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An economic analysis of debarment☆

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ABSTRACT

With a view to reducing the consequences of corruption in public procurement, many governments have introduced debarment of suppliers found guilty of corruption and some other forms of crime. This paper explores the market effects of debarment on public procurement. Debarment is found to make little difference in markets with high competition, while in markets with low competition it may deter corruption as long as firms value public procurement contracts in the future and there is a certain risk of being detected in corruption. On the other hand, debarment – when it works – has an anti-competitive effect, and this contributes to facilitate collusion between suppliers. If designed with an understanding of the market mechanisms at play, debarment can deter both collusion and corruption, thus improving the results of public procurement. If so, most current debarment regimes need modification.

1. Introduction

In many jurisdictions, suppliers convicted of certain forms of crime, such as corruption, collusion, organized crime, or money laundering, are "debarred" from public tenders, meaning that they cannot be awarded any government contracts. Those who are only suspected of having been involved in illegal affairs, perhaps because of an ongoing investigation, can be debarred on a discretionary basis (that is, at the discretion of the procurement agent rather than automatically). The literature on debarment is written by legal scholars who address important procedural dilemmas related to the act of debarring, on due process, and on the legal status of those debarred.[1] As a result, the debarment instrument has been enacted in countries around the globe without the support of economic analysis. While debarment is expected to enhance integrity, no systematic attempts have been made to explore its impact in markets. This paper is motivated by the need for economic insights into the mechanisms at play.

Debarment was introduced as an element of modern public procurement regulations when the US Congress enacted a law in 1884 requiring the executive branch to award contracts only to the lowest "responsible" bidder, later established as an active preventive strategy by the Comptroller General in 1929.[2] However during the 20th century, most governments rarely excluded contractors; when they did, it happened primarily as a result of criminal indictments and convictions. As concern about the consequences of corruption intensified, starting in the mid-1990s, the option of debarring fraudulent suppliers was brought to the fore by various actors in the development community. Debarment increasingly was seen as a strategy to curb the risk of corruption. This idea was advanced by nongovernmental organizations

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[1] Such as the question of identification (what unit is to be debarred – a company, its owners, a company division or country office?); whose judgment or verdict provides sufficient basis for debarment (which courts are accepted or not, whose suspicion or investigation should be taken into account); what rights pertain to the offender; and what a supplier must do to regain status as trustworthy (a process referred to as self-cleaning). For introductions, see Piselli (2000), and Arnáiz (2009).

[2] For details, see the US Department of the Interior, "A Brief History of the Debarment Remedy," http://interior.gov/pam/programs/acquisition/upload/Brief-History-of-Debarment-Remedy_Final-3_2_15.pdf. The legal reference to responsible bidders can be found in the Act of July 5, 1884, Ch. 217, 23 Stat. 109.

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and multilateral organizations concerned about the propensity of private sector suppliers to exploit institutional weaknesses in developing countries, but also by the US government, the European Union (EU), the United Nations, and the Organisation for Economic Co-operation and Development (OECD). The United Nations Office on Drugs and Crime, for example, states "as anti-corruption initiatives around the world gain momentum, one device for fighting corruption – debarment, or blacklisting, of corrupt or unqualified contractors and individuals has emerged as an especially noteworthy tool." The same report maintains that "suspension or debarment from public contracts has proven to be an effective tool in the fight against corruption" (UNODC, 2013:25). The statement is made without any reference to empirical research, and we have not managed to find evidence that supports the claim.

Despite the lack of evidence of its efficiency, during the first decade of the 2000s, the debarment option extended in scope, with procurement agencies required to perform their own assessments of suppliers' trustworthiness, regardless of any criminal justice proceedings in the case. As a consequence, public procurement agencies were given authority to exclude suppliers (or threaten to exclude them) merely upon reasonable doubt of their integrity. Combined with more efficient whistleblower programs, increasing requests for suppliers' self-disclosure of fraudulent conduct, and rising voter demands for anticorruption vigilance, debarment from public procurement became a real concern for many suppliers.[3]

