



# **SME AND EXPORT-LED GROWTH: ARE THERE ROLES FOR PUBLIC PROCUREMENT PROGRAMMES?**

## **A Practical Guide for Assessing and Developing Public Procurement Programmes to Assist SMEs**

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## FOREWORD

Small and medium-sized enterprises (SMEs) can play an important role in the growth and development of countries. They have the potential to become significant exporters, to promote economic growth, and to alleviate poverty among various groups in a society (Badrinath, 1997; Badrinath and Kirpal, 1997). There is not much in the literature, however, on public procurement policies that might assist SMEs in becoming competitive and export oriented. What roles can government play in public-sector procurement to enhance the comparative advantages of SMEs or to alleviate their competitive disadvantages? What role can public-procurement programmes play to make SMEs competitive in export markets?

This Guide is intended to fill the gap in the literature. It adopts an analytical but readable perspective, highlighting the effects of various approaches to assisting SMEs. We have attempted to "scratch beneath the surface" and to understand the implications of programmes, so that policy makers, governments, SMEs and their representatives, as well as consumer organizations and large firms, can understand, based on the best available evidence, how various public-procurement programmes can or cannot provide the needed encouragement of SMEs.

The Guide serves a multitude of purposes, none of which is mutually exclusive. First, it attempts to extend current levels of understanding on whether and how programmes in public procurement can nurture SMEs into becoming more competitive as exporting concerns. Public procurement disciplines can help to develop needed business and production skills in SMEs in order to make them more competitive. A more competitive domestic industry is more likely to enlarge its potential market place to include exporting to other countries.

Secondly, the Guide will assist governments in understanding how to structure and implement SME programmes in public procurement. It will provide assistance to governments both in understanding the various techniques to assist SMEs in the procurement process and the policy ramifications of various choices that governments can make in the selection and implementation of SME procurement programmes. Thirdly, the Guide will provide information to industry associations and chambers of commerce so that they may more effectively work with government and industry to assist SMEs. Fourthly, the Guide is intended to serve as a training document on the use of public-procurement programmes to assist SMEs.

We have used a modular approach to prepare this Guide. The modular approach has several advantages. It maximizes the relevance and utility of the Guide. Modularization permits governments, associations and contractors to be able to extract and use those parts of the Guide that are relevant to particular situations. Modularization allows a focus on a broad set of issues relevant to a wide audience. Finally, modularization is particularly useful when the Guide is used as teaching or training material.

We trust that you will find the Guide useful and informative.

## **ACKNOWLEDGEMENTS**

This Guide was conceived and its preparation directed by Wayne Wittig, Senior Adviser on Public Sector Procurement, International Purchasing and Supply Management Section, Division of Trade Support Services, International Trade Centre UNCTAD/WTO (ITC). Mr. Wittig assembled an international team of experts to jointly prepare the work. These experts hailed from diverse regions and countries, and included participants from developing and transitional economies as well as from industrialized countries. In addition, the team was interdisciplinary, with expertise in economics, engineering, accounting, law and public management. The lead investigator and principal author is John Linarelli, Lecturer in Law at the University of Wales, Aberystwyth.

The input of co-authors, however, was instrumental in the preparation of the Guide and so it is truly a joint effort of its several authors. The individual papers of the co-authors, presented at a workshop at the International Trade Centre UNCTAD/WTO headquarters in Geneva on 5 to 6 November 1998, are set forth in the annexes. As will be obvious, the papers in the annexes were used extensively in the preparation of this Guide. The co-authors are, in alphabetical order:

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## NOTE

The following abbreviations are used:

ABE	Affirmable Business Enterprise (South Africa)
APEC	Asia Pacific Economic Cooperation
BRAIN	Business Referral and Information Network (South Africa)
CFR	Code of Federal Regulations (United States)
CMR	Commercial Market Representatives (in the United States, Small Business Administration)
COC	Certificate of Competency (United States)
CSBP	Centre for Small Business Promotion (South Africa)
CSIR	Council for Scientific and Industrial Research (South Africa)
Crores	currency unit (India)
DTI	Department of Trade and Industry (South Africa)
EC	European Community
ECDP	Emerging Contractor Development Programme (South Africa)
ECU	currency unit (European Union)
ELPRO	European Electronic Procurement System (European Community)
EU	European Union
FACNET	Federal Acquisition Computer Network (United States)
FASA	Federal Acquisition Streamlining Act of 1994 (United States)
FAR	Federal Acquisition Regulation (United States)
FDA	Food and Drug Administration (United States)
FEHBP	Federal Employees Health Benefits Program (United States)
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
GPA	Government Procurement Agreement (World Trade Organization)
GSA	General Services Administration (United States)
GTPMS	Geographical Targeted Procurement Management System (South Africa)
GWAC	Government Wide Acquisition Contract (United States)
HFED	Hungarian Foundation for Enterprise Development
HUBzone	Historically Underutilized Business Zone (United States)
HUF	forint (currency unit, Hungary)
IDIQ	Indefinite Delivery Indefinite Quantity Contract (United States)
IFI	international financial institutions
IMF	International Monetary Fund
ITC	International Trade Centre (UNCTAD/WTO)
KVIC	Khadi and Village Industries Commission (India)
Lakhs	currency unit (India)
LBSC	Local Business Service Centre (South Africa)
LSI	large-scale industries (India)
MAP	Manufacturing Advisory Centre (South Africa)
MPT	Micro-purchase Threshold (United States)
MSI	medium-scale industry (India)
NAFTA	North American Free Trade Agreement
NGO	Non-governmental organization
NSIC	National Small Industries Corporation (India)
OAS	Organization of American States
OECD	Organisation for Economic Co-operation and Development
OFPP	Office of Federal Procurement Policy (United States)
OMB	Office of Management and Budget (United States)
OPM	Office of Personnel Management (United States)
OPPL	Office of Procurement Policy and Liaison
PCR	Procurement Center Representative (United States)

PHARE	Development Assistance for Central and Eastern Europe and other regions
PSU	Public Sector Undertaking
Rand	currency unit (South Africa)
SADC	South African Development Community
SAP	World Bank Social Action Programmes
SBA	Small Business Administration (United States)
SBDC	Small Business Development Center (United States)
SBIR	Small Business Innovation Research
SCORE	Service Corps of Retired Executives (United States)
SDB	Small and Disadvantaged Business Concern (United States)
SEBRAE	Small Business Assistance Service (Brazil)
SF	World Bank Social Funds
SIC	Standard Industrial Classification (United States)
SME	small and medium-size enterprises
SMME	small, medium and micro enterprises (South Africa)
SOE	State-owned enterprise
SOP	standard operating procedure
SSI	small-scale industry (India)
TIS	Trade Information Services (South Africa)
TP	targeted procurement
UNCTAD	United Nations Conference on Trade and Development
UNCITRA	United Nations Conference on International Trade Law
US	United States of America
USC	United States Code
VSB	very small businesses (United States)
WTO	World Trade Organization

## Introduction

This Guide attempts to provide the best available analytical and factual bases for considering the roles of public procurement in SME assistance. The intended audiences for the Guide are governments, SMEs, and interest groups that support SME interests (chambers of commerce, industry associations and SME associations, for example) in developing countries and in countries in transition from socialism.

There is a substantial economic literature that focuses on gains from trade as a means to achieve economic growth and higher standards of living, and generally as a means to generate wealth in a given country and globally. The law of comparative advantage is perhaps one of the most powerful economic ideas ever conceived. The law of comparative advantage provides that when markets are competitive, people will trade and will gain from trade when there are differences between countries in the relative costs of production. (Kenan 1994) In addition, many engaged in making trade policy have advocated export-oriented industrialisation for developing and transitional economies, an approach that relies on an open economy that exports goods to industrialised nation and other markets. There has been a great deal of focus on the "East Asian Miracle" and on the extent to which the economies of Northeast Asia relied on exports to generate significant rates of economic growth, often in the neighbourhood of ten percent per annum.

In addition to the findings on export-led growth, there have been some significant findings in what has been termed "growth theory" on what makes countries develop. Classical growth models focused on capital accumulation, and particularly the increasing returns to capital that occurred in countries that were starved for capital. New growth theories, particularly endogenous growth theory, focus on technical change as the catalyst for economic growth. By technical change we mean decisions by individuals in an economy in response to market forces that result in growth because of technical change in three areas: 1) increasing returns to specialisation in an economy; 2) human capital accumulation through education and training; and 3) "learning-by-doing" or growth through increased experience in business and production; and 4) research and development. All of these factors leading to growth complement the law of comparative advantage. (Francois & Shiells 1993).

What are the roles of SMEs in realising the gains from trade and other economic benefits? The potential for SMEs to engage in export-led growth is well known and well documented. SMEs "play a vital role in promoting job creation and distributing the benefits of economic development more fully."<sup>1</sup> The principal question that the Guide addresses is: given the policy objective of increasing exports in developing countries, can governments use programmes in public procurement to assist SMEs in becoming better exporter?

Public procurement markets tend to be substantial in relative terms in most countries, regardless of whether a country is industrialized, developing or transitional. We present here selected data on the size of the public procurement market and provide an approximate measure of the size of the market that becomes available to the firms operating in the countries for which we have data.

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<sup>1</sup> Jannik Lindbaek, Executive Vice President, International Finance Corporation, 1996 Annual International Finance Corporation Luncheon Address.

## Procurement levels

In most European Union (EU) member states, public procurement is [estimated](#) at 10 to 15% of gross national product (GNP), or 25 to 30% of public expenditure. The economic importance of public procurement in Europe should not be understated: public authorities and utilities subject to procurement directives of the European Community spend approximately ECU 720 billion annually on goods and services. In 1994, this number represented 11.5% of the gross domestic product (GDP) of all 15 member states of the EU, or the combined economies of Belgium, Denmark and Spain. Similarly, according to calculations by the Organization of American States (OAS) and the Inter-American Development Bank, the equivalent of 20% of the GDP of Latin American countries is spent by governments in public procurement<sup>2</sup> (OAS, 1995).

The OAS estimates that within the free-trade region of the North American Free Trade Agreement (NAFTA), total government procurement is close to US\$ 1 trillion (OAS, 1995). The central government's component of all public procurement has been estimated to be about 35% in the United States, 30% in Canada, and 74% in Mexico (McKenna and Cuneo, 1993). Canada, Mexico and the United States are all federal states and there will thus be significant procurement at the subcentral level that these estimates do not capture. Procurement in East Asian countries is estimated to be from 20 to 40% of GDP, but the significant degree of decentralization in many of the East Asian countries makes the data unreliable. The Africa region is characterized by similar decentralization issues as well as a general lack of resources to gather statistics on public procurement.

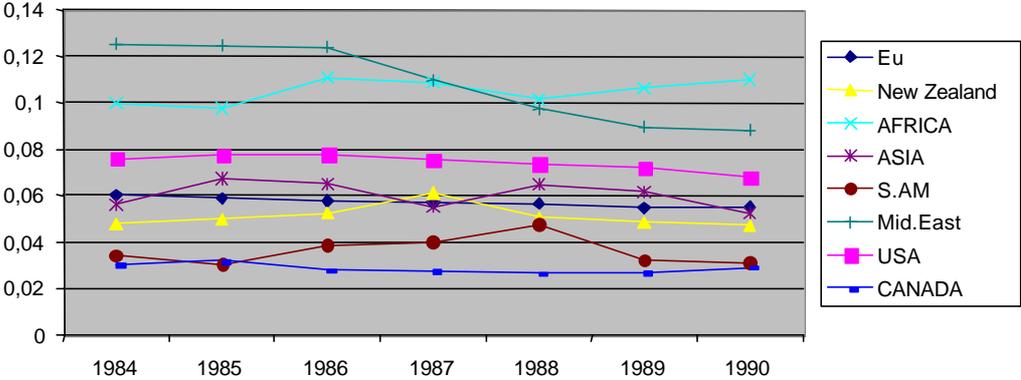
Determining the extent of procurement in most countries is inexact whilst determining the amount targeted to SMEs is impracticable. In general, many governments, especially in the developing and transitioning economies, do not keep good statistics on overall public procurement, let alone on the value of contract awards made to SMEs. Public procurement is decentralized in many countries between many ministries and increasingly between central and sub-central levels of government, which makes assessing the role played by SMEs difficult. Nevertheless, given the significant dollar amounts spent on public procurement, an examination of the issues related to the role of SMEs, combined with hard data on the distribution of contracts, is timely.

Despite the difficulties in measurement, international comparisons covering a wide set of countries is possible when one considers central government procurement only. We report the computations appearing in Trionfetti's contribution to the Guide, found in Annex E. His computations are based on central government procurement data published in *Government Finance Statistics* of the International Monetary Fund (IMF).

Figure 1 shows total central government purchases of goods and services other than salaries for the central governments of 27 countries grouped by regional areas.<sup>3</sup> The size of central government purchases varies considerably across countries. It is between 5 and 8% of GDP for most industrialized countries, except for Canada. The latter and the South American group seem to have very small central government purchases - between 3 and 4.5% of GDP. Although this Guide does not purport to investigate whether this is a reflection of the governmental structure of Canada and the South American countries, and whether figure 1 reflects only central government procurement, conflicting figures from the OAS, combined with

our understanding of the public administration of these countries, indicate that these figures do not take into account public procurement by non-central governments, and could underestimate total (central and non-central) government procurement (Trionfetti, 1997). For the Middle East and Africa, the magnitude of central government purchases ranges from 9 to 13% of GDP. African and Middle Eastern countries have a small GDP, yet, proportionally, they have larger government procurement than, for instance, European countries. Formal statistical analysis confirms that small developing countries make on average larger central government purchases as a percentage of GDP than do industrialized countries of equal size (Trionfetti, 1997). Finally, we observe that there is hardly any time trend or any significant fluctuation of the size of central government purchase over time.

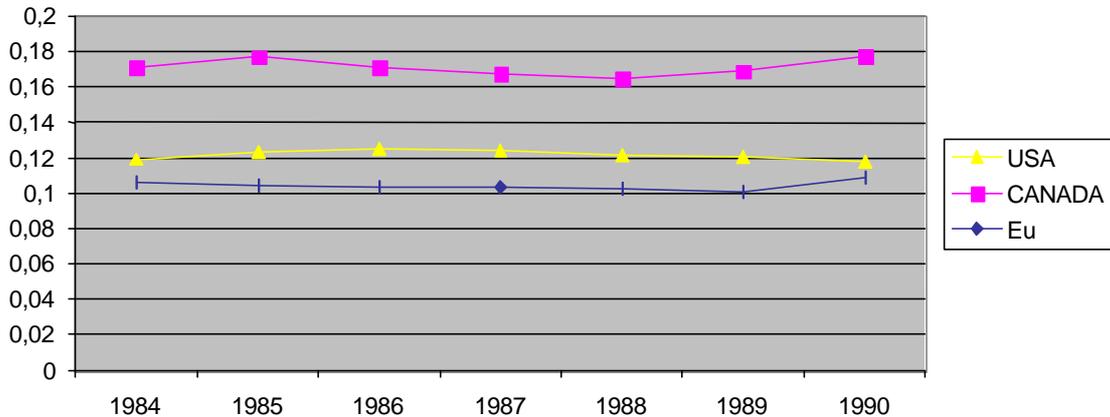
**Figure1. Central Govt. Procurement %GDP**



In sum, central government purchase of goods and services (excluding salaries) varies significantly across countries, ranging from between three percent (3%) and twelve percent (12 %) of GDP. A large part of it is represented by expenditure in construction. Netting out construction, other purchases are in the magnitude of 2.5 percent to eight percent (8%) of GDP. We cannot over stress, however, that these data may be understated significantly because of decentralisation of government functions.

A comparison of government purchase of all level of governments is possible, using the same data, among the countries who report data for all levels of government: these countries are the US, some European countries (Austria, France, Germany, Italy, Norway and Sweden), and Japan. The result (taken from Trionfetti 1997a) is in Figure 2.

**Figure II.2.1. GPGS/GDP**



### **Importance of social criteria in some countries**

In addition to the explicit economic aspects of SME programmes, in some countries, assistance to SMEs is based on policy objectives that may not be reflected in the concept of economic efficiency or economic growth. Governments sometimes prefer to emphasize other normative goals, such as political stability, social cohesion, re-mediation of serious racial or ethnic discrimination, cultural pluralism, "fairer" distribution of wealth where significant imbalances exist because of past government intervention, rapid and "equitable" increases in employment potential and balanced regional growth. In India, for example, SME programmes in public procurement are viewed as a means to provide employment to large numbers of citizens and to remove disparity in growth of various regions of a large country. In the United States and South Africa, some SME programmes are viewed as means to re-mediate racial discrimination. The issues associated with SME development thus may not be explicitly economic but may have political, social and even emotional overtones. These goals may conflict with the social welfare concerns of the whole versus those of selected groups in a given country. They indeed may be economically inefficient and detrimental to economic growth, and involve substantial social costs on the whole.

