic areas.

13. There are certain factors that help bidders to engage in practice of collusion, such as⁵:

- High entry barriers that make it difficult for new or smaller firms to bid for contracts;
- Opportunities for repeated interaction among market participants
- Presence of active trade associations
- A high level of market transparency that makes it easy to see what the competitors are doing (if bidders are easily identifiable)

14. Corruption in government abets such collusion as corrupt government officials turn a blind eye to practices such as bid rigging, with such behaviour being linked to a share in the gains enjoyed by colluding firms.

2.2 Public Procurement in India: Status and Challenges

15. In India, different procurement rules apply at the Central Level, in the states/territories, to the central public sector units and to public sector enterprises. At the federal level, procurement is regulated through executive directives. The General Financial Rules, issued by the Ministry of Finance, lay down rules and procedures for the procurement of goods and services. A manual on policies and procedures for purchase of goods has been published to assist the procurement entities and their officers in procurement.

16. At the Central Level, procurement is administered by the individual government agencies. Certain control and functions are carried out by central authorities such as the Comptroller and Auditor General and the Central Vigilance Commission (CVC). The Comptroller and Auditor General of India (CAG) undertakes ex-post audit of government expenditures including government and public sector procurements, essentially checking the budget for expenditures and adherence to procedures. The CAGs annual and special reports highlight unauthorised and wasteful expenditures, losses to the public exchequer

⁵ <http://www.oecd.org/dataoecd/36/40/42594504.pdf>.

and unjustified departures from established procedures. The reports are published and are discussed in the Parliament and State legislatures.

17. However, in India there is no single authority at the Central Level which is exclusively responsible for overseeing procedures relating to the procurement process. Thus, all states and public sector units have their own procurement organisation. There is no Central Procurement Authority though Central Purchase Organisations such as the Directorate General of Supplies and Disposal (DGS&D) are active in finalising contracts with registered suppliers for goods and items under the provisions of Government Financial Rules and State Financial Rules.

18. One major problem being faced in India is the confusion created by the existence of multiple procurement guidelines and procedures issued by various agencies (centre and state level). There is neither a single comprehensive public procurement standard nor a single agency to deal with public procurement policy in India. For example, in the US the Federal Acquisition Regulation is the public procurement standard which codifies a uniform policy for acquisition of supplies and services. This office is headed by a committee consisting of the heads of the major procuring organisations. Lack of standardisation not only causes inefficiency but also creates a major hurdle in ensuring transparency and accountability in procurement and provides enough leeway for indulgence in corrupt practices.

19. In the absence of a Central law or State act in public procurement, each ministry department, agency, etc, follows the basic tender system with certain variations. The key stakeholders involved are always the government and the private sector but these are represented by different agencies in different cases and thus procedures and practices vary from case to case. This reduces the credibility and public confidence in the system, creates confusion and thus provides room for corruption.

20. Another problem that one faces in public procurement is the multiplicity of tender documents used by different ministries and agencies in India. According to one estimate, there are more than 150 different contract formats used by the government and its agencies. This leads to confusion in the minds of bidders and concern about the risks imposed on them. Often in a given state, for the same work (for example, construction of a bridge), the tender document differs with the agency of issue, i.e. the nature of the document issued by the Public Works Department is different from that issued by the Municipal Corporation and both documents are different from that issued by the Metropolitan Urban Development Authority or the State Road Development Corporation. The differences manifest themselves in differences in criteria such as qualification requirements, selection, payment terms, dispute settlement mechanism, etc.

21. Thus, there is an urgent need in India to put in place comprehensive public procurement law/standards with a single authority to deal with relevant issues.

22. The efforts made by the Government to ensure standardisation in other areas such as steps taken by the Committee on Infrastructure under Planning Commission of India to adopt Model Concession Agreements with respect to Public Private Partnerships⁶ can be potentially replicated for standardising the whole public procurement system in India.

2.3 Public procurement at State level in India: Presence of Corruption

23. In a federal set up, states compete with each other to attract industrial investment by offering various incentives to the private sector such as electricity duty waivers, tax holidays, etc. Similar packages are also provided to protect and promote local units. One such preference given by the States is to local units during public procurement. Under this policy, price preference is given to the local units.

