



Reputation, competition, and entry in procurement[☆]

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ABSTRACT

Based on my recent work with several co-authors this paper explores the relationship between discretion, reputation, competition and entry in procurement markets. I focus especially on public procurement, which is highly regulated for accountability and trade reasons. In Europe regulation constrains the use of past performance information to select contractors while in the US its use is encouraged. I present some novel evidence on the benefits of allowing buyers to use reputational indicators based on past performance and discuss the complementary roles of discretion and restricted competition in reinforcing relational/reputational forces, both in theory and in a new empirical study on the effects restricted rather than open auctions. I conclude reporting preliminary results from a laboratory experiment showing that reputational mechanisms can be designed to stimulate rather than hindering new entry.

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1. Introduction

Firms, governments and international organizations repeatedly procure large amounts of goods and services of different value and complexity from outside suppliers. The fall in transport costs and other trade barriers together with technological developments in ICT considerably reduced the transaction costs of outsourcing, shifting the balance of the “make-or-buy” decision toward procurement.¹

For a number of different reasons, from poor/costly contract enforcement to the complexity of many goods and services, court-enforced contracts are often not sufficient to achieve an effective

governance of the exchange. Since procurement exchanges are rarely occasional, reputational forces may be exploited to improve on what formal contracting allows achieving.

This essay briefly reviews some recent work of mine with several co-authors aimed at better understanding the role of long-term relationships (relational contracts) and reputational mechanisms in procurement. In particular, I focus on how these interact with other crucial forces, like supplier competition, entry, buyer's discretion and the regulatory framework.

Public procurement is particularly interesting because – besides sharing the governance problems of private procurement – it also has to solve the major problem of public governance: how to keep public buyers accountable in the absence of market pressures and with the many layers of agency shielding them from tax-payers' control. The interaction between this regulation and the governance of quality in procurement transactions is all but trivial. Therefore, I emphasize more often issues related to the current public procurement debates, although most of the results discussed are relevant for both private and public procurement.

The debate on public procurement regulation is particularly intense in Europe at the moment, where the revision of the 2004 Directives 17 and 18, which coordinate public procurement in all EU countries, is taking place (See the [European Commission 2011a](#), [European Commission](#)

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¹ We are talking about a large part of the world economy: public procurement alone amounts to over 15% of GDP in most advanced countries.

2011b). However, there is a lively debate also in the US, in particular on how much discretion should be left to public buyers in the attempt to reduce transaction costs (see e.g. Yukins 2008) and on whether the use of reputational indicators based on past performance encouraged by the Federal Acquisition Regulations reduce the ability of new contractors to enter the market.²

A caveat is in order at this point. Space limitations do not allow me to discuss the many excellent previous papers on which the work discussed here builds. However, each of the mentioned papers has (or will have) a rich discussion of the related literature the reader can look at.

The remainder of the paper unfolds as follows. Section 2 discusses the main reasons why reputational forces are important in procurement and how regulation affects them in the case of public procurement. Section 3 presents evidence on the gains that a reputation mechanism can produce in terms of higher quality looking at the introduction of such a mechanism in a large firm. Section 4 offers a tool for interpreting these effects by discussing a theoretical model of the relationship between competition, discretion and reputation for quality in procurement. Section 5 presents empirical evidence on these forces using a Regression Discontinuity Design approach. Section 6 deals with the question whether reputational mechanisms deter entry by new contractors looking at the results of a laboratory experiment, and Section 7 concludes with some avenues for future research.

2. Limited enforcement, reputation, discretion and accountability

Reputational considerations are important in private procurement, whether they are informal and subjective or formalized in a feedback mechanism/vendor rating system (e.g. Bannerjee and Duflo, 2000). There are several reasons why complementing explicit contracts with reputational mechanisms based on ex-post evaluations of contractor performance may improve the governance of procurement transactions. These are linked to the inability of explicit contracts to describe or of the court system to verify important aspects of the procurement transactions at reasonable cost, but also to the high costs of enforcing explicit contracts through litigation. Several important quality aspects of supplied goods and services, particularly of more complex and valuable ones, are either difficult to appropriately specify in an explicit contingent contract in a practical and cost effective way, or they are impossible to observe or properly evaluate ex-post for a third party that could enforce the contract (like a court or an arbitrator). Even when a qualitative dimension or choice could be specified contractually and verified by a court, the cost of enforcing the contractual remedies and the negative effects that this may have on the continuation of the buyer-supplier relationship often prevent an effective purely contractual governance.³

