

# **The system of public procurements in Russia: on the road of reform <sup>1</sup>**

*(HSE policy paper)*

**Abstract:** This paper examines main principles of current public procurement law in Russia. We pay special attention to the discussion of problems and imperfections in the system singled out by the participants of the public procurement system in the country. We demonstrate that a unified approach to all categories of goods and services together with strong restrictions that regulate behavior of public customers has indeed a number of unforeseen negative consequences and may create incentives for collusion. We formulate a range of challenges to the system which are to be solved in a new version of the Law on public procurement, to make this sector work more efficiently.

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<sup>1</sup> This HSE policy paper was prepared by the group of authors: Andrei Yakovlev (team leader), Olga Allilueva, Irina Kuznetsova, Alexander Shamrin, Maria Yudkevich, and Lev Jakobson on the basis of the research project “Functional analysis of the public procurement system in Russia and proposals to improve it” supported by HSE Program for Fundamental Studies in 2009. In the preparation process materials by Olga Balaeva, Anna Baltsevich, Natalia Eremenko, Svetlana Pivovarova, Elena Podkolzina, Mikhail Rozhkov, and Elena Yudina were used. The authors express their gratitude to Yaroslav Kouzminov, Fuad Aleskerov, Alexander Belenky, to respondents who filled in the HSE questionnaires in 2009, as well as to the representatives of governmental agencies and public customers involved in the HSE expert seminars on public procurements.

The Federal Law “On placing orders to supply products, production performance, rendering services to satisfy public and municipal needs” (94-FL) was adopted in July 2005 and became effective in 2006. One of the most radical reforms in the second half of the first decade of the millennium, it has affected many economic agents both in the public and private sectors. In this paper we shall analyze and discuss the impact and shortcomings of this recent law.

One of the obvious benefits of the reform is that **public procurements have now been established as an institution**. Before 2005, the only operative instruments pertaining to the area were declarative normative acts that set no limitations on the arbitrary decisions of public customers. 94-FL introduced a system of public procurement regulatory standards and also provided sanction mechanisms for violators of the norms. The enforcement practice in 2006-2009 (sometimes contradictory, judging by the consequences) underscores the necessity of making public procurements more satisfactory and taking the whole public procurement system to a new level of development. Progressive steps need to be taken, but we must first analyze the reform’s key ideas and its chief result in an unbiased way.

### **The reform prerequisites and substance**

The radical changes in the public procurement legislation of 2005-2006 were of an objective nature: at the beginning of the decade, public procurements grew (visibly faster than Russia’s GDP) against a background of inefficient regulatory mechanisms – the legislation was essentially a loose framework containing nearly no sanctions for poor compliance. It resulted in growing corruption in the public procurement system<sup>2</sup> and growing concern on the side of the state.

The passage of the 94-FL law in 2005 was supposed to address these problems. To make public procurements more efficient, the following key ideas were to be implemented:

- Setting up the conditions for competition. This measure was designed to guarantee free access to public procurements for all economic agents, primarily SMEs. To ensure access for new participants, the setting of qualification demands when assessing and selecting applications was prohibited, and the suppliers’ “quality” prerequisites were brought to a reasonable minimum (i.e. the qualifications and business reputation of potential performers). To foster the entry of SMEs into the

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<sup>2</sup> The enlarged scale of corruption was indirectly confirmed by the reduced average number of applications at public procurement auctions, an increased share of public contracts placed with one bidder, and other similar indicators.

public procurement market, 94-FL set very low thresholds in order to make competition purchase procedures for public customers obligatory (60 thousand rubles in 2006-2007, 100 thousand rubles in 2010).

- Securing maximum transparency for procurements. Prior to 94-FL, information on tenders might have been published in a local newspaper almost without any standards, but after it was passed, all of the procurement information was unified and placed on a common official site <http://www.zakupki.gov.ru/>. To make public procurements transparent and limit bid manipulations by public customers, applications were selected according to minimum price criteria.
- Fighting corruption. At the time of 94-FL's development and passage, corruption was viewed as a key problem for public procurements. An extremely formal and unified approach to all procurement procedures, coupled with a drastic reduction of room for maneuver for public customers and procurement-responsible employees as well as increased transparency, was expected to deal with the problem and influence the selection of suppliers. Another important anti-corruption instrument was to build up simple control measures, including streamlined procurement procedures with easier controls on the regulator's side.