### **Approach of the Guide**

Reconciling economic and non-economic criteria represents the classic trade-off that many public policies must eventually face. The Guide does *not* take any normative policy stances on the desirability or undesirability of public procurement programmes designed to assist SMEs. Such normative policies are the responsibilities of national governments and policy makers. The Guide deals with the policy environment as exogenous. However, it exposes and identifies the various potential advantages and disadvantages, and potential costs and benefits, associated with various policy prescriptions.

Unit 1 describes the business and policy environment for SMEs and looks at the following:

- ◆ Constraints on SMEs in competing in the public procurement market place.

- ◆ Advantages of SMEs in the public procurement market place.
- ◆ Effects of public procurement programmes designed to assist SMEs.

Unit 2 attempts to define the SME concept based on various country experiences and the lessons learned. It looks at the ways in which various countries, big and small, developed and developing, have created standards for determining what is an SME in their economies.

Units 3 and 4 provide a detailed examination of the "tool-kit" used in public procurement to assist SMEs. These units examine the tools in the tool-kit on the basis of the magnitude of government intervention that is required for each tool. Procurement reform, which benefits SMEs as well as large businesses and is not targeted specifically to help SMEs, is covered in Unit 3. Unit 4, by contrast, covers tools that are targeted specifically to assist SMEs. In increasing magnitude of government intervention, the tools examined in Unit 4 fall into the following categories:

- ◆ Technical assistance, by government to SMEs.
- ◆ Training, of both government and SME managers, as well as acting as mentors of SMEs.
- ◆ Financial assistance and subsidies for SMEs.
- ◆ Subcontracting programmes, in which a government directs, recommends or encourages large business to provide subcontracting opportunities to SMEs.
- ◆ Price preferences, in which a government will add a percentage onto the price of large business, in order to provide SMEs competing in the procurement an improved chance to win a contract award.
- ◆ Targeted procurement, in which preference margins vary with the value of intermediate inputs from SMEs into the tenders that are received in response to a solicitation.
- ◆ Set-asides, in which only SMEs are eligible to compete in a public procurement or win contract award.

Unit 5 provides guidance on the implementation of public procurement programmes designed to assist SMEs. For example, one of the questions that this unit will address is that once the decision is made to assist SMEs, what are the practical steps that governments can undertake to initiate, implement, maintain and, if necessary, modify or abolish the programmes? This Unit also furnishes an important analytical framework for policy assessment and provides an institutional model for evaluating policy options. In summary, the 9 key elements of the institutional model are the following:

**1. Commitment:** Commitment is an important first step in devising and implementing durable public procurement programmes designed to assist SMEs. In order for programmes to be successful, a government must find a credible commitment both within its institutions and its polity. Various segments of the polity should have significant input into the construction of the programme, including SMEs, associations and interest groups with interests in assisting SMEs, as well as those that may be opposed to SME assistance programmes, chambers of commerce, the professions and community organizations.

There are two models of citizen participation in establishing policy. One is a political model,

based on the idea of participatory pluralism, and in giving people a voice in public policy. The other is an economic model, which is concerned with the inefficiencies associated with the use of the political process to divert scarce resources from one group to another.

The key aspects of commitment are that it should be *credible* and *consensual*. The major components of building credible commitment in a consensual manner depend very much on the country in question, but they include establishing a sound legal and policy environment, identifying potential participants, disseminating information, consulting with interested parties, and collaborating among the government, SMEs and industry groups.

**2. Baseline institutional capacity:** The ability of a government to deliver results depends in large part on its ability to monitor, audit and enforce government policy and programme effectiveness. It may be difficult or impracticable to achieve effective delivery of results in a government programme designed to assist SMEs if the institutions that are required to implement the programme are absent or weak. A country should "baseline" its institutional capacity before devising a programme to assist SMEs. A baseline provides information on what a government can realistically do and expect from a programme. What can be accomplished and the way it is accomplished depend on the institutions in a given country.

**3. Legal and regulatory structure:** The kinds of legal instrument that will be required to implement an SME assistance programme will depend on the manner in which such programmes are implemented in the country in question. SME programmes are typically implemented in legislation, which is law promulgated by a legislature in the form of a statute or code. Some countries will adopt regulation that will provide additional detail to implement the legislation. Depending on the legal system, regulation may or may not require authorization in legislation or in a constitution. In some states, SME programmes may be implemented solely by an executive branch of the government, through circulars, guidance or executive orders, without or with a bare minimum of legislative authority.

**4. Organization:** A significant aspect of SME programme development is in the choice of the appropriate institutional structures for the public management of SME programmes. Some public body or combination of public bodies has to "own" the programme. To the extent that the SME assistance may conflict with efficiency or value for money goals in public procurement, a distinct public body may be appropriate. The kinds of organization that are appropriate and the powers that they will possess will depend on the baseline of institutional capacity for a given country, and on the resource constraints within the country's system of public finance and governance.

**5. Implementing guidelines:** In addition to a legal or regulatory framework, a more detailed and rudimentary set of guidelines may be necessary to ensure that the law or regulation is "operationalized" to the level of the particular government bodies that will be responsible for implementing the programme.

**6. Training:** Training is an important element in the success of SME programmes. Two important audiences for training are: (1) government managers; and (2) SME managers. Training should be based on local conditions and should be accessible locally.

**7. Measurement of results:** Measurement and data collection efforts should be devised to ensure that programmes are evaluated on the basis of effectiveness and not merely on inputs. The lack of rigorous statistical measures is particularly acute in developing and transitioning economies. Data not only need to be collected in well-accepted and unbiased ways; they should also be assessed based on established credible measures. Programme success has to be: (1) defined in accordance with the public participation process outlined above; and (2) measured on the basis of the agreed-upon definitions. A standard method for assessing the credibility of government programmes is cost-benefit analysis.

**8. Evaluation and review:** Governments should be prepared to evaluate SME programmes periodically.

**9. Modification or abandonment as necessary:** Governments should adapt and be prepared to modify or even abandon programmes that are ineffective. Programme reform is often difficult not for policy reasons, but for political reasons. Governments should take steps to be able to shed unsuccessful programmes and to keep and improve successful ones. When a government reaches this stage, it loops back to step 1, Commitment. Governments can undertake programme revision based on the criteria and methods set forth in unit 5 to ensure adequate information, public participation and accountability.

Table 1 contains a summary matrix of this institutional model. Full details of the model are set forth in Unit 5.

**Table 1 Institutional model**

<b>Elements of model</b>	<b>Key features</b>
1. Commitment	<ul style="list-style-type: none"> <li>▪ Widespread popular participation and acceptance</li> <li>▪ Sustainable, equitable and democratic development</li> <li>▪ Credible and consensual commitment</li> <li>▪ Interest group participation without capture or rent-seeking</li> </ul>
2. Baseline institutional capacity	<ul style="list-style-type: none"> <li>▪ Government as service provider, emphasis on quality and management</li> <li>▪ What can public and private institutions actually do?</li> <li>▪ Focus on results</li> <li>▪ Tailor programmes to institutional capacity</li> <li>▪ Monitor, audit, enforce</li> </ul>
3. Legal and regulatory structure	<ul style="list-style-type: none"> <li>▪ Domestic and international levels</li> <li>▪ What works in your country</li> <li>▪ Strive to meet international standards</li> </ul>
4. Organization	<ul style="list-style-type: none"> <li>▪ Implementation, oversight and advocacy</li> <li>▪ Different public bodies or in procuring entities?</li> <li>▪ Taking ownership</li> <li>▪ A function of resource constraints, among other things</li> </ul>
5. Implementing guidelines	<ul style="list-style-type: none"> <li>▪ “Operationalize” programmes and policy</li> <li>▪ Trade-off rules versus discretion</li> <li>▪ Depends on institutional strength and weaknesses</li> </ul>
6. Training	<ul style="list-style-type: none"> <li>▪ Government and SME</li> <li>▪ Develop capacity</li> <li>▪ Improve compliance</li> <li>▪ Nurture support</li> </ul>
7. Measurement of results	<ul style="list-style-type: none"> <li>▪ Rigorous data collection</li> <li>▪ Credible statistical measures</li> <li>▪ Unbiased</li> <li>▪ Based on credible and durable measures</li> <li>▪ Cost - benefit analysis</li> </ul>
8. Evaluation and review	<ul style="list-style-type: none"> <li>▪ Periodic</li> <li>▪ Function of institutional capacity</li> <li>▪ Use data developed above</li> </ul>
9. Modification or abandonment as necessary	<ul style="list-style-type: none"> <li>▪ Programme reform</li> <li>▪ Political obstacles</li> <li>▪ Dismantle bad programmes</li> </ul>

## Unit 1

### **Business and Policy Environment**

This unit identifies and explains the various challenges, advantages and disadvantages of public procurement programmes designed to assist small and medium-sized enterprises (SMEs) from two perspectives. First, it addresses the features of SMEs as business concerns and the private costs and benefits to SMEs themselves in seeking and performing public contracts. It looks at the constraints on the competitiveness of SMEs in public procurement markets. Secondly, the unit examines the social costs and benefits of public procurement programmes intended to assist SMEs. It looks at the costs and benefits to government and to society resulting from public procurement programmes designed to assist SMEs.

#### ***Learning Objectives***

*By the end of this Unit, you should be familiar with the following:*

- ◆ *Problems and pitfalls associated with SME status.*
- ◆ *Constraints on competitiveness of SMEs in public procurement markets.*
- ◆ *Advantages which SMEs possess in competing in public procurements.*
- ◆ *Effects of public procurement programmes designed to assist SMEs, including positive and negative effects, from public, government and SME perspectives.*

#### **1.1 SMEs in the global market place: public procurement**

SMEs face a number of constraints on their competitiveness in both public procurement markets and in commercial markets. This Guide focuses on the problems that SMEs face in public procurement. By contrast, it provides only an overview treatment of many of the problems that SMEs face generally in the market.

##### **a) Competitiveness constraints on SMEs**

SMEs are subject to a number of constraints on their competitiveness in public procurement markets. Many of the constraints result from the relative effects of fixed costs on SMEs to conduct public procurement relative to the effects of fixed costs on large businesses.

There are two types of cost that SMEs, and firms in general, incur. Variable costs are costs that change with production of a good or service. For example, most firms hire labour to deliver specific outputs. Labour is in this context a variable cost. A fixed cost, on the other hand, is one that a firm must incur in order to maintain its existence. Fixed costs must be paid in order for the firm to stay in operation, even if the firm produces nothing. Fixed costs and variable costs comprise the total costs of the firm. These are standard definitions in the industrial organization literature. The effect of fixed costs on SMEs may be a relatively greater burden on SMEs than on large firms. Fixed costs may comprise a larger proportion of the total costs incurred by SMEs. The fixed costs of large firms, on the other hand, tend to be

relatively lower and less of a burden on the large firm. In sum, the costs of just "getting in the game" tend to be much greater, in relative terms, for SMEs than for large firms.

The significant constraints are the following:

*Restricted access to finance*

This constraint includes restricted availability of capital from normal commercial sources, a relatively higher burden arising out of slow payment under public contracts and barriers to entry in public procurement markets due to performance bond and guarantee requirements that are onerous, on a relative basis, for SMEs.

*Performance versus demand guarantees*

There are two main types of guarantee, those based on *performance* and those on *demand*.

- ◆ Under *performance guarantees*, a financial institution warrants that all the terms of the contract between the government and the contractor will be completed successfully. The guarantee, which in the United States normally costs about 1% of the amount guaranteed, contains the criteria as well as the adjudicating conditions that determine success. Non-compliance must be confirmed by a third-party or by the guarantor. If the contractor is found to have failed to have completed the contract as specified, then the guarantor has the option to either pay the government the amount guaranteed or to find and pay another contractor to complete the project. The amount guaranteed varies from 100% in the United States to 30% or less in Europe, where other forms of guarantee are included to reach the total value of the contract. Asia has shown the fastest growth in performance guaranteed contracts while this type of guarantee is not widely used in Latin America, mostly because of impediments found in legislation in Latin American countries.
- ◆ *Demand guarantees* typically cover a smaller portion of the contract. They require a payment to the government ranging from 5 to 15% in the event of non-performance. Demand guarantees are exactly that. They are payable upon demand and thus can be called without identifying the specific conditions that the contractor violated. Thus, a government can declare that the conditions of the contract have not been met and demand payment from the guarantor. The only recourse for either the contractor or the guarantor is to take legal action.

From a legal perspective, a demand guarantee is sometimes a standby letter of credit. Public procurements in developing and transitional economies often mandate the use of demand guarantees rather than performance guarantees. Although demand guarantees may be a constraint on both large and small enterprises, the effects are relatively more burdensome on SMEs. Demand guarantees may constitute a significant barrier to entry into public procurement markets for SMEs because they require collateral in the form of assets of significant value. Because of legal principles mandating the independence of the demand guarantee from the performance underlying the public contract, the issuer's obligations to the procuring entity do not depend on the contractor. The demand guarantee is a primary

obligation of the issuer, payable upon the fulfilment of specified documentary conditions. A performance guarantee, however, is a secondary obligation that is effective only if the contractor fails to perform, and the issuer of the guarantee enjoys the same contractual defences as does the contractor (Shinn, 1997).

#### *Access to information*

Information is costly. SMEs face considerable barriers to entry because of the costs of obtaining information on goods, works and services being sought by governments. Information costs may be sufficiently onerous so as to preclude SME involvement in public procurement. The difficulty of acquiring information is more significant in the international context. Large firms, especially multinationals, have easier access to information about invitations to tender in foreign countries than do SMEs. Potentially, the lack of information is damaging particularly to firms in developing and transitioning economies. Lowering the costs of information will remove or lessen a significant impediment to SME participation in public procurement. The problem of information (and knowledge) is so critical that it is the subject of a World Bank report (World Bank, 1998).

Governments can assess the efficiency and appropriateness of information dissemination and the charging of fees for procurement documentation such as invitations to tender, specifications and drawings. Technology is proving to be an effective means of lowering information costs for SMEs and governments in Europe and in the Asia-Pacific Economic Cooperation (APEC) countries. The decrease in information costs often has to be accomplished in coordination with telecommunications infrastructure development and sector reforms in telecommunications.

#### *Barriers to human capital development*

SMEs face considerable impediments to accessing skills and skilled labour markets. Labour costs are variable costs as are, to some extent, training costs. The costs of searching for skilled workers, however, are mostly fixed costs. Thus, if skilled labour is scarce, search costs are comparatively more expensive for SMEs than for large enterprises. Moreover, procurement offices may seek levels of technology that are in excess of what is needed in a given procurement and this may constitute a barrier to entry for SMEs.

The relative scarcity of skilled labour may be the result of institutional constraints in a country. In South Africa, for example, there are the particular problems that apartheid has created in the development of educational institutions. Educational institutions are only in the nascent stages of developing training programmes that are relevant to SMEs and that focus on self-employment and entrepreneurship.

#### *Access to markets and procurement opportunities*

This constraint would seem to relate to the access to information constraint, although it may encompass broader issues. SMEs generally face a number of hurdles in obtaining access to

markets, such as the relatively high costs of preparing tenders. Another potential constraint is the relatively high cost of transportation for the supply of lesser quantities of goods by SMEs than larger quantities of goods by large firms.

### *Social constraints*

Discrimination, bias, prejudice, historical disadvantage, apartheid and segregation (past societal discrimination) may have hindered a good portion of SMEs in particular countries. For some SMEs, many of the other constraints result from social constraints. For example, it has been well documented that many African-Americans, today and historically, due to racial prejudice, lack access, to capital in the form of bank loans. It has been well documented that in South Africa, Blacks were unable to gain access to bank financing during apartheid. One of the questions addressed in this Guide is, given these social constraints, which in some cases are formidable, does public procurement play a role in eliminating the constraint or mitigating its effects?

### *Government procedures and practices that favour large businesses*

Governments may bundle quantities sought in procurements so that they may lower transaction costs associated with procurement by dealing with fewer contracts and contractors and take advantage of quantity-discounting strategies. Bundling often makes it difficult for SMEs to compete for contract awards. There may be substantial costs for SMEs in registering and qualifying as a government supplier. Some registration and qualification conditions may be onerous and lead to exclusion of SMEs from various lists maintained by procuring entities.

The regulatory burden associated with the public procurement process and with contract performance may be formidable for SMEs. Some regulatory aspects of procurement, much of which is not related directly to selection of the contractor or contract performance, may constitute a significant barrier to entry for SMEs. Fees associated with procurement documentation may be onerous for SMEs. The costs of inspections and contract administration may be relatively more burdensome for SMEs. It is often very difficult for SMEs to seek legal recourse against the government, and dispute resolution or litigation may entail transaction costs that are unduly burdensome to SMEs that lack in-house counsel who are paid fixed salaries. Competition law and sometimes the law on small business programmes themselves may make twinning or joint venturing costly or risky.