⁶ <http://infrastructure.gov.in/mca.htm>.

24. The aim of such policy is to protect and support small sector units, which otherwise might find it difficult to meet competition from large enterprises. Even if products of other players are better in quality or more competitive, these are not purchased because of price preference. Overall, the policy of giving preference might be desirable in the context of promoting balanced development and might keep vote banks happy but the incentives it offers for cartel formation by local units under the aegis of government protection are problematic. In such cases, the State Government invariably ends up paying a higher price for a product which might be of inferior quality (refer to Box 1).

Box 1. Barbed wire association in Rajasthan

As per an earlier Rajasthan Government policy, a certain quota of barbed-wire was to be procured from local manufacturers. This is supposed to have led to the formation of a 'cartel' under the name of Rajasthan Barbed – Wire Manufacturers Association in mid-80s. This association hiked the prices and with an implicit arrangement allocated the total requirement of barbed-wire amongst its members.

As a consequence of this arrangement, poor quality of barbed-wire was procured at high price with almost no quality checks at the Government end. Local manufacturers depended solely on Government's patronage rendering them uncompetitive. With the changed Government procurement policy, local units were closed down and the association broke up.

Source : Mehta. P (2006), "Towards a Functional Competition Policy for India", CUTS International

25. In this context, the Parliamentary Standing Committee on Railways in 2004 observed, that "the procurement of concrete sleepers has become a sensitive matter, because a lot of unscrupulous existing manufacturers have formed a 'cartel' to secure orders by unfair means or tampering with the procedure and simultaneously keeping the new competitors out of the race. The committee is constrained to notice that there exists a regional imbalance in the setting up of concrete sleeper manufacturing unit. They also expressed their unhappiness that new entrants are not encouraged, which ultimately strengthen the cartel of old/existing manufacturers". This, in procuring 160 lakhs broad gauge sleepers, the Railways awarded contracts to existing 71 firms, and ignored 24 new firms entirely.⁷

26. Further, collusion between the contractor and/or supplier and the procurement agency to earn extra profits is a major problem. By the very nature of the arrangement, it is extremely difficult to detect and curb these though there have been instances where the agreement did not materialise and the cases were reported:

"Few instances could be drawn from the CAG report. One such example is the procurement of Balau sleepers from Malaysia by Indian Railways, involving a sum of INR 20 crore. The Railways went against the report of the Forest Research Institute and cleared the imports. Later, the officers who were charged with the responsibility of checking quality standards also cleared the sleepers, despite their being of sub-standard quality. Thus, few of the strategies that are followed in collusion with the suppliers are:

- *Quantity variations or change in specification ex post to favour the contractor in case of projects;*

⁷ Mehta. P (2006), "Towards a Functional Competition Policy for India", CUTS International.

- *Accepting poor quality product or work;*
- *Coming up with ingenious requirements and arguments in favour of the contractor or the supplier.*⁸

3. Way Forward

27. In recent times, public procurement has attracted attention in the policy discourse on improving governance to promote sustainable growth and improve quality of public services. However, the situation is not so grim in all Indian states. For example, in Tamil Nadu, an Act called ‘The Tamil Nadu Transparency in Tenders Act 1998’ came into effect in 2000. The Act mandated an open advertisement mechanism for the tender system, and publication of tender notices and tender decisions in weekly bulletins, and also introduced an appeal procedure.

28. Following the steps taken by Tamil Nadu, the state of Karnataka too enacted ‘The Karnataka Transparency in Public Procurement Act 1999.’ The steps taken by the two states have enhanced transparency and improved public confidence. The performances of public sector enterprises have improved a lot and large business houses have also become more efficient and transparent in their functioning. Overall, the number of public complaints has gone down.

29. Thus, other states could also follow the steps taken by Tamil Nadu and Karnataka to ensure transparency and accountability in public procurement. Given below are a few suggestions for policy makers/decision makers to fight corruption in public procurement.