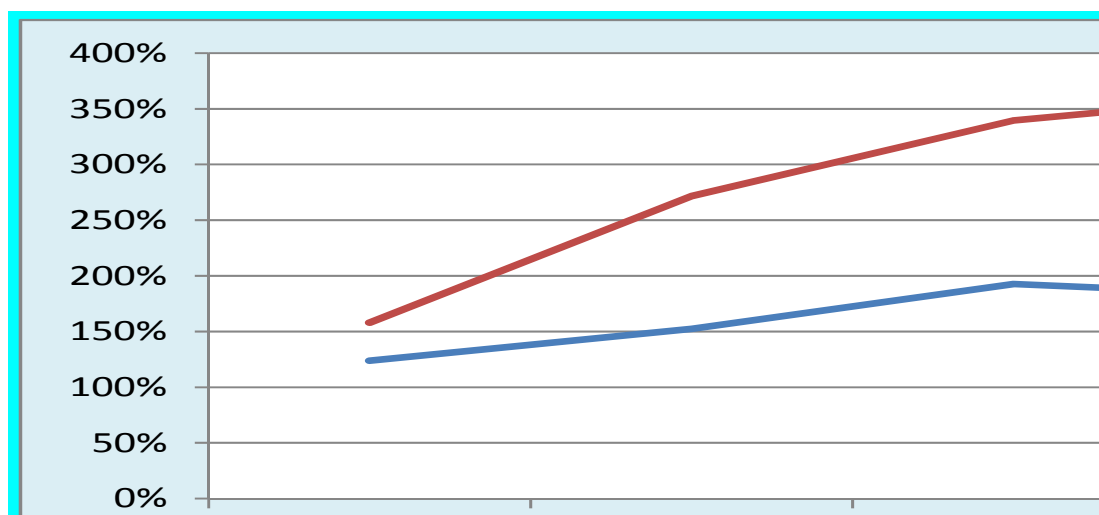
The implementation of the measures described above was supported by a set of sanctions stipulated in the Code for Administrative Violations. If the 94-FL rules were not observed, the Federal Antimonopoly Service and its territorial bodies were authorized to cancel bid results and impose fines on procurement-responsible officials in public customer organizations. Later, 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 94-FL were expanded to the level of criminal liability. Complaints from suppliers whose rights had been violated in the bidding process were reason enough to start a case and impose sanctions. In case of disputes, the controlling bodies based their actions on the presumption of supplier good will and customer unfairness.

### **Certain results**

94-FL was approved in July 2005 and became effective in 2006. The law received notable political support and was accompanied by a significant rise in public procurements: their volumes doubled between 2006 and 2008, from 1922 bln rubles to 3981 bln rubles. The growth rate of public procurements in the post-94-FL period visibly bypassed that of the GDP, as shown in diagram 1.

But there were enforcement problems with the law almost from the very beginning. Monitoring conducted by the HSE Institute of Public Procurement (Box 1) detected violations of 94-FL in 80% of 2006 procurements; in 2007, the indicator went down by 60% and has remained nearly unchanged to date.

Diagram 1. GDP and public procurements from 2006-2009



The massive procedural violations committed by various parties were given numerous explanations. Public customers complained of difficult 94-FL procedures, a lack of specialists, and Budget Code limitations. The legislators maintained that the procedural violations were due to unfair competition and public customers' preferential treatment of certain suppliers.

#### **Box 1. Monitoring of 94-FL violations**

Experts from the U-HSE Institute of Public Procurement monitored 94-FL observance in accordance with the following parameters: documents and time of their filing; and order placement periods on completed procedures in 2006-2009, including notifications, bid papers, auction papers, order placement protocols for open competitions, auctions, and quote requests. The sampling was made by 85 agencies of the RF executive power that place procurement information on the RF official site [www.zakupki.gov.ru](http://www.zakupki.gov.ru). Quantity (aggregate) data on poor compliance with 94-FL and the presence/absence of violations (binary principle) were recorded for each document or procedure. The HSE Institute of Public Procurement's monitoring data differs from the Federal Antimonopoly Service's data. The reason is that the FAS assesses the scope of violations on the basis of complaints without considering latent 94-FL violations.

At the same time, in practice, the 94-FL revealed numerous problems of an objective nature, making it hard for public customer organizations to perform their key functions. The HSE research project "Functional analysis of the public procurements system and proposals to

improve it”, based on case studies and survey of to public customers, discloses the following problems.

At the order preparation stage, customers and procurement-responsible employees underlined the following problems:

- Detailed performance specification is not enough to guarantee proper quality of procurement. Mass-produced products do not pose such a problem, but the issue is more critical for products/works/services whose quality can only be assessed while in operation or in use or even after their use.
- No credible basis for objective assessment of contract starting prices. According to customers, no methodology guidelines for determining contract starting prices are currently available. Sources of information on prices for similar products are also inaccessible. The portal [www.zakupki.gov.ru](http://www.zakupki.gov.ru) could theoretically provide price information to public customers, but it is presently interfaced to satisfy the needs of the regulator rather than those of the market players. The absence of publicly available information on prices in similar procurement contracts and absence of methods to determine prices brings about conflict situations. One of the interviewees referred to a participating company that over the course of a bid cut its starting price for a computer supply contract by 49%. The customer organization was reprimanded by controlling bodies for the excessive starting price of the contract. In the end, the contract was executed, but the supplied equipment did not meet the customer’s expectations, and had a different starting price; it was a lower quality “equivalent”.