In some cases, governments may take action to alleviate regulatory burdens on SMEs. The point here is that, in the absence of government intervention targeted specifically to deregulate the procurement process so as to reduce costs and barriers to entry in public procurement, procurement procedures and practices may deter SMEs from participating in public procurement.

These are the principal constraints that governments and policy makers have identified and recognized when making policy. The Guide makes no value judgements on these

constraints, and does not question the motives of government officials in asserting these rationales to make law or policy to assist SMEs.

## **b) Competitive advantages of SMEs**

SMEs enjoy a number of competitive advantages, including the following:

### *Flexibility*

SMEs may have greater flexibility, relative to large firms, in adapting production and sales to changes in the market. The advantage, however, may be more apparent than real in some cases. Computerized technologies (numerical control, robotics, etc.) may make large-scale production extremely flexible.

### *Innovation*

SMEs in some countries are a source of innovation and may serve as the catalysts for economic growth. They may become large firms, or disappear, not infrequently by being bought up by other companies wishing to take up their ideas. In the United States, for example, where the small business sector is dynamic and growing, more than 70% of new small firms do not last more than 5 years. Governments may establish a policy environment that does not impede innovation and entrepreneurship, and in some cases might mean doing very little except getting institutions right and engaging in minimalist forms of intervention that are designed to protect contract and property rights. In developing countries overall, SMEs account for 60 to 70% of domestic industrial production, and up to 90% of employment in the industrial sector. This does not necessarily mean that people are better off with SMEs, however. SMEs are often not as productive as large firms and this is reflected in the lower prices associated with their factors of production.

### *Lower costs*

In some cases, SMEs have lower costs than large firms, including lower labour costs and lower indirect costs such as lower overhead. Whether costs are really lower for SMEs than for large firms depends on the structure of the market and the technologies associated with production in the market.

### *Spatial benefits and the potential for decentralized supply opportunities*

The potential for decentralized supply opportunities exists where SMEs are local suppliers that are closer to areas of distribution or have relatively better information on distribution points than large firms. When supply is required at several points that are geographically apart, SMEs located at or near the respective supply points may have comparative advantages over a large unit operating from a fixed point.

*Lower congestion costs*

Lower congestion may be reflected in contract pricing by SMEs. SMEs located in less congested areas outside or in the peripheries of metropolitan areas may have lower costs. There may be relatively less use of congestible resources such as land, infrastructure and housing, in areas where SMEs are located.

By "congestion" we mean the use of a fixed supply of a good by "too many" users. Examples are congested roads or congested airports. Suppose that there is a fixed amount of infrastructure (say, one circular road) and a production capacity of 100 units is to be located on the circle. Now, let us assume that one could choose between one large-scale plant that produces 100 units and 50 small-scale plants each producing 2 units. If production is concentrated in 1 plant, congestion is necessarily created where, on the circular road, the plant is located. The services and trade with the large plant will congest on the small neighbourhood of the road where the large plant is located, while the rest of the circular road is underutilized because there is no business there. If, instead, there are 50 small-scale plants, they can be spread evenly around the circle and therefore utilize evenly the entire circular road. The first solution creates congestion (overutilization of the same resource in some place and underutilization in other places). The second solution does not create congestion. Congestion results in an inefficient use of available (fixed) resources.

Table 2 summarizes the advantages and disadvantages of SMEs that have been explored in this section.

**Table 2** **SMEs in the global market place**

<b>Competitive constraints</b>	<b>Competitive advantages</b>
<ul style="list-style-type: none"> <li>▪ Restricted access to finance</li> <li>▪ Diminished guarantee and bonding capacity</li> <li>▪ Barriers to human capital development (skilled labour)</li> <li>▪ Restricted access to markets, including public procurement markets</li> <li>▪ Social constraints</li> <li>▪ Restrictive procurement procedures and practices</li> </ul>	<ul style="list-style-type: none"> <li>▪ Significant innovation potential</li> <li>▪ Relatively lower costs?</li> <li>▪ Spatial benefits – decentralized procurement opportunities</li> <li>▪ Relatively lower congestion costs?</li> </ul>

## 1.2 Effects of SME public procurement programmes

This section will identify and discuss the positive and negative effects of public procurement programmes designed to assist SMEs.

### a) Potential negative effects:

#### 1. A governmental or social perspective

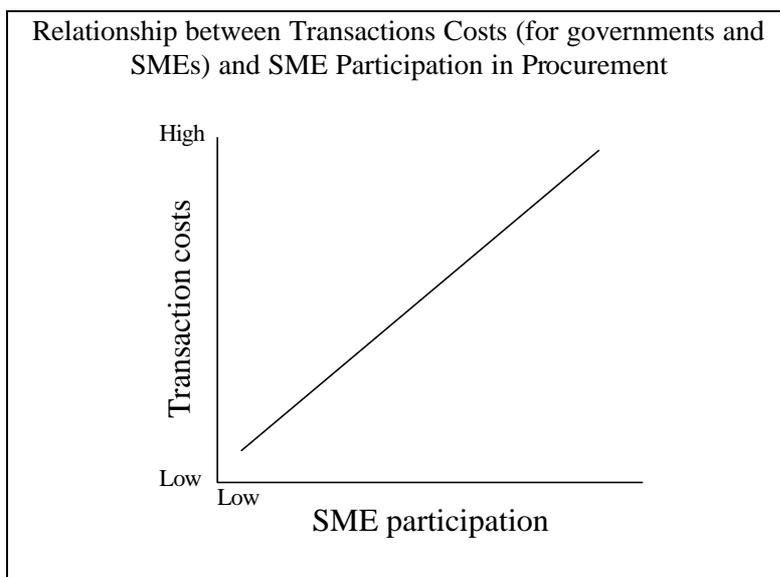
##### *Administrative and personnel costs*

SME programmes in public procurement may increase the costs of public procurement for the taxpayer. For government procurement officers the cost of dealing with SMEs includes:

- ◆ Costs of evaluating a small bidder;
- ◆ Costs of monitoring many small suppliers rather than one large one;
- ◆ Costs of monitoring quality control of many small suppliers;
- ◆ Risks of a small company defaulting and the associated costs of dealing with default.<sup>4</sup>

A major disadvantage for procuring entities in contracting with SMEs is the high transaction costs inherent in dealing with small firms. Rather than procure from one large firm, procuring entities must duplicate their efforts with several smaller ones. Figure 2 illustrates this phenomenon.

**Figure 2: Relationship between transaction costs (for government and SMEs) and SME participation in procurement**



### *Premium costs*

Premium costs are the costs incurred by the government in awarding a contract to an SME when that SME offers either: a higher price than if the competition for contract award were unrestricted, or when the government accepts lower quality, given a constant price, due to a contract award to an SME. It is widely contended that premium costs are inevitable, and that there would be no need to restrict awards for SMEs if there were no premium costs incurred by the government and ultimately by taxpayers. This point is controversial and some would argue that SME awards actually result in cost savings, although the cost savings may be difficult to quantify.

In the United States, premium costs are acknowledged and well accepted as part of the cost of having SME programmes, as is explained by the United States General Accounting Office, a legislative agency that has jurisdiction to hear bid protests relating to federal procurements:

[I]n view of the congressional policy favouring small businesses, contracts may be awarded under small business set-aside procedures to small business firms at premium prices, so long as those prices are not unreasonable. . . . In this regard, we have noted that a small business bidder's price is not unreasonable merely because it is greater than the price of an ineligible large bidder, since there is a range over and above the price submitted by the large business that may be considered reasonable in a set-aside situation. *Hardcore Dupont Composites, L.L.C.*, B-278371, 20 January 1998, 1998 Comp. Gen. LEXIS 14; see also *Interstate Commerce Commission - Request for Reconsideration*, B-237249.2, 16 April 1990, 1990 Comp. Gen. LEXIS 438, 90-1 C.P.D. ¶ 391 ("even though ICC, like many other government agencies, has experienced budget cuts and additional expense due to federal pay raises, those facts alone do not make [the small business] bid unreasonable, particularly in light of the relatively small difference . . . between [the small business] quote and the large business's courtesy quote.").

### *Restricted choice by the user caused by restrictions on competition*

The costs associated with restricted choice are related to the concept of premium cost, in that restricted choice may increase the costs of transportation, warehousing and other contract costs to be passed on to public-sector consumers.

### *Lobbying costs*

SMEs may incur costs to obtain and maintain SME benefits and special programmes. SMEs may engage in rent seeking, which is the use of the political process by economic actors to obtain economic profits that otherwise would not be available in market transactions. The basic problem with rent seeking is that persons devote scarce resources to obtain and protect legally created monopolies rather than invest those scarce resources in explicit product markets. The consequences of rent seeking are socially wasteful monopoly rents that are dissipated in the course of SME efforts to obtain the rents in the political process.

Government creates an implicit market for SME programmes. This implicit market is to be distinguished from the explicit market for the products of SMEs. Given the incentives created by government assistance, some would argue that SMEs may find it advantageous to remain weak and dependent on the government. Government assistance may be viewed as a form of compulsion for SMEs to obtain contracts and differential advantages that they otherwise would not be able to obtain in the market place. To the extent that firms seek out government benefits, they will divert their scarce resources from private markets and from unassisted public markets to the pursuit of government-mandated assistance. Given scarce resources, they cannot pursue both the implicit market for government assistance without forsaking opportunities in explicit product markets. The concept of rent seeking is well known and well accepted (Tullock, 1967; Tullock, 1971; Krueger, 1974; Laffont, 1998).

Large firms may also engage in rent seeking, if not in seeking special procurement programmes, then in other areas, such as in seeking protection from international competition in their industries. We do not assert that small firms engage in rent seeking on a larger scale than large firms. Large firms, on the whole, may indeed engage in more significant overall levels of rent seeking than small firms. The point here is that small firms and their interest groups may engage in such activity in connection with SME programmes. It could very well be that many small firms in some instances may face more significant coordination problems than a few large firms, and thus their lobbying activities for those small firms in such a case may thus be more costly and difficult to undertake.

#### *Transfer costs*

There may also be costs associated with transfer payments in the system of public finance in a given country. There are costs associated with taxing the private sector, taking resources from the private sector and reallocating them to the public sector. As explained in one text that adopts the premise that government has a productive role to perform in regulating economic activity, "the size of the pie which is available for distribution is not unrelated to how it is to be distributed" (Musgrave and Musgrave, 1989). Policies to promote goals such as balanced regional growth and "fair" or "equitable" distribution may involve significant losses to a country. The gains obtained by the beneficiaries of a government programme may be less than the losses sustained by citizens that pay for the programme. The effect may be slower economic growth and a decrease in overall welfare of the populace. Governments often lack the information that will lead to the design of a proper programme that minimizes such costs. When the problem of rent seeking is added to the policy-formulation stage, the incentives of government to construct a policy that minimizes loss may be hindered substantially.

#### *Market structure costs*

SME programmes may determine the extent of the market. There may be markets in which SMEs have a comparative advantage without government intervention. The extent of the market may be market driven, created by private consumer demand for the product in question. Government intervention, however, may create markets where none would exist without it. Government may in some instances create an SME sector where none previously existed. There inevitably will be ramifications in connection with such government programmes. Governments typically lack adequate information on the effects of such activities.

## *Protectionism*

Discrimination by government in favour of domestic producers constitutes a non-tariff barrier to international trade. The effect of discriminatory procurement depends on the underlying market structure. Effects may be negligible in very competitive markets, but in markets characterized by monopolistic competition, the effects may be deleterious to economic well-being of a country. Governments again face a serious information problem in devising the right policy for the right circumstances.

## **2. An SME perspective**

The disadvantages for SMEs participating in public procurement include the following:

### *Relative effects of fixed costs to conduct public procurement*

SMEs may face higher costs in public procurement relative to large business. For example, the costs of pre-qualification, qualification, and other costs associated with accessing the market may pose much greater burdens on SMEs than on large businesses. Absolute costs may be higher for large businesses, but the relative costs may be higher for SMEs. This disadvantage affects all of the categories of costs identified in this unit.

### *Bid and proposal costs*

One of the variable costs that SMEs face in the public procurement market place are substantial bid and proposal costs. Public procurements often involve substantially greater bid and proposal costs than what is found typically in commercial contracting.

### *Costs of obtaining information*

SMEs typically encounter relatively significant costs in obtaining marketing information, including learning about, bidding on and fulfilling opportunities.

### *Bonding*

SMEs face formidable burdens in obtaining bid and performance bonds and guarantees. For example, in Latin America, the use of demand guarantees instead of performance guarantees is a significant factor in keeping SMEs out of public procurement.

### *Restricted working capital, including slow payment*

SMEs face significant burdens in obtaining the necessary capital to run and grow their business. This problem is exacerbated by the poor practice of many governments in paying

contractors too slowly. Many governments are slow payers and their regulatory and institutional structures hinder their ability to pay contractors within a reasonable period of time. Large firms are better at waiting for payment, since they typically have adequate financial resources from other sources that they can tap into to pay their factors of production, pending receipt of payment by the government. SMEs often have no such financial resources.

### *Regulatory costs*

Public procurement tends to be highly regulated, and this entails substantial costs for SMEs.

### *Excessive centralization of government*

SMEs may be located in the peripheries of countries; they typically are not national or multinational enterprises. Unlike large businesses, they may not have representatives in the centres of countries. To the extent that procurement is centralized in a given country, this can be problematic for SMEs.

### *Legal risk of dealing with the government*

The costs associated with legal risk are similar to regulatory costs. Regulatory costs are preventative in nature. Legal risk, on the other hand, entails the costs relating to the consequences of failing to adhere to regulation. Some businesses may engage in a risk assessment, comparing the costs of detection with the costs of compliance.

## **b) Potential positive effects**

### **1. A governmental or social perspective**

#### *An increase in the competitive base and a decrease in industry concentration*

Developing a strong SME base may increase competition in public procurement, which may provide government with better value for money and increased efficiency in public procurement. The benefits of competition in procurement are well accepted.

United States policy is based partly on the concept of increasing competition in the domestic economy and on a policy preference, as set forth in the United States Small Business Act, for small businesses. The various political bodies historically have expressed concern and implemented legislation to prevent industry concentration and "trusts." The fear of centralization has recurred throughout United States history. Judge Learned Hand said in *United States v. Aluminium Company of America*, 148 F.2d 416, 427 (2d Cir. 1945) that the US Congress, in enacting anti-monopoly legislation, "was not necessarily actuated by economic motives alone" and that "[i]t is possible, because of its indirect social or moral effect, to prefer a system of small producers, each dependent for his success upon his own

skill and character, to one in which the great mass of those engaged must accept the direction of a few." American antitrust law is based in substantial part on the preference to avoid large business concentrations.

During the years immediately following the Second World War, however, there was growing uneasiness in Congress about the future of small businesses. The US Small Business Administration was officially launched by Congress on 30 July, 1953. Its basic charter is the Small Business Act of 1953, as amended, which states:

The essence of the American economic system of private enterprise is free competition. Only through full and free competition can free markets, free entry into business, and opportunities for the expression and growth of personal initiative and individual judgement be assured. The reservation and expansion of such competition is basic not only to the economic well-being but to the security of this Nation. Such security and well-being cannot be realized unless the actual and potential capacity of small business is encouraged and developed. It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small business concerns in order to preserve free competition enterprise, to insure that a fair proportion of the total purchases and contracts or subcontracts for property and services for the Government (including but not limited to subcontracts for maintenance, repair and construction) be placed with small business enterprises to ensure that a fair proportion of the total sales of Government property be made to such enterprises, and to maintain and strengthen the overall economy of the Nation (15 U.S.C. para 631(a).

India maintains a policy based on self sufficiency, which in part is designed to assist SMEs. The fundamentals of the policy has been summarized in the preamble to the General Financial Rules, 1963 (Chapter 8 - Stores) as follows:

The policy of Government is to make purchases of stores for the public service in such a way as to encourage development of indigenous production of stores to the utmost possible extent and to make the country self-sufficient in the matter of its own requirements. The following rules which supersede all previous orders on the subject and which are applicable to the purchase of stores (except stationery stores) for the requirements of Government and Union Territories are prescribed in accordance with this policy.

Economists have criticized such policies (Krugman and Obstfield, 1997; Bajpai and Sachs, 1998) India may in the future abandon or limit these policies as it progresses in its current programme to open up its economy.

*Re-mediation of past discrimination and historical disadvantage*

From a societal perspective, SME programmes may serve as re-mediation of past discrimination and historical disadvantage. This would be particularly relevant for ethnic and racial groups and gender categories and for geographical regions of the countries that policy makers decided have lacked access to business opportunities and capital.

### *Promoting equity and fairness*

An SME programme in public procurement may be viewed as a direct approach to address equity, fairness and social concerns in a given polity.