Today's debarment regimes send a signal to the private sector that access to public procurement markets requires compliance with laws and regulations, a signal that may well have a long-run positive effect on overall integrity and productivity. In practice, however, the debarment instrument implies challenging trade-offs. Excluding a competitor leads to reduced competition, and this in turn may result in higher prices or lower quality, quite the opposite of what procurement rules are supposed to deliver. Oligopolistic markets are particularly exposed to these risks, and this typically characterizes markets where large government contracts are awarded. Shifting to an alternative supplier may be costly and cumbersome, in some cases because of unique technical solutions with horizontal and/or vertical spillover effects on other acquisitions. From a legal perspective, exemptions from debarment rules are possible, and they are frequently used in practice, but this is not a good solution since it easily leads to a situation in which rules are applied differently depending on the player's market position. If debarment is only applied to firms operating under competitive pressure or whose services are not preferred in any case, we are left with rules that condone illegal practices by the strong and powerful. And for all we know, their market position could be a result of the very practices supposed to trigger debarment, that is, it may be based upon corruption or money laundering that provides the extra profits needed to outbid a competitor.[4]

This study is motivated by concerns about corruption in public procurement and about the market consequences of debarment, both of which represent departures from the premise of equal treatment and optimized price-quality combination. We need to analyze the economic trade-offs between excluding firms not found trustworthy and ensuring competition. Generally, the debarment instrument is introduced with wide discretion given to procurement agents, hence an implicit assumption that procurement agents are honest. In our perspective, however, corruption would not be a risk in these contexts if procurement agents were always honest. Since it takes two parties to cut a corrupt deal, this analysis place emphasis on the risk that the procurement agent herself can be corrupt; specifically, how she can facilitate bribery through the choice of acquisition mode. The direct consequence of excluding a competitor follow from elementary microeconomics, with normative implications against debarment. What complicates that logic are the more general importance of trusting business partners, the need to secure state revenues against crime, and the desire to realize the long-term benefits of more integrity among actors in public procurement markets.

While internationally, there are hardly any systematically collected data on the actual debarment practices, for this article we have reviewed numerous cases that reveal severe difficulties in the enforcement of the rules. Section 2 presents a concise overview of what appears to be the main challenges. Next, in Section 3 we present the model and discuss its assumptions. Section 4 proposes an economic analysis of the impact of debarment in public markets, assuming the rules are properly enforced. To what extent can this tool be expected to prevent corruption and protect the gains from competitive bidding? And can it also be used to fight collusion as advocated by international development banks? Keeping the focus on incentives and payoffs, while ignoring subtle/indirect signal-effects on moral standards, the analysis shows that debarment is a tool that works under some market conditions, but not all, and whose impact depends on predictable enforcement. The extent to which debarment deters suppliers from entering into corrupt schemes depends on how much value they place on future government contracts. This estimated value depends on the likelihood that they will win future procurement auctions, and this probability depends on the number of firms that may compete in the market in the future. With well-functioning debarment rules, the number of firms decreases as corruption is detected, and this fact influences the firms' estimated value of future contracts. In our stylized analytic framework we capture some of this dynamics in repeated purchase games.

In Section 5 we discuss the policy implications of our results. Debarment might deter corruption when the number of firms competing in the market is not too large, when they care about future sales, and when the probability of detection is substantial. However the policy tool needs to be managed by authorities with solid competence about the market situation and with incentives to secure consistent enforcement. Our review of cases show that this is a critical obstacle in its practical implementation. In addition to securing unbiased law enforcement, we propose to move the authority to debar suppliers from procurement agencies to antitrust institutions. Procurement agencies may themselves be involved in the corrupt deals or inclined to deviate from debarment rules, whereas antitrust institutions have proven to be very efficient in the fight against collusion. Moving the responsibility to antitrust institutions would also reduce the risk that indiscriminate debarment undermines leniency programs in competition law. The institutional change might contribute importantly to a more coherent regulatory approach to protecting markets against collusion and corruption.

2. Debarment practices

Over the past two decades, most countries around the globe have reformed their procurement rules, and while debarment of fraudulent suppliers is one of the principles associated with best practice legislation, there is no standardized way to introduce this instrument. The most important difference is between debarment administered by public procurement agencies and debarment

[3] For discussion of the altered use of the debarment instrument, see Gordon and Duvall (2013) and J. Crawford "How Proposed Debarment Became Equal To Suspension" at Law 360 on 2 February 2015, see http://www.law360.com/articles/616957/how-proposed-debarment-became-equal-to-suspension.

[4] Several authors find a clear empirical correlation between corruption and market concentration, including Ades and Di Tella (1999), Søreide (2008) and Treisman (2007).