At the order placement stage, most respondents mentioned the time-consuming procedures of open competitions/auctions, which hindered the normal activity of customer organizations, especially in the absence of applications. In addition, the documental support of applications was procedurally flawed (including the inability to demand data or supporting and substantiating information in the supplier’s application).

Other problems were attributed to supplier opportunistic behavior (deliberate price cutting by agency firms to secure a contract from real suppliers – with idea to receive later financial compensation from the suppliers or from a customer in exchange for refusing to sign the contract) and the inability to prevent this behavior; inability to secure interaction with the same supplier who made a good impression in the past vis-à-vis the quality of supplies (this is especially important when you need to service previously supplied equipment, IT systems, etc.); and the necessity of going through auction procedures to make unique procurements (i.e. when the market has only one real supplier capable of insuring good quality products, works or services).

As for the performance stage, respondents mentioned the following issues:

- Inability to adapt a contract to changing outside conditions. In many cases public contracts are signed under high uncertainty caused by a number of external factors. This scenario is mostly typical for large procurements with long fulfillment periods. The prohibition (at the time of placement) on introducing changes to contract terms may seriously impact the execution of a public contract. For instance, such a limitation can influence contract results for design work. In the process of implementing design contracts, especially in historic areas of a city, initial conditions may change due to pre-design stage results with a high degree of probability. The prohibition on making changes to public contracts set at the order placement stage may cause the design contract to be suspended or terminated.  
Given the rapidity of technological changes, IT equipment suppliers often face similar problems. If the contract takes longer than 6 months to execute, some models of computer equipment may go out of production, but a supplier is usually ready to supply a newer and better model for the same price. At the same time, public customers, who do not have the right to introduce any changes to specifications of the procured equipment, should reject the supply of newer and more modern computers. They are also devoid of the right to lower prices for outdated and objectively cheaper models. A way out is the so-called “frame performance specification” and “frame contracts with sliding conditions”, which only specify the procurement cost and approximate range, as well as rules and procedures for adjustment.
- High risk of poor quality supply. A customer prepares performance specifications fully aware that bidders will promise to fulfill all quality demands regardless of their actual ability to do so, but the quality of goods can only be assessed upon delivery. Respondents in the study cited design and survey work as problematic; a customer is totally unprotected from small contactors, who might ultimately prove incapable of executing a contract fully and properly. The point is that it is not possible to assess a contractor’s quality ahead of time in line with the current legislation (due to the prohibition on subjecting bidders to qualification requirements). But a customer’s expenses for construction or assembly work, maintenance, and servicing of the project seriously depend on the quality of the design and survey work done by the contractor. In the case of IT products, the low quality components procured for periphery equipment (toner, cartridges, etc.) can cause malfunctions and even complete breakdowns of costly IT equipment. There were instances of unscrupulous suppliers offering products for half-price and then readily agreeing to provide repair

services for 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, the customer's total losses dramatically exceed any savings from the purchase of cheaper components offered by unscrupulous suppliers.

- Untimely supplies. Public customers cited this problem as the most severe in anonymous formal questionnaires, but in interviews they avoided giving specific examples and mostly said, "Somehow we managed". Facing undelivered supplies by the end of a calendar year, public customers have to choose whether to withhold payment from the supplier (and thus return the money to the budget and do without the required products, works and services) or make "a deal" to pay the supplier in an accounting business period and receive the supplies later. The first option is in line with the spirit and letter of 94-FL, but hinders the normal activity of a customer organization. Customers therefore usually choose the second option and enter an informal zone of relations with their suppliers.
- Limited capacities for bringing an abusive supplier to order. Respondents stressed that the 94-FL provision to register public contract violators on a special list of abusive suppliers is possible only in two cases, i.e. upon refusal to sign a contract or if a contract is terminated by court ruling. But numerous precedents do not fall into either category. Besides, the measure is only likely to be effective with good-willed bona fide companies, and cannot intimidate fly-by-night companies geared specifically for "one time" participation in a bid. Similarly, possible compensation of losses through courts, insurance against contract non-performance risks, or mechanisms of bank guarantees cannot resolve the impact that poor quality products, faulty services, or untimely delivery of supplies has on the customer's business operations.

The manifestation of these and other problems while the new system of supplies was being implemented brought about numerous changes to 94-FL. Nineteen sets of amendments were made from July 2005 to the end of 2009. Legislative activity gathered steam over time: 94-FL received only 2 sets of amendments in 2005-2006FL, 7 in 2007-2008, and 10 in 2009.

This activity was dictated by the desire to put 94-FL in line with real life practices and reflected the dire situation in the public procurement institution. But the proceedings had internal contradictions.