### *Promoting social cohesion and mitigating social exclusion*

Some governments have developed programmes designed to redress problems associated with social exclusion by promoting social cohesion. In the United Kingdom, "social exclusion" is "a shorthand label for what can happen when individuals or areas suffer from a combination of linked problems such as unemployment, poor skills, low incomes, poor housing, high crime environments, bad health and family breakdown" (United Kingdom Social Exclusion Unit, [www.open.gov.uk/co/seu/seuhome.htm](http://www.open.gov.uk/co/seu/seuhome.htm)). In the United Kingdom, however, there are no public procurement programmes designed to alleviate social exclusion. Rather, the Blair Government has adopted programmes such as a welfare to work programme, with an emphasis on raising standards of literacy and numeracy, a national childcare strategy, and a review on how to implement civil rights laws for disabled persons (United Kingdom Social Exclusion Unit, [www.open.gov.uk/co/seu/seuhome.htm](http://www.open.gov.uk/co/seu/seuhome.htm)). In the United States, similar programmes exist, but there are also substantial SME programmes in public procurement.

### *Equitable distribution of public contract funds*

Some countries maintain a policy of treating public contracts differently from private contracts. Public contracts involve taxpayer funds, and in some countries, the policy is to facilitate constituent interests by promoting what is deemed to be an equitable distribution of public contract funds. These kinds of policy are controversial because they depart from the value-for-money paradigm in public procurement and they have the potential to introduce political issues into procurement that are not related directly to buying the best products and services.

### *Potential to foster job creation*

In some countries, such as India, SME programmes are viewed as a means to increase employment opportunities across broad sectors of the country. Procurement programmes targeted at SMEs may increase employment for some regions or industrial sectors, although the effects may be ambiguous. The potential sources of savings would be tax payments from SMEs, net employment gains leading to lower unemployment benefits and higher tax collections, more rapid economic growth which also results in more taxes being paid as well as greater overall prosperity.

Do SMEs actually create more net jobs? The evidence is mixed and a great deal more empirical work is necessary. In manufacturing, SMEs appear not to be the engine of job growth that many claim they are - small businesses create jobs in about the proportion that they contribute to the economy as a whole.

### *Balanced regional growth*

Some contend that SME programmes in public procurement foster balanced regional growth and a decrease in disparities among regions within a country. This is a policy underlying SME programmes in public procurement developed by the Indian Government. Their policy findings are that SMEs create employment, and bring money and affluence to a larger percentage of the population. Large-scale units distribute their benefits among fewer people, and by contrast, SMEs spread benefits more widely and create conditions for balanced growth.

### *Redressing mal-distributions of wealth*

In some countries, SME programmes in public procurement are viewed as a means to redress mal-distributions of wealth and to increase the tax base of a given country. Mal-distributions may have been created as a result of government intervention favouring certain ethnic groups, as has been the case, for example, in South Africa.

## **2. An SME perspective**

These effects are obvious. They include:

### *Improved access to the largest markets in many countries*

As explained in the Introduction, public procurement markets are significant markets in many countries, particularly in developing and transitional economies in which private enterprise remains in emerging states of development.

### *Technology transfer*

SMEs can acquire knowledge, information, skills, experience, technology, management skills and a host of other knowledge-related inputs from participation in public procurement.

### *Assistance in developing competitiveness in the private sector*

### *Potential for linkage with large business*

Procurement programmes to assist SMEs may facilitate the provision of information on SME capability to large businesses and may increase business opportunities for SMEs. Notably, through such programmes, governments may be able to overcome the natural tendency of

procuring entities to obtain goods and services from familiar, large business sources. This is especially important in any governmental efforts to ensure equitable opportunities for SMEs.

*Breaking through past barriers to business success*

*Export development*

The purpose of this Guide is to look at how public procurement programmes may assist SMEs to improve their exporting. In some countries this may be an explicit policy of the government. In others, it may be a by-product of assistance in general.

In India, for example, SMEs have played a significant role in development of its exports. The Government recognizes the potential of growth of its exports through SMEs and it encourages the establishment of purely export-oriented units. The export performance of SMEs is monitored and assistance is provided. The contribution of Indian SMEs to the exports of their country has been significant and is at around 40% of the total manufacturing sector exports.

Table 3 contains a summary of the analysis in Unit 1.2.

**Table 3            Costs and benefits of SME public procurement programmes**

<b>1. Social costs</b>	<b>1. Social benefits</b>
<ul style="list-style-type: none"> <li>▪ Government administrative and personnel</li> <li>▪ Premium</li> <li>▪ Restricted end-user choice</li> <li>▪ Lobbying</li> <li>▪ Transfer</li> <li>▪ Market structure</li> <li>▪ Protection</li> </ul>	<ul style="list-style-type: none"> <li>▪ Increase in competitive base</li> <li>▪ Decrease in industry concentration</li> <li>▪ Re-mediation of past discrimination and disadvantage</li> <li>▪ Promoting equity and fairness</li> <li>▪ Promoting social cohesion and mitigating social exclusion</li> <li>▪ Equitable distribution of public money</li> <li>▪ Potential for job creation</li> <li>▪ Balanced regional growth</li> <li>▪ Redressing mal-distributions of wealth</li> </ul>
<b>2. Private costs</b>	<b>2. Private benefits</b>
<ul style="list-style-type: none"> <li>▪ Higher fixed costs in public procurement</li> <li>▪ Bid and proposal</li> <li>▪ Information</li> <li>▪ Bonding</li> <li>▪ Capital (including slow payments)</li> <li>▪ Regulatory costs</li> <li>▪ Cost associated with government centralization</li> <li>▪ Legal risk</li> </ul>	<ul style="list-style-type: none"> <li>▪ Improved access to large markets</li> <li>▪ Technology transfer</li> <li>▪ Developing competitiveness for private sector</li> <li>▪ Potential large firm linkage</li> <li>▪ Breaking through past barriers</li> <li>▪ Export development</li> </ul>



## Unit 2

### **TOOLS AND EXPERIENCE I: WHAT IS AN SME?**

This unit provides the eligibility criteria for SME status as used in various countries and explains the relevance of SMEs in the global market place. The definitions of SMEs vary country by country, depending on such variables as its state of development, its size, the strength of its industrial and business sectors and the particular problems SMEs face in that country.

#### ***Learning Objectives***

*By the end of this Unit, you should be familiar with the following:*

- ◆ *Relevant criteria for establishing SME eligibility.*
- ◆ *Examples of what constitutes SMEs in a range of developing, transitional and industrialized countries.*
- ◆ *Need to develop SME eligibility criteria based on a country's stage of development.*
- ◆ *Domestic and international rules on SME programmes in public procurement.*

#### **2.1 Domestic approaches**

Countries generally try to identify their SME sector in order to target it for special assistance. Yet, what an SME is depends to a great extent on local conditions; an enterprise considered to be an SME in one country may well be larger than many large companies in another. In some cases, the SME sector is further broken down into separate groups: small companies and medium-sized companies.

A generic definition is not easy to find; any definition or classification of SMEs can thus only be considered particular to the country in question. Countries have widely different definitions of SMEs. For example, in India, the criteria for determining SME status are based on investment, while in South Africa SME eligibility depends on the number of employees and turnover. There are nevertheless three parameters that are generally accepted, either singly or in combination, when defining SMEs in most countries. These are:

- ◆ Number of workers employed, which is the most widely used criteria.
- ◆ Firm's level of capital investment or of assets.
- ◆ Its volume of production or business turnover, sometimes measured in average annual receipts over a predetermined period of time.

In many countries, medium-scale industry is not defined and is understood to include those that fall between small-scale and large industries.

This Unit focuses on the approaches of four countries: South Africa, India, Hungary and the United States. It provides an overview, based on available data, on selected Asian countries. Finally, it explains the approaches to SME policy found in the European Community and in the GATT.

### **a) South Africa**

South Africa's 40 million people are spread over 2,000-odd local authorities, with about 60% of the population living in urban areas and 40% in rural villages and on farms. It has been estimated that there are 800,000 small, medium and micro enterprises in addition to the 2 to 3 million people involved in different self-employment "survival activities".

Accordingly, in the South African context, reference is usually made to small, medium and micro-enterprises (SMMEs) and not exclusively to small and medium-sized enterprises (SMEs). Since we focus on SMEs in this Guide, we will refer to SMEs, although the South African programmes are, more accurately, geared to SMMEs.

The small business sector absorbs nearly 44% of the people formally employed in the private sector, and it contributes about 32.7% to the country's GDP. Given the recent significant increase in the number of registered enterprises, the sector holds further promise for generating economic growth.

Millions of people are trapped in survivalist activities with incomes below the poverty level. Various research reports clearly show that many Black entrepreneurs are confined to low value-added activities with little prospect of graduating to higher levels of production.

The South African Government has determined that SME classification is important in order to understand which types of policy intervention are most appropriate, and so that SMEs may self-select or sort into the appropriate categories. The following reasons for SME classification have been identified:

Policy makers and service providers need to know which target groups should be assisted so that they can develop better policies and services for small businesses.

Small business owners need to know into which target group they fall so that they can determine the support measures for which they qualify.

Researchers need a common understanding of what small business is so that they can measure and compare its performance in different regions and sectors and with other countries.

For example, survivalist enterprises are best served with interventions that complement the community development approach, whereas micro enterprises need increased access to finance and information to help them to graduate into the SME league. SMEs require an individualized package of technical assistance, training and credit resources.

The National Small Business Act (Act 102 of 1996) provides the first national definition of small business. The Act describes a small business as a separate and distinct business entity. It cannot be part of a group of companies. If it does have subsidiaries and branches; they must all be included when measuring its size. A small business should be managed by its owner or owners and can therefore be a natural person, a sole proprietorship or partnership, or a legal person such as close corporation or company.

The definition in the Act includes agricultural activities and activities of professionals. It is essential to determine the criterion to distinguish between self-employed on the one hand, which is included in the definition, and casual labour, which is excluded. Self-employment activities are performed for one's own account and risk. By applying this criterion, it becomes clear that economic activity based on an authoritative relationship, such as domestic work and selling goods for someone else, does not qualify as self-employment and therefore does not qualify a person for SME status.

The Act classifies small businesses into four categories: micro, which includes survivalist enterprises; very small; small; and medium. To classify small businesses, the Act uses the employment, turnover and assets criteria, and the enterprise must comply with all three. A description of the different size classifications is set forth in table 4.

**Table 4 SMME sector in South Africa**

<p><b>(Extract from the State of Small Business in South Africa)</b></p> <p>The National Small Business Act (Act 102 of 1996) classifies SMMEs according to five size categories, ranging from Survivalists to Medium-sized.</p> <p style="text-align: center;"><b>Survivalist enterprise</b></p> <p>Survivalists enterprises are enterprises with no paid employees and minimal asset value. These enterprises generate income below the minimum income standard or the poverty line, and their main aim is to provide minimal subsistence means for the unemployed and their families. Most entrepreneurs in this category are involved in hawking, vending, subsistence farming, etc. In the National Small Business Act, the survivalists sector is considered to be part of the micro-enterprise sector.</p> <p>It is estimated that the survivalists sector constitutes 23.3% of all enterprises recorded in South Africa and contributes approximately 3% of total employment. This category has great potential for the absorption of unskilled labour, as has been confirmed by the correlation between the unemployment rate and the amount of self-employment in unregistered, mainly survivalists, enterprises that prevails in informal settlements and rural areas. The largest number of South Africa's survivalists enterprises are located in KwaZulu Natal, Gauteng, the Eastern Cape, and the Northern Province (23%, 21%, 17% and 11% respectively).</p> <p><b><i>Micro enterprise</i></b></p> <p>Micro enterprises have a turnover below the VAT registration limit (presently R150, 000 per annum) and have less than 5 paid employees. These enterprises</p>
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tend to lack formality in terms of registration for tax-purposes, labour legislation, business premises and accounting procedures. Examples of micro-enterprises are spaza shops, mini taxis, and household industry. Micro enterprises without employees constitute approximately 31% of all enterprises and are estimated to contribute 3.9% of total private sector employment, while micro enterprises with 1 - 4 employees constitute approximately 16.4% of all enterprises and contribute about 6.8% of employment. The largest numbers of micro-enterprises are located in Gauteng, KwaZulu-Natal, the Western Cape and Eastern Cape (34%, 18%, 14% and 10% respectively).

#### ***Very small enterprise***

Very small enterprises employ fewer than 10 paid employees - but in the mining, electricity and manufacturing and construction sectors, fewer than 20. They operate on the formal market and usually have access to modern technology. The smallest of these enterprises are self-employed owners with no employees, such as artisans and professionals. Very small enterprises make up an estimated 19.7% of all enterprises recorded and account for 13.3% of employment. The largest concentrations of very small enterprises are found in Gauteng (42%), the Western Cape (16%) and KwaZulu-Natal (15%).

#### ***Small enterprise***

Small enterprises have fewer than 50 paid employees and are more established, with more complex business practices. Usually, the owner does not manage the enterprise directly, and a secondary co-ordinating mechanism has been put in place. Growth from a small to a medium-sized enterprise requires an accumulation of resources as well as a set of appropriate incentives for enterprise expansion. Small enterprises constitute an estimated 7.6% of all enterprises and contribute 19.9% of employment. Almost 50% of small enterprises are located in Gauteng (46%). A further 16% and 12% are located in KwaZulu-Natal and the Western Cape, respectively.

#### ***Medium enterprise***

Medium-sized enterprises are enterprises with up to 100 paid employees – although in the mining, electricity and manufacturing sectors, up to 200. Although usually still controlled by an owner/manager, the ownership and management structure is more complex. Often the decentralisation of power to an additional management layer and a greater division of labour are the main differences between small and medium-sized enterprises. A more complete separation of ownership and management is often the natural barrier between medium and large enterprises. Medium-sized enterprises make up 1.4% of enterprises recorded and account for approximately 13.8% of employment. Medium-sized enterprises are concentrated in the metropolitan areas of Gauteng, KwaZulu-Natal and the Western Cape.

In practice, the number of employees has become the most important criterion, except for microenterprises, where the turnover criterion is the most important. The turnover and asset criteria are flexible enough to take into account large differences across various sectors of the economy.

Registration of contractors is a common practice in many countries. In some developed countries, contractor registration is used as part of the process of procuring goods, services

and works by means of a qualification system. This system requires firms to qualify to be included on an approved list of tenderers. Public bodies can access the list, draw up a schedule of firms which are suitable for a project (pre-qualify), and seek tenders from firms of equivalent size, capability and experience rather than to call for public tenders.

Although there can be advantages to registration, in practice there can also be serious disadvantages. In some countries, lists and registrations are non-tariff barriers to trade. In such a scenario, a government uses registration to exclude foreigners from competing in public procurements. Despite these potential pitfalls, however, lists, if used properly, can make public procurement more efficient. In connection with SME programmes, they can assist in determining which enterprises are eligible for SME assistance. In some SME programmes, procurements may be reserved or set aside exclusively for SME participation, or preferences may be established to provide SMEs with better chances to win a contract award. In such cases, barriers to trade exist, and lists and registration may not add any more protection than these explicit protectionist devices already add to the mix.

Registrations of contractors on databases can either be undertaken by the public body itself or by a commercial organization. In some countries, suppliers pay an annual registration fee to a commercial organization to be placed on their database which, in turn, is sold to public bodies. In South Africa, however, this latter practice would be unlikely to satisfy constitutional provisions. As such, public bodies would have to establish and maintain their own databases.

Many developing countries in Africa have contractor grading systems for works contracts. Typically, contractors are classified in terms of their resources, for example, their financial capability, equipment, supervisory staff, and previous experience. Monitors are appointed to verify contractor classifications and to reassess classifications from time to time. Contracts are packaged to suit contractors of a particular classification, usually in terms of complexity, monetary value and nature of the work. Typically, contractors may not tender for work above their contract status but may tender for work below their status, i.e. a B class contractor may tender for class B, C or D contracts, but not for class A contracts.

This grading system has proved to be useful in developing a local industry. It, however, also has worked as a trade barrier for foreign companies, as the system ensures that work that the local industry is capable of undertaking is packaged appropriately. As a potential trade barrier, it may entail increased costs and lower quality in government-provided works projects. On the other hand, for relatively small projects involving local bidding, it reduces the risk exposure of donor bodies and government departments as the categorization in essence is aimed at minimizing failure to perform.

In the context of determining SME status, the question of registration can be approached in a number of ways and may be required for a number of reasons, one of which is to identify the SME's field of operation (activity) in order to effectively target and promote certain types of business. In South Africa, registration is considered necessary for accreditation purposes and as a means of:

- Compiling a database and for the packaging of contracts;
- Regulating the industry;
- Ensuring "equitable" workloads to pre-qualified contractors;
- Certifying the bona fides of SMEs.

Table 5 sets forth the South Africa Green Paper proposals on registration.<sup>5</sup> Table 6 provides a list of industry activities that has been used by the Government to identify SMEs and to collect data on SME activity.