Even in the formal world of public procurement, contracts are often not enforced. For example, some years ago there was an in depth investigation of how public buyers manage the framework procurement contract auctioned off by Consip, the central Italian Public Procurement Agency. A specialized audit firms collected information on the execution of a sample of these contracts between 2005 and 2008 for a total of 4457 audits. It recorded whether the contractor violated contractual terms (technical and quality characteristics of the goods/services, timing of delivery and installation, accounting standards, after-sale support) and whether a penalty was enforced in case of violation of one of the terms of contract for which a penalty is required. Descriptive statistics in Table 1 indicate that the percentage of contracts in which an

Table 1
Nonconformity and enforcement of penalties (2005–2008).

	No.	Penalties	% of penalties
Non-conformities, of which	1614	63	3.90%
Major	848	29	3.42%
Minor	137	4	2.92%
Other nonconformities (not clearly identified)	629	30	4.77%
Conformity	2843		
Total	4457	63	1.41%

infringement (no-conformity to the contract) has been detected and registered by the buyer is relatively high, about 36%, 53% of which are identified as major non-conformities. However, the enforcement of penalties, the main contractual remedy, is dramatically low: only 3.4% of the major non-conformities detected and registered by the buyer are contractually sanctioned.

Corruption could of course be one of the reasons why contracts are not enforced in public procurement, the civil servant in charge may be bribed to accommodate lower performance without exercising remedies. We do not believe this to be the main explanation for these data, however, because we would expect a corrupt civil servant in charge of contract management to hide the low performance rather than recording it in the books, as this makes the non-enforcement of the contract evident. Moreover, lack of enforcement of explicit contractual remedies after low performance seems to be common in other countries where corruption is less of a problem than in Italy. Analogous anecdotal evidence on non-application of deduction exists for large procurement of complex services in the UK (e.g. HM Treasury, 2006) and for elderly care procurement contracts in Sweden, where in over ¾ of the 120 procurement contracts we analyzed, credible contractual remedies were not even present in the contract (e.g. Bergman et al., in progress).

In private procurement past performance indicators affect the selection of suppliers and their behavior because buyers can act upon past performance, refraining from selecting suppliers with a poor track record and favoring those with a good one. In public procurement this type of ‘discretion’ is typically limited. The need to prevent favoritism and corruption led lawmakers around the world to ensure that open and transparent auctions where bidders have equal treatment (even when in some dimensions they have very different track records) are used as often as possible. Open competition is not only seen as an instrument to achieve efficiency and value for taxpayer money, but also to keep public buyers accountable by limiting their discretion in the allocation of public funds.⁴

In many countries this attempt to reduce discretion led to a two-stage contractor selection process where a qualification stage that excludes firms without the basic ability to supply is followed by an awarding stage in which only the bids are evaluated, with no reference to the characteristic of the bidder. This amounted (almost) to a ban on reputation, as exclusion from the bidding stage is justified only for extremely poor past performance.

The fact that limiting discretion to ensure public buyers' accountability comes at the possibly large cost of not allowing reputational forces to complement incomplete procurement contracts was stressed for example by Kelman (1990). A recent study by Bandiera et al. (2009), exploiting the introduction of a central procurement agency in Italy as a policy experiment, shows that accountability gains from a tighter regulation reducing autonomy may be small. They find that semi-autonomous public buyers (universities and health authorities), which are endowed with more discretion, are significantly more efficient and are not more corrupt than more rigidly regulated ones (central administrations).

² The US Government Accountability Office just released a report dealing with this concern for the US Senate (GAO-12-102R, October 18, 2011). The relationship between reputation and entry is a central theme of this essay.

³ In his classic study of relational contracting Macaulay (1963) discusses extensively the latter problem and reports a purchasing manager saying: “One doesn't run to lawyers if he wants to stay in business because one must behave decently” (p. 61). On the often very high costs of contract enforcement see the discussion in Iossa and Spagnolo (2011) and references therein.

⁴ Another way by which lawmakers limit civil servants' discretion is constraining ‘discretionary’ payments, i.e. monetary transfers not based on observable but non-contractible tasks. Public buyers then tend to recover their discretion – for the good or for the bad – at the contract management/enforcement stage; see Iossa and Spagnolo (2011) for an analysis of discretionary contract enforcement.

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