On the one hand, a significant number of the 94-FL amendments were in line with the law's main ideas. A striking example relates to electronic auction standards, which are a definite plus in the case of simple standardized products. On the other hand, the legislators were trying to

respond to the problems that surfaced during the 94-FL implementation process, especially in dealing with complicated/unique procurements. But the legislators failed to adequately classify the problems and or to develop proper procurement instruments. Instead they took a piecemeal approach, implementing individual solutions for individual cases – mostly by exempting certain procurements from the 94-FL competition procedures (see Box 2).

**Box 2. 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 this patchwork approach to modifying the procurement legislation was that it ended up becoming an extremely complicated and internally inconsistent normative law: despite its initial simplicity 94-FL was expanded more than 3 times, growing from 47 to 147 pages. Many of its norms left room for interpretation, and practical enforcement and control body directives collided with Civil Code norms.

The law was characteristically treated by the Federal Antimonopoly Service and Courts of Arbitration in different ways. The Courts of Arbitration, in line with the Civil Code norms, considered specific cases and issued several decisions, according to which it is permissible to: a) change the costs stated on a construction work contract if the contractor makes a convincing argument; b) set demands vis-à-vis performance specifications related to the technology of works, employees and equipment to be used as well as other requirements which precondition successful quality performance; c) grant rights to a public customer to terminate a contract



unilaterally in the project documents; and d) change the terms of a contract without changing the legal nature of the contractual object.

Any further discussion of a systemic improvement of the legislation on public and municipal procurements needs to be based on a systematic analysis of arbitration practices. The Supreme Arbitration Court has recently gained notable experience in the area of public procurement legislation. It should be understood that the very fact of court litigation against the orders of control bodies would bring about – with high degree of probability – reciprocal attention from these bodies to the 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 efficiency of the public procurement legislation. The inconsistencies of 94-FL were probably responsible for the failure of the public procurement reforms to achieve the intended goals. Thus, according to Rosstat data, the costs of bid contracts in 2006 were three times higher than public orders placed with a single supplier. The indicators were almost equal in 2008, and within three quarters of 2009, procurements from a single supplier increased the costs of bid procurements. However, this dramatic growth should not be attributed to exceptions for certain products or categories of customers, another reason being “frustrated bids” with only one participant admitted or no participants at all. The widespread nature of such situations seems to be illustrative of the fact that the demands of 94-FL not only create problems for bona fide public customers but also fail to attract bona fide suppliers.

On orders from the Ministry of Economic Development, from February-June 2009 HSE analyzed the results of survey of supplying enterprises (encompassing 957 companies) as a second round of monitoring competitiveness in the manufacturing industry, and came to similar conclusions.

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’, ‘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 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 monitoring round 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?” (any number of answers permitted – spring-summer 2009)**

	<b>Total sampling</b>	<b>Small firms (below 250 workers)</b>	<b>Big firms (over 1000 workers)</b>	<b>Firms receiving public orders</b>
1. New opportunities to participate in public procurements	<b>10.8</b>	10.0	12.4	<b>17.9</b>
2. Increased competition among suppliers	<b>16.1</b>	15.5	18.2	<b>25.6</b>
3. Public procurement system became more transparent	<b>7.5</b>	5.8	8.0	<b>12.3</b>
4. Public customers raised general demands for suppliers	<b>14.2</b>	11.8	17.5	<b>23.8</b>
5. Reduced requirements relating to suppliers' experience and qualifications	<b>7.4</b>	8.6	2.2	<b>11.5</b>
6. Document preparation to participate in public procurement bids grew more complicated	<b>20.3</b>	20.6	23.4	<b>33.8</b>
7. Increased expenses for participation in public procurement bids (preparation of bid documents, provision of collaterals, etc.)	<b>15.3</b>	14.4	19.7	<b>25.6</b>
8. Participation in public procurements became less profitable	<b>11.8</b>	13.0	13.1	<b>22.0</b>
9. New possibilities for dumping by unscrupulous bidders	<b>14.3</b>	14.2	14.6	<b>23.0</b>
10. Other	<b>2.9</b>	3.3	2.2	<b>2.3</b>
11. No principal changes	<b>28.2</b>	29.2	24.8	<b>21.0</b>
12. Hard to respond	<b>30.1</b>	29.3	30.7	<b>13.8</b>
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 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.