**Table 5 Green Paper Proposals on registration in South Africa**

Public sector procurement reform in South Africa

This paper suggests that registration must be instituted as a means of :

Compiling a database for the packaging of contracts and identifying target groups;  
regulating participation in public sector procurement;  
promoting good business practices and adhering to statutory regulations and requirements;  
and

censuring those who transgress codes of conduct, fail to meet their tax, levy or service charge obligations, or obtain work in a fraudulent manner.

In terms of the proposals, non-registered suppliers, service providers and contractors should not be permitted to participate in public sector procurement activities.

The paper proposes that registration must be subject to the observance of a code of conduct which should, *inter alia*, require that signatories undertake to :

Tender only on projects which they are capable of executing with the resources they are able to marshal in accordance with the terms and conditions of contract;  
Remunerate staff in accordance with relevant labour legislation;  
Pay UIF, Workman's Compensation, service charges, VAT, income tax and other taxes as appropriate;  
Adhere to safety and health regulations insofar as their worker's are concerned;  
Engaged subcontractors at reasonable prices so that they have the potential to adhere to labour standards;  
Not engage in Dutch auctioning in the engagement of subcontractors (i.e. the practice of hawking prices around in order to drive prices down); and  
Adhere to environmental standards.

Creating an enabling environment for reconstruction, growth and development in the construction industry

This paper suggests that the registration and categorisation of contractors and enterprises will enable the following :

The operation of a preference scheme or approved public sector tender list which would reduce industry and public sector costs associated with the tender process.

Performance monitoring to enable the promotion of improved contractors and to ensure compliance where standards are violated.

The targeting of resources to emerging enterprises which are demonstrating progress and the withdrawal of support from those who have graduated or have failed to progress.

**Table 6 List of activities in South Africa: - SME classification and data capture**

<b>1. CONSTRUCTION</b>	<b>2. SERVICES</b>	<b>3.HOLESALERS/DISTRIBUTION</b>
C1 Airconditioning Systems	S1 Accommodation	W1 Automotive Parts
C2 Alarm Systems / Security Systems / Access Control	S2 Advertising / Public Relations	W2 Building Materials / Hardware
C3 Autoclaves	S3 Auto Repairs & Services	W3 Cleaning Supplies / Chemicals/ Pesticides
C4 Automatic Hanger Doors	S4 Bookkeepers	W4 Clothing
C5 Automatic Sliding Doors	S5 Carpet Cleaning	W5 Computer Equipment / Software
C6 Automatic Sprinkle Fire Protection	S6 Catering/Vending/Food Supply	W6 Curtains
C7 Brickwork / Masonry	S7 Cleaning Services	W7 Domestic Appliances
C8 Cabinet / Furniture Making	S8 Computer Supplies / Services	W8 Medicines
C9 Carpeting / Tiling / Floor Covering	S9 Diesel & Petrol Engines	W9 Electrical Supplies &Equipment
C10 Ceilings, Partitioning and Shopfitting	S10 Debt Collection	W10 Fire Extinguishing
C11 Cladding Contracts	S11 Educational Services	W12 Floor Coverings
C12 Cooking & Related Systems	S12 Florists / Garden Services	W13 Food Supplies
C13 Compressed Air Installations	S13 Food &Beverage/Entertainment	W14 Fuel Supplies
C14 Concrete works	S14 Funeral Services	W15 Furniture
C15 Demolition	S15 Handyman	W16 Generating Sets
C16 Electrical Contracts	S16 Horticultural Services	W17 Industrial Catering Equipment
C17 Evacuation Systems	S17 HV Fault Finding, Jointing & Terminations	W18 Laundry Equipment
C18 Fencing	S18 Insurance / Employee Benefits	W19 Medical Supplies & Equipment
C19 General Building Work	S19 Interior Decoration	W21 Office Equipment
C20 General Electrical Work	S20 Interior / Industrial Design	W22 Paint Supplies
C21 Glazing	S21 Laundry Services/Dry Cleaning	W23 Recreational Supplies
C22 Hauling / Heavy Equipment/ Transport	S22 Locksmith Services	W24 Refrigeration&Air Conditioning
C23 Hot Water Installations	S23 Mailing / Courier Services	W25 Vehicles
C24 Incinerators	S24 Medical/Ambulance/Health Care	W26 Workshop Equipment
C25 Landscaping / Earthworks	S25Municipal Services	W99 Other
C26 Lift & Escalator Equipment	S26Personnel Services	
C27 Mechanical Contracts	S27 Pest Removal Services	<b>4. PROFESSIONAL SERVICES</b>
C28 Metalwork and burglar uards	S28 Printing / Photography / Graphic Design	P1 Accountants / Financial Advisory Services
C29 Painting	S29 Real Estate	P2 Architects
C30 Paving	S30 Safety & Security Services	P3 Attorneys / Legal Services
C31 Plastering	S31 Security & Access Control	P4 Consulting Engineers (Civil/Structural)
C32 Plumbing	S32 Servicing HV & LV Switchgear / Transformers	P5 Consulting Engineers (Electrical)
C33 Precast Concrete Manufacture	S33 Site Cleaning	P6 Consulting Engineers (Mechanical)
C34 Pumping Installations	S34 Solid Waste Disposal	P7 Consulting Engineers (Multidisciplinary)
C35 Road Marking + Signage	S35 Telecommunications	P8 Land Surveyors
C36 Roadworks & Site Clearing	S36 Travel Agencies	P9 Medical Practitioners
C37 Roofing & Waterproofing	S99 Other	P10 Pharmacists
C38 Sewage Installations/ reticulation		P11 Project Managers
C39 Specialist Contracts		P12 Quantity Surveyors
C40 Steam Installations & Ancillary Equipment		P13 Teachers
C41 Steel Fabrication & Erection		P14 Town Planners
C42 Water installation / reticulation		P15 Training Providers
C43 Stormwater Drainage		P99 Other
C99 Other		

In the United States, there is a well-developed SME programme that has been in existence since the 1950s. When the term "SME" is used to refer to the United States, we are referring to its small and minority business programmes. The United States Government does not have public procurement programmes for medium sized-firms. The principal regulatory body for the programmes is the United States Small Business Administration (SBA). SBA receives its mandate from federal legislation, principally the Small Business Act, 15 U.S.C. §§ 631-56 (1996), which is passed by the United States Congress and signed by the President. The principal programmes are designed to assist small business concerns, regardless of whether they are owned and controlled by persons in historically disadvantaged categories (such as African-American, Hispanics, Asian-Americans, Native-Americans and women), and small minority business concerns, which are both small and owned by persons in the historically disadvantaged categories. Here we will examine two questions: (1) what constitutes a small business; and (2) what constitutes a small minority business. We will focus on the question of what is "small" and what is a "minority" under applicable federal law and regulation. The US Federal Government does not maintain any programmes for medium-sized enterprises in the public procurement field.

There are a variety of state and local programmes that are outside the scope of the Guide. These programmes, however, are similar to the federal programmes and influenced by them.

#### *What is a Small Business in the United States?*

The question of what constitutes a small business in the United States is governed by size standards promulgated by SBA as federal regulation. They are found in Title 13 Chapter 1 of the United States Code of Federal Regulations (C.F.R). As explained at 13 C.F.R. § 121.101 (1998), "SBA's size standards define whether a business entity is small and, thus, eligible for Government programs and preferences reserved for 'small business' concerns." The SBA has created size standards by type of economic activity, and maintains a size standard for each four-digit code set forth in the Standard Industrial Classification (SIC) System maintained by the US Department of Commerce. The SIC System assigns four-digit SIC codes to all economic activity within 10 major divisions. The current size standards matched against four-digit SIC codes is set forth in Annex D. The size standards are based on number of employees for manufacturing concerns and average annual receipts over a 3-year period for service contractors.

SBA size standards are set in accordance with the following regulatory guidance:

(a) SBA considers economic characteristics comprising the structure of an industry, including degree of competition, average firm size, start-up costs and entry barriers, and distribution of firms by size. It also considers technological changes, competition from other industries, growth trends, historical activity within an industry, unique factors occurring in the industry which may distinguish small firms from other firms, and the objectives of its programmes and the impact on those programmes of different size standard levels.

(b) As part of its review of a size standard, SBA will investigate if any concern at or below a particular standard would be dominant in the industry. SBA will take into consideration market share of a concern and other appropriate factors which may

allow a concern to exercise a major controlling influence on a national basis in which a number of business concerns are engaged. Size standards seek to ensure that a concern that meets a specific size standard is not dominant in its field of operation.(13 C:F.R. para 121.102, 1998).

In order to be classified as small, a concern has to avoid all affiliation with other concerns of natural persons that would result in the concern being classified as "other than small." Affiliation is broadly defined by SBA regulation and by administrative precedent published by various SBA administrative tribunals with competence in the field. Affiliation does not depend merely on formal ties, as they would be established in laws governing business associations, but on the totality of the circumstances. The SBA regulation on affiliation, which should be read in conjunction with SBA precedent, provides in pertinent part as follows:

(a) General Principles of Affiliation.

(1) Concerns are affiliates of each other when one concern controls or has the power to control the other, or a third party or parties controls or has the power to control both.

(2) SBA considers factors such as ownership, management, previous relationships with or ties to another concern, and contractual relationships, in determining whether affiliation exists.

(3) Individuals or firms that have identical or substantially identical business or economic interests, such as family members, persons with common investments, or firms that are economically dependent through contractual or other relationships, may be treated as one party with such interests aggregated.

There are a number of exceptions to these rules, and the regulations continue with additional rules, but the main concepts are as set forth above.

The US Government has for many years required procuring entities to set procurements aside for exclusive competition between small businesses when certain conditions are fulfilled. Firms self-certify their size status in these small business set-aside procurements. In other procurements, particularly those pertaining to a specific minority small business programme, the so-called 8(a) programme discussed in below, size is determined at the time a firm applies for 8(a) status. When the size status of a business is questioned, a formal size determination is performed by SBA Size Specialists in Government Contracting Area Offices. Any interested party may protest the size status of a business. An interested party could be an offeror on a set-aside contract, a contracting officer, SBA, or other persons as defined by regulation. See 13 C.F.R. § 121.1001 (1998). The protest can be in reference to the award of a specific small business set-aside contract or to the award of future set-aside contracts.

In the absence of a protest, a contracting officer may accept a firm's self-certification as true for the procurement in question unless he/she has "credible information which causes the contracting officer of the SBA to question the size of the concern." 13 C.F.R. § 121.405.

## *What is a Small Minority Business in the United States?*

As explained above, the US Federal Government maintains a number of programmes designed to assist small businesses that are owned and controlled by persons that fall within categories that have been characterized by historical discrimination or prejudice. One of the more significant programmes is the 8(a) programme, named after Section 8(a) of the US Small Business Act. In the 8(a) programme, firms interested in participating must submit an application and pass a number of different regulatory tests in order to obtain 8(a) certification from the SBA. Unlike in the small business set-aside programme, there is no self-certification in the 8(a) programme. 8(a) firms compete with each other for award of contracts set aside for them. Nominally, the SBA is the prime contractor with the procuring entity, and the 8(a) firm the subcontractor.

In order to qualify for 8(a) status, a firm must meet the following requirements: (1) be small in its industry and not exceed the above size standards; (2) be owned and controlled by persons who are both economically and socially disadvantaged; and (3) have "reasonable prospects for success in competing in the private sector and has been in business in its primary industry classification for two full years." 13 C.F.R. §§ 124.101, 124.103, 124.104, 124.107. There are somewhat different rules when Native American or Native Hawaiian organizations are involved, which do not need to be covered here in order to understand the programme.

SBA regulations define social disadvantage as follows:

a) General. Socially disadvantaged individuals are those who have been subjected to racial or ethnic prejudice or cultural bias because of their identities as members of groups without regard to their individual qualities. The social disadvantage must stem from circumstances beyond their control . . .

b) Members of designated groups. (1) In the absence of evidence to the contrary, the following individuals are presumed to be socially disadvantaged: Black Americans; Hispanic Americans; Native Americans (American Indians, Eskimos, Aleuts, or Native Hawaiians); Asian Pacific Americans (persons with origins from Burma, Thailand, Malaysia, Indonesia, Singapore, Brunei, Japan, China, Taiwan, Laos, Cambodia (Kampuchea), Vietnam, Korea, The Philippines, U.S. Trust Territory of the Pacific Islands (Republic of Palau), Republic of the Marshall Islands, Federated States of Micronesia, the Commonwealth of the Northern Mariana Islands, Guam, Samoa, Macao, Hong Kong, Fiji, Tonga, Kiribati, Tuvalu, or Nauru); Subcontinent Asian Americans (persons with origins from India, Pakistan, Bangladesh, Sri Lanka, Bhutan, the Maldives Islands or Nepal); and members of other groups designated from time to time by SBA according to procedures set forth at paragraph (d) of this section (13 C.F.R. para 124.105).

To qualify for the programme, persons must fall within these groups but must also be United States citizens. Should a person fall within one of the above groups, social disadvantage is presumed.

As for persons outside of the above groups, he or she "must establish his/her individual social disadvantage on the basis of clear and convincing evidence." 13 C.F.R. 124.105(c). The regulation continues:

A clear and convincing case of social disadvantage must include the following elements:

(i) The individual's social disadvantage must stem from his or her colour, ethnic origin, gender, physical handicap, long-term residence in an environment isolated from the mainstream of American society, or other similar cause not common to small business persons who are not socially disadvantaged.

(ii) The individual must demonstrate that he or she has personally suffered social disadvantage, not merely claim membership in a non-designated group which could be considered socially disadvantaged.

(iii) The individual's social disadvantage must be rooted in treatment which he or she has experienced in American society, not in other countries.

(iv) The individual's social disadvantage must be chronic and substantial, not fleeting or insignificant.

(v) The individual's social disadvantage must have negatively impacted on his or her entry into and/or advancement in the business world. SBA will entertain any relevant evidence in assessing this element of an applicant's case. SBA will particularly consider and place emphasis on the following experiences of the individual, where relevant:

(A) Education. SBA shall consider, as evidence of an individual's social disadvantage, denial of equal access to institutions of higher education; exclusion from social and professional association with students and teachers; denial of educational honours; social patterns or pressures which have discouraged the individual from pursuing a professional or business education; and other similar factors.

(B) Employment. SBA shall consider, as evidence of an individual's social disadvantage, discrimination in hiring; discrimination in promotions and other aspects of professional advancement; discrimination in pay and fringe benefits; discrimination in other terms and conditions of employment; retaliatory behaviour by an employer; social patterns or pressures which have channelled the individual into non-professional or non-business fields; and other similar factors.

(C) Business history. SBA shall consider, as evidence of an individual's social disadvantage, unequal access to credit or capital; acquisition of credit or capital

under unfavourable circumstances; discrimination in receipt (award and/or bid) of government contracts; discrimination by potential clients; exclusion from business or professional organizations; and other similar factors which have impeded the individual's business development.

13. C.F.R. § 124.105(c).

The regulations also advise how new groups may seek recognition as a group rather than on an individual basis.

For a number of years, based on the above standard, it was very difficult for women to qualify for 8(a) status. This has changed somewhat over the years, and in addition, the SBA has developed new programmes for women outside of the 8(a) programme.

As set forth above, in addition to social disadvantage, an 8(a) business owner must also suffer economic disadvantage. SBA regulations set forth the following relevant policy:

a. Economic disadvantage for the 8(a) programme.

(1)(i) For purposes of the 8(a) programme, economically disadvantaged individuals are socially disadvantaged individuals whose ability to compete in the free enterprise system has been impaired due to diminished capital and credit opportunities as compared to others in the same or similar line of business who are not socially disadvantaged, and such diminished opportunities have precluded or are likely to preclude such individuals from successfully competing in the open market. In determining economic disadvantage for purposes of 8(a) programme eligibility, SBA shall compare the applicant concern's business and financial profile with profiles of businesses in the same or similar line of business which are not owned and controlled by socially and economically disadvantaged individuals.

(ii) This programme is not intended to assist concerns owned and controlled by socially disadvantaged individuals who have accumulated substantial wealth, who have unlimited growth potential or who have not experienced or have overcome impediments to obtaining access to financing, markets and resources.

Thus, economic disadvantage is not presumed, and the owners of the applicant for 8(a) certification cannot be wealthy individuals with no impediment to accumulating capital other than the impediments applicable to all businesses.

The size regulations and policies are applied to programmes beyond the set-aside programme. The regulations are used by federal as well as some state and local governments as the basis to establish eligibility for small business preference programmes. As an example, the US Food and Drug Administration (FDA) has a small-business exemption under the Prescription Drug User Fee Act. SBA performs size determinations for the FDA. If the company is determined to be small, the FDA does not charge the company the user fee to test its proposed new drug.