3.1 Adoption of a dedicated agency for public procurement

30. The absence of a nodal agency to look after issues pertaining to public procurement policies/processes has contributed to the multiplicity of procedures, rules, practices and documents, etc. It is recommended that an agency be created at the Centre with offices in each state to exclusively deal with public procurement policies and bring about standardisation in theory and practice.

3.2 Introduce Public Procurement Law and Public Procurement Regulations⁹

31. A ‘Public Procurement Law’ complemented by a set of Public Procurement Regulations, to replace and consolidate the present fragmented rules, will improve transparency and ensure accountability. The law would discourage the polity and corrupt officials from adopting short cuts in the name of public interest. The law could also define the precise scope for court intervention, thereby eliminating frivolous suits which result in wastage of time.

32. A few States have taken the lead - for example, the issue of ‘The Tamil Nadu Transparency in Tenders Act 1998’ by Tamil Nadu followed by a similar issue by the Karnataka Government. There are also international models to draw lessons from - for example, the UNCITRAL model law published in 1980 which has served as a model for the procurement law being legislated in most East European and ex-Soviet Union countries, as well as some developing countries in Africa and Asia; and the Government Procurement Agreement of the WTO.

⁸ India Infrastructure Report (2003), “Public expenditure allocation and accountability”, 3iNetwork, Oxford University Press.

⁹ World Bank (2003), “India Country Procurement Assessment Report”, Report No 27859-IN.

3.3 Adoption of E-Procurement Process

33. Procurement is generally regarded as a sensitive function of the public sector and is rarely transparent. Governments across the globe are under immense pressure to meet the expectations of citizens and ensure transparency in the process as well as enhance accountability of involved government officials. There is a growing realisation in governments that usage of information and communication technology (ICT) can remove existing hurdles and make the public procurement mechanism more efficient and transparent.

34. The history of extensive use of e-procurement in the public sector in India is short and therefore does not yield many pointers for the future. “The e-procurement project of Government of Andhra Pradesh has been implemented successfully. The implementation was instrumental in reducing cartel formations amongst contractors and suppliers since all the bidding is done online through the portal. It has actually increased the participation from the supplier community since anybody can bid for a tender remotely through the internet. The new system has considerably empowered the small and medium-sized suppliers¹⁰”.

3.4 Role of Competition Commission of India

35. The Indian Competition Act, 2002 specifically prohibits collusive bidding. Thus, the Competition Commission of India (CCI) is mandated to play an important role in developing an efficient public procurement system in India. There is a need to buttress competition advocacy with effective enforcement through action against cases of bid rigging, collusive bidding, etc. Strict and proactive enforcement against bid rigging has promoted fair and free competition in public procurement in many countries and saved significant public resources by enhancing competition.

36. The following are certain steps that could be taken by CCI:

- Creation of awareness regarding risks of bid-rigging in procurement by way of outreach programmes;
- Education and capacity building of procurement officials in detecting and collecting evidence which could then be used against colluders in a court of law;
- Education of public procurement officials and government investigators on the cost of bid-rigging to the government and taxpayers;
- Development of a toolkit to catalogue standard indications of potentially collusive conduct which could help procurement agencies to undertake spot investigation for identifying possible collusive activities, etc.

3.5 The Right to Information Act, 2005

37. The adoption of the Right to Information Act, 2005 in India marks a watershed in attainment of transparency and accountability with its objective of creating an informed citizenry to facilitate effective democracy. Procurement procedures are covered by the Act. The active involvement of civil society organisations in social audit could lead to greater awareness and transparency in the whole process of public procurement. Information relating to the procurement process is accessible by the citizens under this Act.

¹⁰ http://www.csi-sigegov.org/casestudies/22_implement_e_procure.pdf.

38. The Right to Information Act is one tool through which we can monitor the work of anti corruption agencies and use this information to create political pressures for change. It is only when the common man is able to use these tools and take a more proactive role in the discourse on checking corruption that pressure for reforms emerge, as it would be unrealistic to expect insiders who benefit from the system to take initiatives to improve the system and make it more transparent and corruption free. Political pressures need to be created externally and public pressure is thus essential.