Again, we want to emphasize that the enforcement problems for 94-FL are different on different markets. Positive results are evident in the case of buying simple standard products, but losses are more profound when it comes to buying technically complicated products and services. Later we shall explain this phenomenon from the point of view of economic theories, but in practical terms the problems were visible almost from the moment the law took effect. As a result, bona fide (non-opportunistic) public customers were seriously encouraged to pull their procurements out of the rigorous formal frames of 94-FL. The consequences differed depending on the “political weight” of the corresponding actors. For instance, in the early stages of legislative development, the Ministry of Emergency Situations and the Ministry of Defense managed to introduce supplier pre-qualifications for procurements in their ministries. As far as we know, at a certain point the legislation’s problems regarding the purchase of complicated products and services led to the common decision to put public corporations beyond the reach of 94-FL. As for less influential agencies, they managed to mitigate the demands of 94-FL only partially – as in the case of price limits in procuring R&D or obtaining permission to demand pre-qualifications for large-scale construction projects.

It should be noted that in 2006 World Bank experts became aware of the glaring absence of internal logic in 94-FL when it came to light that suppliers to the Ministry of Emergency Situations and the Ministry of Defense were supposed to be pre-qualified, but suppliers of

medical equipment can't be subject of pre-qualification. After that the World Bank stressed the necessity of introducing supplier pre-qualifications as well as other "quality selection" procedures for all procurements of "complicated" products and services.

Keenly aware of the flaws in the existing system of public procurements, the Russian leadership put item 35, which concerns the development of legal acts related to the improvement of the public procurement legislation (including the procurement of technically complicated products), into the RF public anti-crisis program for 2009. In his address on the budget policy for 2010–2012, the president Dmitry Medvedev announced that measures would be taken to improve the mechanisms of public procurements by means of modern order placement procedures, to introduce client consolidation, and to implement comprehensive methods of investment project management. The budget address emphasized that the system of public procurements should eliminate 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 the structural transformation of the Russian economy, encourage technological modernization, and improve the competitive edge of efficient manufacturers.

### **What were the obstacles to implementing 94-FL?**

Analysis of 94-FL's basic ideology indicates that the law was targeted at a specific type of market, i.e. an ideal model of *perfect competition* between "atomized" companies that manufacture homogenous products and have full information about the same products made by their competitors. This 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 evaluating 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 pressing problem for the majority of bona fide public customers is *non-performance risks or poor performance of public contracts* and the corresponding *potential losses*. The 94-FL developers are of the opinion that mechanisms of *future court sanctions* against suppliers for breaking contract conditions are sufficient to compensate for all possible losses of public customers and even prevent possible opportunistic behavior of suppliers.

But this kind of approach fails to take numerous circumstances into account. First of all, monetary compensation does not always make up for losses of time, especially considering the budget process specifics, which are 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 one manages over time to prove poor quality of supplied products, the procurement of substandard drugs for medical institutions or the supply of substandard equipment for waste disposal plants are fraught with losses that may significantly exceed the cost of the initial procurement. Fourth, products on high technology markets are constantly being updated and falling in price; therefore, the current practice of locking in all quality characteristics in bid documents with a court procedure being the only way to revisit a contract brings about direct losses in quality and expenses.

To reduce risks in the process of buying “complicated” products (services, works) one is supposed to take into account the *qualification and reputation of suppliers*.<sup>3</sup> International literature take the issue for granted and discuss proper mechanisms of accounting under different circumstances. International research 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. In international practice, scientifically approved *adaptation mechanisms* for signed contracts are used to contend with changing external conditions – but the changes are supposed to be *transparent*.

Unfortunately, foreign experience was not properly studied in the preparation period for 94-FL. Moreover, the World Bank’s warnings on the law-related risks, which later proved to be correct, were brushed off without any coherent reasoning. The 94-FL permits to use in Russia *less than half of the procurement methods* presently used worldwide – mainly the simplest and the easiest to control for the regulator. Indeed, a substantial number of the basic ways to make public procurements more efficient were prohibited, which brought about serious problems for bona fide public customers interested in procuring high quality products and services in a timely fashion. Under these circumstances, more influential public customers took advantage of ‘administrative bargaining’ and did their best to obtain their procurements below the radar of 94-FL. Others were doomed to look for ways to bypass dishonest (or potentially dishonest)

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<sup>3</sup> Qualification and reputation checking in the process of procurement has been discussed both in theoretical and practical literature. Theoretical backing for a limited number of potential suppliers in the case of special quality demands is given, for instance, in Bakos et al. (1992, “When quality matters: information technology and buyer-supplier relationships”). The 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 economics-computer works, for example in Ng et al. (1998, “Case-based Reasoning for Contractor Prequalification”).

suppliers. But such activity *easily makes room for corruption*. In such an environment, it is very difficult to distinguish between honest and opportunistic agents.

However, we can state that 94-FL has truly encouraged competition (as was previously mentioned by suppliers in the HSE study). But the different features of competition on different markets, including the risk of honest competition being pushed out of markets by dishonest actors, were not taken into consideration. Objective prerequisites that have been thoroughly analyzed by economic theory could and should be implemented to thwart malfeasance. Contrary to natural theoretic demands, the conditions for identifying bona fide and competent procurement participants (for instance, by looking at past market behavior and performance history) were not secured; similarly, mechanisms to cut off opportunistic participants were not used (for instance, the requirement to justify prices and decline an application in case of a negative expert assessment of this justification).