A pilot programme which resulted from a provision in the SBA's 1994 Reauthorization and Amendments Act, which charged SBA with establishing and implementing a pilot programme to improve access to Federal contract opportunities for very small business (VSB) concerns. This programme is an extension of the small business set-aside programme. Procurement Center Representatives (PCRs) will work with the District Directors in the 9 designated geographical areas to identify very small business concerns that are eligible to participate. (For purposes of this programme, a very small business concern is one that has 15 or fewer employees and has average annual receipts that do not exceed US\$ 1 million.)

The SME programmes in the United States are in a state of transition. Changes to the regulations are currently being prepared to comply with recent US Supreme Court precedent on the constitutionality of minority assistance programmes.

### **c) India**

Industries in India are classified into the following categories, according to size:

- ◆ Large-scale industries (LSI);
- ◆ Medium-scale industries;
- ◆ Small-scale industries (SSI);
- ◆ Tiny sector.

There are no formal legal definitions of the large-scale and medium-scale units. Definitions have however emerged in usage with general consensus. Large-scale industry refers to those units, where the investment exceeds Rs 100 crores (US\$ 25 million). Medium-scale industry refers to the units whose investment falls between those of SSIs and LSIs.

SSIs are units whose total investment in plant and machinery does not exceed Rs 3 crores (US\$ 750,000). The definition of investment does not cover money spent on buying land and erecting buildings and workshops, nor does it include working capital. The investment limit is revised upwards from time to time; the single exception is the revision being done currently to revise it downwards from US\$ 750,000 to 150,000.

Tiny sector units, as the name suggests, have an investment limit of Rs 25 lakhs (US\$ 62,500). This is also likely to be revised downwards.

In addition, there is the cottage industry sector, which does not fall into any of the above categories. Cottage industry refers to the production of traditional goods in villages by very small units. It is often comprised of illiterate persons with no formal training who work in their own homes and not in factories. They usually acquire the skills from their elders and have no exposure to machines. The units use local raw materials, develop local initiatives and cooperation and promote the skills of the artisans. They need low capital investment for generation of income and employment.

The Government of India supports the growth of SSIs as a matter of policy, which has been an important and permanent feature of the Government's long-standing industrial policy. There has always been an emphasis on the establishment of new SSIs, particularly in industrially backward areas, and a concern for their viability and continued growth. Encouragement to SSIs and the cottage-industry sector in the public buying programme is one of the earliest policy decisions taken by the Government. It recognized the importance of cottage- and small-scale industries for the national economy and the scope they offered for village and cooperative enterprises and for the rehabilitation of persons displaced on account of the country's partition in 1947. Observing that public procurement could be utilized for development of cottage- and small-scale industries, it was decided that an objective of the public buying programme should be to encourage production and utilization of products of cottage- and small-scale industries.

From time to time, the Government has initiated assistance programmes to achieve its broad objectives. These include providing land at concessional rates or free of cost for establishing new SSI units and easy credit at lower than prevailing commercial rates for procuring plants and machinery. Exemptions from certain statutory duties and levies like excise duty and sales tax are generally granted to SSIs.

The Government has also created institutional support to guide and help the SSIs, through the National Small Industries Corporation (NSIC) and the Director of Industries of States. NSIC is a national level organization intended to render assistance to SSIs. It provides training to entrepreneurs and workers, testing and quality control facilities for SSI products and marketing assistance. The state governments have separately and independently extended similar benefits to SSIs located in their territory. However they created no independent organization. Work at the state level is performed by the state's administrative machinery itself under Director of Industries of the State.

NSIC and the Director of Industries have been entrusted with the responsibility of certifying an industrial unit as an SSI unit. In other words, a small-scale unit has to be registered with NSIC or the Director of Industries of the states concerned in order to be eligible for the benefits available to SSI units. This registration is an essential eligibility criterion for participation in the Government's public buying programme.

The best example of a cottage industry is for "Khadi", or hand-spun and hand-woven fabric, which is traditionally produced and worn in India. Blankets and soaps are other well-known products. In all these cases, production is accomplished without machines (unless one classifies the wheel or hand-driven loom as a machine) or electricity. The Indian Government has found as a matter of policy that the cottage industry, by its very nature and tradition, offers employment benefits in the rural areas, and generally assists the economically and socially disadvantaged to supplement their income. The cottage industry continues to this day in modern India.

The cottage industry sector functions under the umbrella of the Khadi and Village Industries Commission (KVIC), which is a statutory body established in 1956 by an act of the Parliament. The Commission supports individual cottage industrial units at the village level and markets their products. Its other objectives are skill improvement through training, transfer of

technology, promotion of self-reliance, building a strong rural community base and rural industrialization.

#### **d) Hungary**

The following definitions of size categories are based on government recommendations and are presently used primarily for official statistical purposes. The definitions correspond to those used to collect statistics in the European Union (EU). The difference between the EU and the Hungarian definitions is in the magnitude of the categories. The Hungarian categories are about one-half the magnitude of the EU thresholds.

The categorization of firms is by size, as follows:

- ◆ Small enterprise: 10 to 49 employees with Ft 700 million turnover or Ft 500 million balance-sheet total, maximum;
- ◆ Microenterprise: less than 10 employees;
- ◆ Medium-sized enterprise: 50 to 249 employees with Ft 4,000 million turnover or Ft 2,700 million balance-sheet total, maximum.

#### **e) Selected Asian countries**

This section will provide an overview of the criteria used in selected Asian countries for determining SME status. Figure 3 and table 7 were developed by the International Trade Centre (UNCTAD/WTO) from the following sources: United Nations, *Small Industry Bulletin for Asia and the Pacific*, No. 30, 1998, p.44, and the APEC Directory of Support Organizations for Small and Medium Enterprises (199\_), and country reports prepared by the United Nations.

Figure 3: Criteria used to determine SME status in selected Asian countries

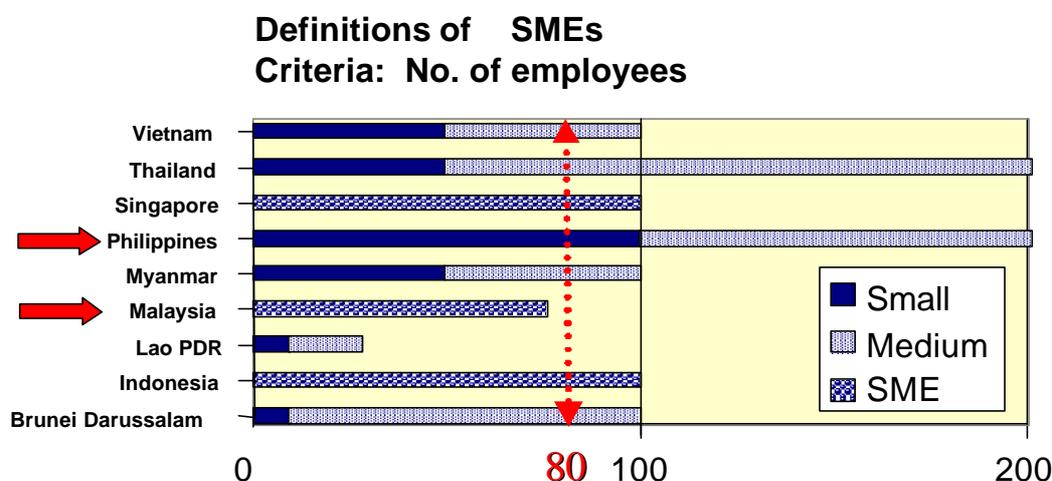


Table 7 Criteria used to define SMEs in South-East Asian countries

	Employees (No.)	Capital (in thousands of US\$ - approx.)	Turnover (in thousands of US\$ - approx.)
Brunei Darussalam	Small 1- 10 Medium 11 - 100		
Indonesia	SMEs < 100	SMEs < 84 (total assets)	SMEs < 1,000 (sales)
Lao PDR	Small < 10 Medium 10 - 29	Depends on the no. of establishments in sector	
Malaysia	SMEs < 76	Small < 198 Medium 198 – 939	
Myanmar	Small < 50 Medium 50 - 100	Small < 167 Medium 167 – 835	Small < 417 Medium 417 - 1,670 (production)
Philippines	Small 10-99 Medium 100 – 199	Small < 570 Medium 570 - 2,282	
Singapore	(services sector) SMEs < 100	(manufacturing sector) SMEs: < 8,570	
Thailand	(labour-intensive industries) Small < 50 Medium 50 - 200	(capital-intensive industries: fixed assets) Small < 781 Medium 781 - 3,905	
Viet Nam	Small < 50 Medium 50 - 100	Small < 4 Medium 4 - 18	

The ceiling for being considered as an SME throughout each of the countries in the region – in terms of numbers of workers – is 29 (Lao People’s Democratic Republic), 75 (Malaysia), 100 (Brunei, Indonesia, Myanmar, Singapore and Viet Nam), and up to 200 workers (the Philippines and Thailand). For countries that distinguish between "small" and "medium", the category of small enterprises ranges in size from up to 10 workers (Brunei and Lao People’s Democratic Republic), 50 workers (Myanmar, Thailand and Viet Nam), and up to 100 workers

(the Philippines).

These data show the variations that occur even among countries in the same region, some of which are at similar stages of development. For example, in Malaysia, an enterprise with 80 workers is not an SME, but it is in the Philippines. Similar variations exist in terms of applying the criteria of value of capital and of turnover.

## **2.2 European Community**

The European Community procurement directives were promulgated to liberalize the internal market among member states of the Community. The rationale underlying the directives, and the principles embodied in the directives, are based on trade liberalization. The directives are trade-liberalizing mechanisms. They are not intended to serve as or substitute for domestic procurement laws of the member states. Their primary purpose is not in the promotion of domestic policy or in codifying substantive procurement norms. In fact, they are intended to open public procurement markets within the member states that have traditionally been closed and that remain resistant to trade liberalization. The directives have been interpreted as allowing for little if any role for policies intended to assist SMEs in the European Community. Available evidence tends to show that the benefits of trade liberalization within the Community far outweigh national policies favouring domestic firms (Checchini, 1998).

Member state programmes designed to provide preferences for domestic firms or restrictions on entry of the firms of other member states in procurement may be subject to challenge by the EC Commission as an infringement of the directives. The Commission has adopted the view that any domestic preferences that are above the threshold of application set forth in the procurement directives are incompatible with the directive requirements. These requirements are that procuring entities evaluate tenders only on the basis of lowest price or economic advantage, and that they evaluate the qualifications of tenderers only on the basis of the technical and financial requirements necessary to perform the contract in question.

The current Community approach tends to rely on improving access for SMEs to public procurement through such initiatives as training and other non-interventionist approaches. [See Public Procurement in the European Union, Commission Communication Com (98) 143 (11 March 1998); Special Sectoral Report No. 1: Public Procurement (Nov. 1997); Green Paper Public Procurement in the European Union: Exploring the Way Forward (27 Nov. 1996)].

The Commission, however, does not appear to rule out the possibility of preferential measures for SMEs for procurements below the threshold of application as set forth in the directives. For acceptance by the EC Commission, such programmes would likely require clear definitions of qualifying SMEs, compatibility among national regimes, and strict conformity with EC treaty requirements on transparency, equality of treatment and non-discrimination.

## **2.3 WTO Government Procurement Agreement**

Government discrimination in favour of domestic producers may be a non-tariff barrier to trade. The World Trade Organization Government Procurement Agreement (GPA) subjects public procurement to international competition. The GPA regulates the tendering process in a way that improves the transparency of the procedures and promotes non-discrimination between domestic and foreign firms, products and services. The GPA, however, suffers from a number of shortcomings. In the opinion of some analysts, the major point of dissatisfaction is the limited participation of developing countries (see Blank and Marceau, 1997). Out of 22 signatory countries only 2 (Israel and the Republic of Korea) are not in the set of industrialized countries.

The first GPA was agreed to in 1979 as part of the Tokyo Round of multilateral trade negotiations under the auspices of the GATT. Although it has been amended and expanded, the GPA still does not apply to a good deal of public procurement, and notably, the GPA does not apply to all WTO members. The GPA is plurilateral; it applies only to those countries that agree to it. Furthermore, even when countries have signed, procedures are complicated. Determinations must be made regarding whether a procurement is covered by the GPA. Then it must be determined if the procuring agency is covered, and if there is a threshold level that has been exceeded. Each country that is party to the GPA negotiates concessions with other GPA parties, which become part of the general notes appended to their schedules. These general notes, when read in combination with the schedules, provide for a number of exceptions, and these must be consulted to determine if a procurement is subject to some other exception. These general notes allow for exemptions for health and national security but also include allowances for discriminatory practices such as the US small business and minority set-asides. The GPA is in effect a set of bilateral agreements reached within a multilateral framework.

The GPA, however, may not provide much flexibility for the development of SME programmes. The existence of the US programmes may be an exception. They are explicitly carved out of the GPA as part of the trade concessions between the parties. The US offer in GPA negotiating rounds tends to be of a high dollar value in any event, and potential signatories without similar offers may be hard pressed to negotiate favourable concessions. GPA Article XVI includes a special exemption allowing developing countries to use offsets - measures used to encourage local development or improve the balance-of-payments accounts by means of domestic content, licensing of technology, investment requirements, counter-trade or similar requirements. The use of offsets by developing countries, however, is restricted by the terms of Article XVI, and the GPA parties may in any future trade negotiations take a negative view of offsets being sought by a country wishing to accede to the GPA. GPA Article XVI is explained in Unit 4.

The ongoing dispute between the United States on one side and the European Community and Japan on the other, concerning the Commonwealth of Massachusetts, provides some insights into the restrictive nature of the GPA with respect to socioeconomic programmes. The Commonwealth requires companies that wish to participate in its public procurements to certify that they do not do business with Myanmar, which is their attempt to link human rights and trade. The EC and Japan view this requirement as a violation of the GPA because it imposes requirements in excess of those necessary to evaluate the qualifications of the contractor to perform the contract and introduces political issues into procurement. The parties to the dispute did not settle it in consultations, and the EC and Japan recently asked the WTO to establish a dispute panel. The Massachusetts dispute illustrates that the GPA may be interpreted as antagonistic to SME public procurement programmes.

At the latest WTO ministerial conference held in Singapore, the WTO contracting parties agreed to undertake a review of the GPA. A Working Group on Transparency was established as a result of the Singapore conference. Some commentators have advocated a basic framework agreement in the WTO to cover public procurement. This new agreement would be more flexible in delimiting the kinds of procurement procedures that parties would have to undertake, and may permit socioeconomic programmes so long as they meet basic requirements of transparency. At present, such an agreement does not exist. It remains to be seen whether a new agreement will emerge from the WTO, and, if so, what its provisions will be. Until then, governments interested in acceding to the WTO should consider what is currently in existence, which is the GPA and the WTO instruments generally.

## 2.4 Microenterprises

The examination of public procurement programmes for microenterprises is outside the scope of this Guide. Microenterprises tend to be very small enterprises that require programmes which, in many cases, differ in kind from programmes that are designed to assist SMEs. Microenterprise programmes merit their own consideration outside of this Guide.

Table 8 summarizes the issues pertinent to defining SMEs.

**Table 8** **Defining SMEs**

<b>Policy question</b>	<b>KEY ISSUES</b>
1. Criteria for SME status	<ul style="list-style-type: none"> <li>▪ Receipts standards or employee standards</li> <li>▪ Based on domestic/local conditions and industry</li> <li>▪ Distinguishing 'small' from 'medium'</li> </ul>
2. Identifying SMEs: registration versus self-certification	<ul style="list-style-type: none"> <li>▪ Monitoring problems</li> <li>▪ Avoiding abuse and corruption</li> <li>▪ Costs and benefits: regulated versus deregulated</li> </ul>
3. Identifying categories of disadvantaged or minority status	<ul style="list-style-type: none"> <li>▪ Should there be separate programmes?</li> <li>▪ How to determine categories</li> </ul>
4. Problem of affiliation	<ul style="list-style-type: none"> <li>▪ SME relations with large business</li> <li>▪ Avoiding undue dependencies between firms</li> <li>▪ Detecting 'fronts' and other corruption</li> </ul>
5. International and supranational issues	<ul style="list-style-type: none"> <li>▪ EC membership</li> <li>▪ WTO GPA membership</li> </ul>

### **Unit 3**

## **TOOLS AND EXPERIENCE II: PROCUREMENT REFORM**

Units 3 and 4 examine the various programmes that are used by countries to assist SMEs in a procurement context. Unit 3 starts with the minimum type of intervention - procurement reform that is not targeted specifically to assist SMEs. Unit 4 looks at programmes designed specifically to assist SMEs. The approach of the Guide is to provide a "tool kit" of the kinds of public procurement programme that various governments have used to assist SMEs. In each of the sections that follow, there will be a description of various tools, and a discussion of their relative advantages and disadvantages.

There are four levels of government involvement in public procurement policy that affect SME-related policy goals. First, at the most basic and least controversial level, governments may correct biases against or remove barriers to SME participation in public procurement. This includes reforms and improvements of the institutions and processes that constitute government procurement.