Furthermore, public procurement participants can easily be *pushed into informal relations* due to the necessity of having to follow the prescribed procurement procedures even for *small procurements*. The 94-FL developers deliberately insisted on binding procedures for procurements of all sizes in order to fight corruption and barriers to SME participation. Thus, in 2006 the law covered all procurements above 60 thousand rubles or 2500 USD at that time (the limit was raised in 2007 and eventually reached 100 thousand rubles). Importantly, international practices set special competition procedures if procurements exceed 50 thousand dollars. As can be seen in Box 3, the much lower “price thresholds” after the adoption of 94-FL brought about visible increases in customer expenses.

In addition, small procurements were characterized by *a lack of interest in bidding* on the suppliers’ side due to the *high cost of filing bid documents* and the low final financial return. So in many “cases” studied by the HSE, public customers were forced to talk potential suppliers into applying for a bid and then prepare the bid documents themselves. The reason is simple: without a formal bid and the presence of at least one supplier, a public customer may not start spending allocated budget funds or perform its main activity. At the same time, the selected supplier can wield its “monopoly” status and impose highly unprofitable procurement conditions upon the public customer. In other words, informal relations were established despite the legislation, and public customers racked up even greater expenses – thus discrediting 94-FL in the most direct way, since all of the participants experienced the economic unprofitability of the bid procedures first hand.

### **Box 3. Procurement expenses for contracts of different scales**

The U-HSE 2009 calculations performed 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 the total contractual costs. But the entire amount of the analyzed procurements was divided into contracts above 1.5 mln rubles (about 50 thousand USD) and below 1.5 mln rubles; labor expenses for the preparation of such contracts were also taken into consideration. As a result, the larger contracts (averaging 20 mln rubles) incurred expenses of 0.15-0.20%, but for the smaller contracts they went up to 7.5-9.0% (average contract less than 400 thousand rubles). These costs were actually “imputed” to public customers, regardless of a possible reduction (or non-reduction) of the procurement price.

Thus, the legislation’s simplified approach to market mechanisms, along with the assumption of *total corruption in the 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 opportunistic, 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 94-FL seems to have a positive side: saving budget funds due to the reduced procurement prices in the framework of bid procedures. The mass media attributed aggregated savings of 500 bln rubles directly to the law. To get the bottom line figure, the sum of the real costs of all signed contracts in Rosstat form “Torg-1” was subtracted from the sum of the initial prices of all purchases. But, as a matter of fact, initial prices were never controlled and might have been extremely high, especially for demonstrating the economy of scale. In addition, for a long time the first part of the Rosstat form (with starting prices) included data on all bids – those that really took place as well as 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 inflated by the sum of bids that did not take place at all.

Still, the following idea has recently surfaced more than once: introduce special encouragement for purchasers' employees by paying them part of difference between the starting and final bid prices as a bonus. This scheme would obviously trigger further artificial overpricing at the initial stage, and create additional pressure to drive down final prices – regardless of the quality of supplied products and services.

Overall, the HSE's analysis of the data collected on public procurements shows that during the four years since 94-FL was passed, the unified system aimed at monitoring public procurements did not fall into place. The Federal Antimonopoly 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 the sites [www.zakupki.gov.ru](http://www.zakupki.gov.ru) and <http://reestrgek.roskazna.ru/> makes it nearly impossible for public customers and suppliers to analyze the information. The situation is quite illustrative of the point made by Nobel Prize winner Joseph Stiglitz: an oversupply of unstructured and non-systematized information is equal to its absence<sup>4</sup>. At the same time, certain Russian corporations (both private and state) have already formed information systems of their own that ensure efficient monitoring and control their procurements. Their experience could serve as a model for developing a monitoring system of public procurements.

We shall conclude the theoretical analysis by saying: the architects of 94-FL tried to create a universal and easily manageable and controllable system of public procurements. One of the understandable motives was to secure all-around control without making regulatory activity too complicated and expensive, but as management theory tells us, the management system cannot be simpler than the management object. In this respect it is not surprising that the developers' methods proved to be adequate only in the 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 bona fide suppliers and public customers.

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<sup>4</sup> See Stiglitz J.E. 1985, “Information and Economic Analysis: A Perspective” and other works by the same author. The influence of methods and the level of information disclosure on purchase results are also thoroughly discussed in Handbook of Procurement (Dimitri, Piga and Spagnolo, 2006).



## **Ways to develop the public procurement system in the Russian Federation**

Summing up the analysis results, we will now single out systemic problems to be resolved by reforming the procurement legislation.

First, a comprehensive system of risk management in the procurement area is required, one that covers all types of risks and all forms of risk indicators at all stages of the procurement cycle. Corruption was considered to be the main risk factor during the 94-FL development and adoption phases. But the implementation of the law demonstrated significant risks of opportunistic behavior and supplier incompetence, which created non-performance risks. In addition, corruption risks were transformed and migrated to other stages of the procurement cycle. The prohibition system, instead of curbing corruption and abuses, simply spurred new forms: bargains struck between a customer and a supplier through additional detailing of performance specifications for concrete suppliers; an increased number of missed bids, with one participant designated to sign a contract for a price close to the initial one; arrangements between potential suppliers who are registered and allowed to make an appearance at auctions, but do not directly participate, so that a contract is signed at a price close to the initial one; disruption of order placement procedures by “grey” participants who make dumping applications or unfounded complaints about customers’ actions; and informal settlement of disputes due to non-performance, untimely or bad contract performance, caused by poor selection of suppliers or customer incompetence.

It is of paramount importance to minimize both of these risks – corruption and contract non-performance – and learn to manage them. We are of the opinion that to accomplish this goal a comprehensive analysis of a system aimed at satisfying public needs – including an order placement stage (the main area of 94-FL), stages of procurement planning, and contract execution – is needed. 2009 saw a renewed discussion of the Federal contract system, which means that the government is well aware of the problem. But we need to move in the right direction faster.

In order to resolve the risk management problem in the public procurement arena, it is necessary, along with covering all stages of the procurement cycle, to build effective barriers to the public procurement system for mala fide and incompetent agents – both suppliers and customers – through corresponding mechanisms of selection, encouragement, and sanctions. Criteria of “bona fide behavior” and “competence” are required and may be defined only in the context of assessing final results: suppliers are to observe and properly fulfill their obligations

with respect to the 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 systemic problem – the need to balance regulatory goals against final procurement efficiency. Legislative activities currently concern only bid procedures, and procurement efficiency is considered by controlling agencies solely in terms of 94-FL procedures. But in real life, the final goal of procurement is to provide for public needs; the regulatory system has to be tuned properly to achieve this particular goal. The readjustment and dramatic expansion of the regulatory system calls for efficient monitoring of public procurements based on certain principles (see below).

Third, the rights and liabilities of suppliers and public customers need to be harmonized. Before 2005 the imbalance was in favor of public customers, but following the introduction of 94-FL the pendulum swung towards suppliers. It is now time to restore the balance by finding the proper combination of rights and liabilities for suppliers and customers and to guarantee the protection of the interests of all fair participants in the public procurement process.

Taking a cue from international experience, fair competition should be developed and suppliers should be encouraged to provide good quality products and services. This can be achieved by means of a non-discriminatory application process for all procurement participants, a process in which qualification demands are thoroughly specified, standardized, and customized for a particular procurement. The competition quality should not be assessed only by minimum price criteria; consolidated criteria of competition should be taken into consideration as well. A procurement process should demonstrate economic efficiency throughout its entire life cycle, meaning its price, quality, and reliability.

Fourth, we have to take stock of the expenses borne by all bid participants (both suppliers and public customers) due to observation of 94-FL procedures. Up to now the regulatory system was designed to simplify administration processes for the regulator. This approach helped to streamline regulation and control regulatory expenses, but the expenses of suppliers and customers incurred from complying with the law also need to be taken into account. In the long run, these expenses are always included in the procurement's 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 unattractive participation conditions for suppliers), or the price goes up indirectly if the supplied products are of low quality. The additional expenses heaped upon public customers force them to perform their main functions in smaller volumes or with poorer quality.

It seems that the above-mentioned systemic problems can be solved by way of agreed reforms of the public procurement system along the following lines:

1. Gradually curtail the *area of non-regulated procurements* (including procurements by State corporations and natural monopolies, whose regulation is presently under discussion by the government).

2. To achieve item 1, however, it is necessary to *expand the spectrum of procurement means and adapt signed contracts to changing conditions*.

3. 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.

4. Granting expanded powers to public customers necessitates building a *multilevel system of monitoring and control* based on a logically organized public system of collecting procurement information; the system should constitute the basis for assessing the final efficiency of procurements and reveal possible abuses in the public procurement area.

Building a practical system for collecting and analyzing information on public procurements will constitute a starting point for improving the public procurement regulation system – along with controlling compliance with 94-FL, the state will also be able to see the whole procurement cycle and assess final procurement results. Certain steps at the design stage are required to guarantee the successful functioning of such a system.

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 the case of standard (mass) products, prices and other supply conditions should be compared for the MPFD, public customers, different methods of procurement, etc. This approach will also enable the MPFD and controlling bodies to check whether procurement starting prices are sound. For non-standard products, direct comparisons of prices and other procurement conditions will mostly be impossible. Still, the accumulated information may come in handy 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 (the MPFD in relation to procurements in subordinate organizations);
- Information for controlling bodies (on all procurements).