While such reforms and improvements will benefit all private-sector firms, it should have a more significant impact on SMEs. Because SMEs have fewer resources, anything that makes the process easier and lowers the cost of involvement will have a greater relative result for them. In some situations, the best thing government can do is to create and maintain a business and policy environment where firms (small and large) can operate and compete on open basis in accordance with legal rules that enforce contract and property rights and that alleviate information problems. Thus, procurement reform is one of the most important tasks. The basic rationale for procurement reform is that it enables SMEs, indeed all participating firms, to compete effectively for public procurements by reducing the transaction costs for SME participation in public procurement. In addition, procurement-reform may alleviate certain information problems that SMEs face in public procurement.

Secondly, governments may target procurement-related assistance towards SMEs to enable their participation. This assistance may be neutral - it is not subsidized - in which case it should not give a particular advantage to SMEs, or it may be subsidized, in which case the policy will not only provide an advantage for SMEs but will also introduce a distortion into public procurement procedures. Thirdly, governments may provide preferences to SMEs, which are in essence a particular form of subsidy. Finally, and most controversially, agencies may mandate, target, or set-aside procurements specifically for SME involvement.

### ***Learning Objectives***

By the end of this Unit, you should be familiar with:

- ◆ *Reforms of public procurement rules and practices that will improve SME access to public procurement markets.*
- ◆ *How to streamline procurement procedures, eliminate unduly restrictive requirements in procurement, and increase transparency in procurement in order to improve SME access to public procurement markets.*

- ◆ *Importance of electronic commerce to the ability of SMEs to participate in public procurement.*
- ◆ *Significance of breakout of quantities in public procurement, as opposed to bundling requirements, to SME participation in public procurement.*

### **3.1 Streamlining**

Perhaps the most minimal intervention on behalf of SMEs is in streamlining and making the public procurement process more transparent. Although procurement reform may be a major task for a government, it is characterized as a minimalist form of intervention because it does not specifically target SMEs for assistance. Large businesses may also benefit from procurement reform. Let us look at a few examples of streamlining procurement found in Argentina, South Africa and the United States.

The reforms in South Africa are designed to assist SMEs. Those in Argentina, while not focused explicitly on assisting SMEs, probably result in helping SMEs as a by-product of reform. The United States reforms have the potential to adversely affect SMEs.

#### **a) Buenos Aires, Argentina: opening up procurement at the municipal level**

Changes in the procurement practices of the city of Buenos Aires exemplify how procurement practices can be reformed to ease the constraints for SMEs and produce substantial savings for a government. In early 1996, Buenos Aires, which has a public procurement budget of around US\$1 billion, (30% of the total city budget) undertook an overhaul of its procurement procedures and practices. The city government had evidence that prices on many municipal contracts were as much as 30% higher than those in the commercial market.

First, officials set out to eliminate "closed procurements," where only a limited number of companies were allowed to bid for a contract, and greatly expanded public advertising of upcoming contract opportunities. Predictably, the number of companies submitting bids increased. Secondly, officials began using a database of "reference prices." Before awarding a contract, officials check the latest market prices for any product or service and compare it with bid prices. When the city requested new proposals for an expiring contract to provide food services to 29 metropolitan hospitals, 34 companies offered competitive bids. The new contract was awarded for just under US\$ 32 million or 47% less than the US\$ 59 million paid to the previous contractor for the same services.

Comparable savings materialized as the city awarded contracts in other sectors. Buenos Aires saved 37% on food services for public schools, 45% on garbage collection and public lighting maintenance, and 60% on contracts to run communal kitchens. Overall, the city saved US\$ 200 million in the first full year following the procurement reforms. The city also improved its relationship with suppliers by overhauling its payment system so that contractors were paid on time. Deficiencies in the previous system, in which payments were decentralized and issued by the unit that had purchased a service, led to chronic payment delays that contractors ultimately used to justify their higher prices. The city has now centralized the

payment system through the creation of a single account managed by the general treasury office. How to relax constraints relating to payment of SME contractors is addressed in Unit 4 below.

This is a simple illustration of how competition introduces savings into a public procurement system. Note that SMEs can benefit substantially from such a fundamental reform. SMEs are often marginalized and outside of the small group of large firms that are familiar to procuring entities. Procuring entities may engage in shirking and lax enforcement of competition requirements or may repeatedly rely on the same firms. SMEs may stand to gain from opening up competition, if the appropriate conditions exist, such as a market structure in which SMEs are present, quantities appropriate to SME capacities are sought, and unduly restrictive requirements are relaxed.

#### **b) South Africa: standardized and simplified procurement documentation**

It has been argued that procurement policies and procedures tend to favour larger and more established enterprises and that they are so complex that they do not provide SMEs with meaningful access to mainstream procurement activities funded by the public sector.

The South Africa Green Paper calls for a commitment from procurement units to use standard contract documentation with minimal deviations from the accepted standard forms of contract and specifications. The Green Paper advocates the discontinuance of the practice of writing extensive special conditions of contract to be included in procurement documentation. The Green Paper proposes that procurement documentation should be overhauled and rationalized to encourage participation by emerging businesses in public-sector procurement activities. The Green Paper recommends that the public tendering process should be made more accessible by ensuring that tender documentation is:

- Easy to comprehend and user-friendly;
- Free of unduly onerous requirements and conditions;
- More widely disseminated and distributed, in order to reach all potential tenderers;
- Standardized.

There are some well-accepted arguments that standardization of procurement documentation may give procuring entities a significant advantage over SMEs based on arguments that governments have significantly more bargaining power than SMEs. On the other hand, there are compelling arguments for standardization. Standardization has the potential to lower the transaction costs of contracting. Standardized terms also tend to produce a positive network externality. As the frequency of their use increases, courts and parties become more familiar with the standardized terms and conditions, and certainty increases. Standardized terms also solve certain asymmetric information problems. Clauses become known in the field and parties are in a better position to know the risks and benefits associated with the clauses (Katz, 1998).

### **c) United States: procurement reform may reduce the favoured position of SMEs**

In the United States, procurement reform has had mixed reviews in respect of assisting SMEs.

The US Federal Acquisition Streamlining Act of 1994 (FASA) seeks to decrease procurement lead times, provide greater discretion to contracting officers, and minimize bid protests through the use of indefinite quantity indefinite delivery (IDIQ) contracts to more than one vendor providing the products/services required. Agencies then issue delivery/task orders to one or more schedule contractors. The US Small Business Administration (SBA) is concerned that using the multiple award strategy provides an opportunity for agencies to use proven contractors and reduce opportunities for small businesses. Strategies to address this are being developed by the US Federal Government.

As US federal agencies developed strategies to streamline, each agency sought ways to shorten procurement lead-time, simplify the procurement process, save money and reduce procurement staff. To achieve these goals, agencies relied more on the use of optional, multiple award General Services Administration (GSA) schedules and Government Wide Acquisition Contracts (GWACs) contracts to fill agency needs. In many cases, small firms under individual contracts formerly provided these requirements. SBA is working with the GSA and other agencies to devise strategies to assure that small business firms retain their share of prime contracts. SBA has persuaded several procuring agencies to use strategies that reserve contract awards for 8(a) firms and small businesses when specified conditions are met. The US Code of Federal Regulations will be revised to provide guidance in using these strategies.

Increased use by agencies of federal supply schedules has resulted in fewer contracts overall, and reduced set-asides for small businesses. Federal supply schedules are essentially government catalogues from which government bodies purchase goods and services. The catalogues are negotiated ahead of time with schedule contractors, on the basis of government-wide quantity estimates. Small businesses are encouraged to compete for inclusion on schedules; however there is no assurance that they will receive orders. SBA is working with other government agencies to devise strategies that would require greater consideration to small firms when purchasing from the schedule.

Some time ago, the US Office of Management and Budget issued OMB Circular A-76, which mandates standards by which federal agencies should evaluate the relative costs and benefits of performing a "commercial" activity in-house or contracting it out. As a practical matter, agencies have been less than aggressive in carrying out this mandate and some have ignored its provisions. Current trends are to place renewed emphasis on contracting out and privatization. SBA has proposed to work with agencies to ensure that small firms continue to receive what the SBA believes is a fair share of prime contracts and subcontracts.

Purchases under the Micro-Purchase Threshold (MPT) of US\$ 2,500 are exempt from the mandatory set-aside provisions set forth in the Federal Acquisition Streaming Act of 1994. Currently, micropurchases account for more than 60% of the Federal Government's annual purchase transaction volume. Micropurchases do not require competition. Such purchases

only require that the buyers determine the award price to be reasonable. There have been proposals to raise the MPT to US \$10,000, which the SBA is resisting.

### **3.2 Eliminating unduly restrictive requirements**

Some assert that one potentially effective way to assist SMEs in the procurement process is to simplify onerous requirements in public procurement. These requirements tend to be focused on postqualification and pre-qualification, requirements for lists and registrations, and a miscellany of other requirements that could prevent entry into procurement markets for SMEs. These requirements could be eliminated when the procurement process will not be unduly prejudiced by their elimination.

#### **a) Pre-qualification and post-qualification**

Many procuring entities require that potential bidders on contracts be pre-qualified. With pre-qualification, procuring entities assess the ability of firms to perform the contract, and only those firms pre-qualified can submit tenders. In procurements in which pre-qualification is used, firms must first submit an expression of interest providing the details of its technical, financial and management capabilities. Only those firms that meet pre-qualification standards may submit a tender in the procurement for which the pre-qualification is being performed. Pre-qualification is often so onerous and time consuming that most SMEs are discouraged from participating in the procurement. In order to discourage SMEs less, it might be useful to eliminate pre-qualification procedures where they are unnecessary, and use different pre-qualification processes at different levels of government or for different values of contracts. It seems clear that larger, more complex works projects should require a more extensive pre-qualification process, but smaller, local projects may not require it at all. Post-qualification may be sufficient for some projects.

Having the same qualification requirements for all sizes of contracts would impose unnecessarily high transaction costs on all parties. For low value contracts, however, fewer companies will be willing to bid if there is pre-qualification or an extensive qualification process. The higher the cost of entering the procurement process as a percentage of potential profit, the riskier that process becomes. There is little standardization across regions or even across countries within the same region and not much transparency in the procedures.

One solution could be to give banks and insurance companies that guarantee government contracts a bigger role in determining appropriate qualifications for bidders on larger contracts. Not only would this remove some of the responsibility from governments, but it also would likely make for greater uniformity and transparency in all government contracts. Furthermore, in some industrial countries, larger firms assist small suppliers to ensure that their quality and delivery standards are met. This approach holds much promise for involving SMEs in public procurement.

One innovation used by the US Government is the small business Certificate of Competency (COC) programme. The avowed purpose of the COC programme is to assure that small

business concerns, especially those that are newly entering into the public procurement arena, are given a fair opportunity to compete for and to receive a government contract.

The COC programme is an appeal process available to a small business that is the apparent low offerer on a prime contract, but found unqualified ("non-responsible" in US terminology) by a procuring entity. The firm is advised that it must apply for a COC to continue to be eligible for a contract award, and it is given only a few days to submit an application. The firm is not required to apply for a COC, of course, but it would no longer be eligible for the particular contract on which it had been found non-responsible. Each COC is reviewed on its merits and is procurement specific. Once SBA issues a COC on behalf of a small business, the procuring entity is required to award a contract to the firm.

Procurement regulation requires the referral to SBA of a proposed rejection of a bid or offer of a small business concern where a determination of non-responsibility has been made. SBA has 15 working days to determine if the small business firm has overcome those issues of responsibility to perform in accordance with the requirements of the procurement. A specialized SBA field staff of individuals with technical, engineering, financial, and government contracting experience carries out the COC process. In making its determination, SBA reviews all material submitted by the procuring entity and the small business firm.

SBA's COC reviews are nearly always completed within 15 work days. Decisions are based on facts and analysis, not on opinion or personal leanings. Unless it can be established, in documentary form, that there is a reasonable assurance of completion of the proposed contract in accordance with all its terms, a COC will not be issued. About 50% of all COC applications processed result in the issuance of a COC by SBA. The on-time performance rate for COC certified small businesses were better than 95% in FY 1997.

A rewrite of the COC programme's Standard Operating Procedure (SOP) was completed and published on 24 April 1998. Streamlined processing procedures for COC referrals below US\$ 100,000 in value were implemented with the publication of the new COC SOP.

The US Federal Acquisition Streamlining Act of 1994 (FASA) and Federal Acquisition Reform Act of 1995 (incorporated into the Defense Authorization Act of 1996) will have a profound effect on the ability of small businesses to enter the US federal market place. These laws and their implementing regulations allow companies to be excluded from contract competition without the benefit of a referral to SBA for a COC determination if issues relating to qualifications are set forth as evaluation criteria in solicitations. Qualification-related factors in such a situation are assessed as part of a bid evaluation and are not subject to the COC process.

The US Small Business Administration contends that one of the major benefits of the COC programme is its positive effects on the expansion of the competitive base of government offerers. One way newly entering small businesses are brought to SBA's attention is through the COC programme. If SBA cannot provide direct assistance in the form of a COC, the firm is referred to other SBA offices, such as the office of Financial Assistance, Management Assistance or Minority Business Programmes.

## **b) Other restrictive requirements**

There are a host of other procurement requirements, other than those relating to contractor qualification, that may prove to be problematic for SMEs, and the relaxation of which may do little harm to the integrity of the procurement process. Some quality standards and restrictive specifications pose particular difficulties for SMEs. Reducing quality should not be viewed as a means of assisting SMEs, or as an inevitable consequence of using SMEs as contractors. SMEs do not necessarily offer lower quality than large firms. But, technical requirements in public procurement should not be overspecified or seek quality in excess of end-user needs, since this may cause prejudice to SMEs. Many of the specifications used by procuring entities present a barrier to entry to SMEs and exclude their participation in particular markets.

Governments can identify and promote the use of technology which has the potential to increase the number of employment opportunities generated per unit of expenditure; provided, however, that any cost premiums associated with such usage are modest. It can also review existing standards, including test methods and acceptance criteria, and modify them, as necessary, in order to facilitate the usage of such technology by the SME sector, provided end-user requirements are not compromised.

In the South African context, for example, small firms have experienced some difficulties in complying with various international standards, such as ISO 9000. SMEs have argued for a simplification of standards and have complained about the cost of certification. There is no doubt that the cost of certification as a proportion of turnover for a small firm is significantly greater than for a large firm.

It may be argued that some standards have been drafted to suit well-established industry, and are framed around plant-based methods of manufacture and medium- to large-scale enterprises which have a reasonable degree of technical competency and testing resources. In addition, the test methods and procedures for quality assurance are generally written for a scale of operation where sufficient quantities for statistical purposes are manufactured, and the cost of testing by external authorities (or that associated with the establishment of in-house laboratories) can be written off against the volume of the article that is manufactured.

The Green Paper on Public Sector Procurement Reform in South Africa suggests that the strategies to overcome difficulties relating to small-scale manufacture should include:

- Monitoring the performance of manufacturers by the State in terms of sampling plans;
- Establishing centralized testing centres;
- Formulating specifications that describe product properties in terms of their physical properties rather than by reference to a series of standards. This is a well-accepted and uncontroversial approach;
- Developing and specifying simple site (point of manufacture) tests which confirm the acceptability of products for their intended purpose;
- Reviewing the testing and acceptance tests, criteria and norms;
- Setting appropriate standards for different applications of a manufactured article; and education and training of manufacturers.

There are some requirements that may be waived with little or no effect on the integrity of the procurement process. For example, in India, bid invitations are supplied free of cost to SMEs. A copy of the bid invitation is also sent directly to NSIC for circulation among SMEs. The efforts reduce the transaction costs of SMEs. Copies of drawings and specifications, even if those are documents for which procuring entities charge a fee, are supplied free of charge to NSIC for distribution among SMEs.

### **3.3 Electronic commerce**

Electronic commerce is a burgeoning phenomenon globally.<sup>6</sup> Many electronic commerce innovations have occurred in inter-firm trading and not in sales to consumers. The electronic commerce model of electronic contracting in the vertical supply chain - from manufacturer to distributor/dealer to supplier, subcontractor or prime contractor - translates well into public procurement and is suited particularly for procuring from SMEs.

In the more technologically advanced economies, governments can reduce the transaction costs associated with gathering information. Even when detailed bid information is published in newspapers and trade journals, it is often not readily accessible by SMEs. It is beyond the capacity of many SMEs to undertake the time-consuming and expensive examination of various sources of information. Electronic dissemination, either through the Internet or by fax, is far more efficient.

The appropriateness of this approach depends upon the level of technological penetration in a given country. On a national level electronic procurement systems are used by governments in the most developed countries as one would expect; however, the systems are also beginning to appear in more advanced developing countries such as Mexico.

Moving to greater use of digital and electronic dissemination of information is an essential reform in the way government does business. It allows the government to reach more businesses with more information at less cost to both business and government. It also makes the government more open and accessible to all businesses, not just those with staff dedicated to government relations.