Generally accessible information on public procurements (one official portal) should enable an outside user to obtain information on new bids and former bid prices. The system's closed part should enable the MPFD and controlling bodies to monitor the procurement process at all stages of the procurement cycle (from planning to contract implementation). Many MPFD's already have such systems at their disposal, so a unified system should be apportioned that takes the specific needs of a concrete MPFD into consideration.

Such an information system would require developing a new control mechanism and would constitute the basis for combating possible abuses in the public procurement system. It is very important to fully and correctly comprehend the notion of abuse in this regard. Public procurement abuse, in our minds, is more than an act of corruption (e.g. when an order is deliberately given to a specific supplier in exchange for a remuneration from a decision-making official); it is also fraud (e.g. when a supplier deliberately reduces a bid price, knowing that he will not be able to secure a supply of proper quality in a timely manner). 94-FL is not always helpful in fighting these sorts of abuses. Both types are mostly manifest in the *notable deviation from the market prices* – up (corruption) and down (fraud) – in the registration process. In the first case, the MPFD 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, the starting price is halved). Such deviations do not usually bring about minimizing in budgetary expenses; they rather imply customer incompetence or supplier opportunism, which can disrupt supplies or pose serious risks if products, works and services are underpriced.

The practical implementation of our methods would seriously complicate the regulator's functions. Clearly, the Federal Antimonopoly Service cannot agree to such proposals without assurance of receiving additional resources. At the same time, to make administration more efficient, the regulator should focus its attention on large-scale orders – which implies increasing bid “cost thresholds” to international levels, and possibly the sharing of functions between the MPFD and the Federal Antimonopoly Service.

We understand that developing the public procurement regulatory system to incorporate the above tasks will take time; furthermore, visible results will not materialize overnight. Therefore, we should start by implementing the various measures at hand, mostly with respect to order placement for technically complicated, innovative and unique products and services (including R&D). The professional community is presently engaged in discussing forms and degrees in which the following conditions should be provided:

- qualification demands for the participants with respect to order placement, with clear differentiation of qualification demands at the stages of access and assessment of the participants' applications;

- similar qualification demands for sub-contractors / co-performers and for products supplied by sub-contractors / co-performers;

- expanded methods of order placement, including a multi-stage bid with possible qualification demands and bid negotiations;

- customer entitlement to ask for explanations and additional information from a participant on a presented application, check on data presented by participants, and decline applications at all stages of consideration;

- customer entitlement to establish methods for verifying supplied products, including checks of product quality and technical compatibility at the stage of participant access;

- the particulars of assessing applications, including selection of a bid winner on the basis of a comprehensive indicator establishing which supplier is the "economically most profitable", which should take into account customer-checked data and total cost of ownership, including auxiliary works, maintenance costs, reparability, performance period, etc;

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

The optimal combination of the above measures would help to negotiate the most urgent problems for bona fide public customers and create the foundation for a constructive dialogue on problems and reform of the Russian public procurement system. It is important not to become overemotional in discussing public procurements, however. Those critical of 94-FL often rebuke its developers for ignoring practical considerations to simplify administration, and those in favor of the law sometimes confuse its criticism with a desire to reinstate the customers' arbitrary ways. Moreover, proponents and detractors alike point out the impressive levels of corruption in the pre- and post-law periods and often accuse each other of unwillingness to fight the phenomenon.

Two circumstances primarily determine the different stances. First, the criteria for the procurement system are often contradictory, especially in the case of complicated and non-standard products. The one-sided approach to different scenarios has caused irreconcilable differences instead of attempts to rectify imbalances. Second, one can hardly modify the procurement system in a significant way by focusing on 94-FL's discrepancies. As we said earlier, the law deals only with one, albeit very important, part of the procurement cycle and sometimes "pushes" problems to other stages.

There is no point guessing today whether in 5-10 years public order placement will require an individual law or will be subsumed under some unified set of standards in the Federal contract system. One thing is clear, however: the ultimate goal is not to fiddle ad infinitum with 94-FL, but to achieve thorough regulation of the entire process of satisfying public needs.

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The objective of this policy paper was to highlight the vital points of public procurement legislation in Russia. Our analysis should in no way be interpreted as endorsing a return to pre-94-FL times. On the contrary, progressive action is required, entailing further development and building up a new institution. This in turn will necessitate establishing adequate procedures for the segments of the public procurement system that remain unregulated. But to avoid the blunders and problems that surfaced upon the adoption of 94-FL, the process of creating a new system should be based on careful analysis and generalization of public procurement practices. The new system should take international experience and domestic best procurement practices (both in public and private sectors) into account. All participants of the procurement process should be ready for dialogue and consistent mutual activities. While we laud the previous efforts in this direction, we must nevertheless remember that they were just the first steps in creating institutions to satisfy public needs in a qualitative and efficient way.

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