The move towards electronic and digital dissemination, bidding, and registration also has a secondary benefit for the SME sector in that it increases the use of technology. In the longer term this has the potential to make SMEs more competitive locally and internationally.

The costs of increasing or introducing digital and electronic dissemination for the government are not high. They are usually more a diversion or reapportionment of current expenditure for dissemination while investment in technology and hardware are ancillary to general modernization and capital investment. Further, models in the industrialized world based on open systems and off-the-shelf technologies are becoming readily available; for example General Electronics' Trading Process Network. In the US and other developed nations, SMEs are being driven into electronic procurement by large private-sector firms. The US retail giant, Wal-Mart, now sources exclusively on-line and is soon to expand this to its foreign

suppliers. SMEs that wish to work with Wal-Mart, or increasingly any large firm, are left no choice but to adopt electronic commerce. At the same time, the drop in computer and telecommunications prices and the availability of open Internet-based systems have made the choice easier for SMEs.

The importance of using open Internet systems cannot be overstressed. The first attempt by the US Government to implement an electronic-procurement system - the Federal Acquisition Computer Network or FACNET - was a failure because it was a closed or proprietary system. A brief review of what happened illustrates several important points about electronic procurement. A 1993 US Government review predicted that adopting electronic commerce for small purchases could save the government US\$ 500 million a year. The Government then mandated the creation and use of FACNET for purchases between US\$ 2,500 and 100,000. Two years later less than 2% of all federal procurements in the specified price range were accomplished through FACNET, and over 75% of the procurements were actually below the US\$ 2,500 threshold. Moreover, barely 1% of all government contractors registered in the FACNET database.

The system failed because it was proprietary. In order to use it, firms had to invest in technology and software that would only work with FACNET. By contrast, open systems like the Wal-Mart system and the new federal system allow users to format data once and gain access to other systems.

In addition to systems of electronic commerce designed to facilitate access to procurement by all firms generally, the US Government has implemented a project designed specifically to assist SMEs. In June, 1997, US Vice President Al Gore announced *PRO-Net*, a new pilot initiative with 6,000 plus small firms in the database. The database is expanding weekly and currently contains profiles of over 180,000 firms. *PRO-Net* is an Internet-based electronic gateway to information for and about small businesses, and is provided to users free of charge. *PRO-Net* provides profiles to federal and state agencies, federal prime contractors, and others who may be seeking small business sources as prime contractors and subcontractors. The system allows participating firms to continually update their profiles with current information. The SBA is currently working with various groups, including state and local governments, colleges and universities, and local economic development centres to sponsor a dedicated *PRO-Net* access workstation at their facilities. SBA's goal is to establish a network of access stations throughout the United States.

Another example is ELPPO, the European Electronic Public Procurement System that will build and demonstrate on a number of sites (including a "virtual procurement region") regional procurement information partnership and business information networks, which are targeted at SMEs. They include a range of free and paid-for telematics services, from fax-on-demand services, electronic data interchange and Internet services to demonstrate ways of establishing SME support networks on any telematics environment in Europe. This will enable procuring entities to generate telematics and support services for local SMEs and at the same time capture the efficiency benefits of electronic procurement for themselves.

The ELPPO example from the EU, and the *Pro-Net* example from the United States, while perhaps ambitious attempts to lower information costs, are not unique. Every industrialized nation has a programme similar in design if not in scope. Moving to greater use of digital and

electronic dissemination of information is an essential reform in the way government does business. It allows the government to reach more businesses with more information at less cost to both businesses and the government. It also makes the government more open and accessible to all businesses, not just those with staff dedicated to government relations.

A good example of how electronic commerce could work by developing countries is provided in Mexico, where the government recently initiated an Internet-based procurement system, named *Compranet*. This system also includes limited access to state procurement.

**Box 1. How small is too small when determining a threshold for competitive bidding?**

If government were to adopt recent advances in electronic commerce, the answer is no amount is too small. Using existing technology, any purchase of standard goods can conceivably be competitively bid, processed, and paid for in less than 5 minutes.

The following scenario illustrates one scheme. A government agent needs to purchase office supplies. The employee opens a web browser, and goes to the government, ministry, or agency procurement site. This can be done at home, at the office or in the field. Once at the site the employee enters a password, and other relevant information, perhaps a departmental code, project budget number. The employee either goes to the office supply page or enters a few key words in a search interface. Depending upon how well the user constructs the search, and the availability of the product, there will be either a short or a long list, which can be further winnowed. The user selects the product description that best fits the need, enters a delivery address, and then enters his or her government credit card information. The bidding program at the government procurement office verifies that the user, budget, address, and credit card information. It then automatically compares prices for the selected item from a catalogue composed of entries submitted and maintained by approved suppliers. The program factors in shipping costs to determine the best or, perhaps the three best options. The user is then returned a few options for delivery time and price. The user selects his choice and payment is made to the vendor.

From the vendor perspective, the system has several advantages. First, most SMEs are moving to electronic commerce to work with large firms. Wal-Mart, General Electric, automakers, and major retailers have embraced electronic commerce and are demanding that sub-contractors and vendors use it. If the central government adopts an open standard\* then SME would likely already have taken the necessary steps to take part in government procurement or would soon be doing so. The cost of entering government procurement is insignificant since the same catalogue of products posted on the web or sent to others can be used. Second, the use of electronic funds transfers, of which credit cards are an example, means no delays in payment. The infrastructure and institutions--banks and credit card companies--for using this electronic payment system is widely, almost universally used. This system is also less susceptible to human intervention in the procurement process since purchase decisions are made autonomously by computer as opposed to budget officers.

From the government's perspective, the system has several advantages. It automates much of the procurement process reducing the cost and speeding the process. It provides a digital trail for audit and supervision. The system also opens government procurement to more firms increasing competition and lowering prices. In one respect it levels the playing field between SMEs and larger firms—on the web IBM and a small start up look and operates the same. The infrastructure for such a system—the hardware and more importantly the software—is commercially available. For example, Microsoft and Lotus already provide most of what is needed in prepackaged software. An open system would work on a variety of platforms allowing all branches of government and vendors to access the system without upgrading or changing hardware and little or no change in software. Similar systems are extensively used in the private sector. In fact, a government system could work as nothing more than an interface with established private procurement centers. For example, the government could link to Wal-Mart's collection of vendors. Though this might not work for small individual purchases it holds promise for larger departmental purchases and is a model of public-private linkages.

\*The terms "open standard" or "open system" are subject to a great deal of specialist debate. However, as used in general discourse and as used here they are meant to indicate nonproprietary systems, ones that can work and exchange information with other systems. For example, HTML, the code behind web pages, which can be used on Unix, Macintosh, and Windows, is an example of what is meant by an open system. HTML documents may be used on any operating system using any browser. Microsoft applications would be an example of a proprietary or non-open system. Although Microsoft applications will run on different platforms, a user still needs Microsoft applications to view the documents created by these applications (except HTML documents as mentioned). For example, a document written in Microsoft Word may or may not be viewable in another word-processing programme. A document written or saved in ASCII, however, will be viewable in any word processing programme. ASCII would therefore be considered an open standard.

Source: Enterprise Research Institute, Washington, D.C.

Another country that is a source of electronic commerce initiatives is South Africa. Currently, a number of electronic commerce systems exist there, each with its own advantages and limitations. The majority of SMEs cannot access procurement opportunities presented through electronic media and, even if they could do so, they probably would lack the resources to devote the requisite time and energy to access the opportunities presented in the various systems. Current South African electronic commerce initiatives are summarized in table 9. The prevailing view seems to be that there is a need for a single point of entry.

A single point of entry system provides substantial benefits to public sector and corporate procurement officers. These offices could enter their tender and other opportunities from their desktop computers and be assured that these opportunities are automatically distributed to all SMMEs. Such an ability to match opportunities to suppliers electronically could contribute substantially to enabling more SMEs to benefit from procurement opportunities.

**Table 9**            **Current electronic media initiatives in South Africa**

**DTI : BRAIN Programme**

BRAIN website (as single entry point for all business information)

Access to government databases such as : Registrar of companies, Exporters, etc.

Means of interacting with SMMEs (Business Centres, call-system, website, Business Buzz)

**TIS (incorporating Sourcelink)**

A self-sustaining business system to access, sort and distribute tender opportunities

Established systems and technology to access opportunities electronically and manually, to distribute electronically or by fax or in hard copy. Also, for suppliers to submit offers (quotes/tenders) and procurement officers to place orders.

R10 billion worth of annual opportunities

**Braby's**

A self-sustaining business system to access information on suppliers, sort and publish such information on the web and in directories.

Established systems and technology to do the above.

600 000 SADC suppliers on their database, which is accessible via the Internet.

A process where approximately five thousand organisations are contracted daily, to update their information.

**CSIR**

A database (multi-media) system called "in-Touch" developed to publish SMME information suitable for procurement from government and corporates.

**Pretoria Metro**

A Tradepoint software programme, close to launch

### **3.4 Breakouts versus bundling**

In some contexts, procuring entities have incentives to combine requirements into large procurements in order to reduce transaction costs. It is cheaper to deal with a few large firms than many small ones. With such combinations of requirements, procuring entities also may take advantage of lower pricing based on quantity discounts. This has come to be known as "contract bundling".

Contract bundling, however, is at odds with the concept of contract breakout, in which requirements are divided between several procurements. The advantages of breakout for SMEs are obvious. SMEs can compete more effectively for smaller contracts.

Contract breakout may conflict with procurement reform initiatives. For example, in the United States, as a result of the Federal Acquisition Streamlining Act of 1994, many agencies decreased their contracting staff and, as a result, increased the practice of contract bundling by consolidating requirements that were formerly separate contracts. SBA's concern is that bundling consolidates requirements that individually were or could be performed by small business and prevents, in many instances, performance by small business. SBA is currently revising Part 125 of Title 13 of the Code of Federal Regulations to add the regulatory language on bundling addressed in the Small Business Reauthorization Act of 1997. The statutory amendments recognize that the consolidation of contract requirements may be

necessary and justified, but require that each federal agency take steps to avoid unnecessary and unjustified bundling of contracts that precludes small business participation as prime contractors. To further assess the effect on their small business constituency, SBA collects data on bundling practices at buying activities and has provided a mechanism for the contractor community to report instances of bundling to SBA via the Internet. SBA advocates breakouts to procuring entities based on its statutory authority.

An issue relating to bundling is the extent to which public procurement should be centralized or decentralized within a given country. The trend towards devolution of political power and control of procurement presents both opportunities and problems for the greater involvement of SMEs in public procurement. Subcentral entities often buy in quantities that are more manageable by smaller businesses. Where procurement is decentralized to local government, lower transportation costs often allow local SMEs selling to local governments to compete more effectively with larger firms. Local government officials may also better know the capabilities of local producers.

However, the problem with purchasing by local governments is that they often lack qualified staff. For much of the developing and transitioning economies this problem continues to present difficulties. While many central governments have increasingly decentralized authority and money, this move has not always been matched by stronger capability at the local level. As a result, the attendant problem, especially for agencies with unqualified or inexperienced staff, is that decentralized, local procurement is harder to monitor, so that transaction costs rise. In addition, the political environment at the subcentral level may bring pressure on subcentral entities to favour local firms and to engage in protectionism at the expense of competition and efficiency.

### **Advantages and disadvantages of procurement reform**

The principal advantage of procurement reform as a method of assisting SMEs is that it is probably the best policy among all those discussed from the standpoint of economic efficiency. If reform is limited to making the public procurement market less costly and more competitive, social costs associated with programmes designed to benefit selected groups should be zero or minimal. Premium costs and costs associated with lobbying, rent seeking and transfers should be insignificant or immaterial with market-liberalizing reforms. Restrictions on choice by end users of government goods and service will not materialize.

There may be costs, however, associated with contract performance. Governments may lack sufficient information to know the precise balance of streamlining policies that will both open public markets to SMEs and not expose the government to risks in contract performance due to relaxed standards in the procurement phase. For example, if a government relaxes pre-qualification standards, some firms not able to perform a contract may be awarded a contract nonetheless, and the risk of default therefore will be increased.

Costs to SMEs directly should decrease as public procurement becomes less burdensome. The benefits to SMEs, however, may be minimal, since these programmes benefit all contractors. Procurement reform indeed could be harmful to the interests of SMEs, particularly inefficient SMEs, if the benefits of reform tilt towards large firms. Taxpayers, on the other hand, may gain regardless of the effects on SMEs, due to savings in public budgets. The "bottom line" for procurement reform is that if it is done properly, it may facilitate efficiency but may not do much in terms of distributing benefits explicitly to SMEs. Emphasis

on efficiency rather than on distribution, however, may have positive effects for competitive SMEs, and may assist competitive SMEs and compel inefficient ones to exit the market.

Table 10 summarizes the policy elements, techniques and effects of procurement reform in SMEs.

**Table 10 Procurement reform: untargeted assistance**

Policy	TECHNIQUES	Effects (all policies)
1. Streamlining	<ul style="list-style-type: none"> <li>▪ Deregulate</li> <li>▪ Improve transparency</li> <li>▪ Improve competition</li> <li>▪ Standardize documentation</li> <li>▪ Improve publicity</li> <li>▪ User-friendly documentation</li> </ul>	<p><b>Potential benefits:</b></p> <ul style="list-style-type: none"> <li>▪ Improve access by SMEs to public markets</li> <li>▪ Reduce entry barriers</li> <li>▪ Potential efficiency gains</li> <li>▪ Avoid inefficiency in implicit political markets</li> </ul>
2. Eliminating unduly restrictive requirements	<ul style="list-style-type: none"> <li>▪ Eliminate unnecessary pre-qualification and post-qualification requirements</li> <li>▪ Innovate qualification programmes to ensure SME participation</li> <li>▪ Thoughtfully apply international standards</li> <li>▪ More efficient testing requirements</li> <li>▪ More efficient specification drafting</li> </ul>	<ul style="list-style-type: none"> <li>▪ Maximizes end-user choice</li> <li>▪ Decreased costs to firms</li> <li>▪ Potential taxpayer savings</li> </ul> <p><b>Potential costs:</b></p> <ul style="list-style-type: none"> <li>▪ Increased default risks</li> <li>▪ Information costs</li> <li>▪ Could be harmful to SME interests</li> </ul>
3. Electronic commerce	<ul style="list-style-type: none"> <li>▪ Obvious benefits</li> <li>▪ But SMEs in developing and transition countries may still have problems</li> </ul>	
4. Breakouts versus bundling	<ul style="list-style-type: none"> <li>▪ Breakouts better for SMEs</li> <li>▪ But may be more costly than bundling</li> </ul>	

### **Unit 4**

## **TOOLS AND EXPERIENCE III: TARGETED ASSISTANCE AND INTERVENTION**

Unit 4 examines programmes in public procurement targeted specifically to assist SMEs. It is thus to be distinguished from Unit 3, which covered untargeted assistance and procurement reform.

### ***Learning Objectives***

*By the end of this Unit, you should be familiar with:*

- ◆ *Various kinds of technical assistance that government and industry can provide to SMEs so that SMEs improve their rates of participation in public procurement;*
- ◆ *Significance of training and mentoring of both SME and government managers to improving SME participation in public procurement;*

- ◆ *Kinds of financial assistance and subsidies that can be used to assist SMEs in the public procurement field, and also the potential disadvantages of such assistance;*
- ◆ *Characteristics of subcontracting programmes designed to either mandate or encourage large firms to use SMEs as subcontractors;*
- ◆ *Use of preferences for SMEs in public procurement and the advantages and disadvantages of preferences;*
- ◆ *Use of set-asides, in which procurements are reserved exclusively for SMEs, and the advantages and disadvantages of set-asides.*

#### **4.1 Technical assistance**

A number of countries maintain programmes that are designed to provide advice, and counselling, marketing guidance and other help - generically, "technical assistance" - to SMEs. Many countries provide targeted assistance to SMEs. This includes assistance in completing bid documents, obtaining financing, and technical assistance in complex technological bids. Some countries also provide assistance in helping SMEs co-ordinate bidding for contracts. These programmes will be examined in this Section. We have classified technical assistance into the following three categories: (1) goal setting and advocacy; (2) advice and marketing assistance; and (3) World Bank approaches in funding social projects.

##### **a) Goal setting and advocacy**

Many countries have established programmes and public bodies or units dedicated to assisting SMEs. These organizations advocate to the private and public sectors on behalf of the SME sector and are responsible for implementing goals for SME sector achievements.

In South Africa, the Centre for Small Business Promotion (CSBP) was established following the President's Conference on Small Business was held in March 1995. The Mission of the CSBP is to implement, monitor and evaluate the South Africa National Small Business strategy, the aim of the strategy being to contribute to job creation, income generation, the redistribution of wealth and overall economic growth. The objectives of the CSBP are achieved through the creation of a legal environment and institutional framework that facilitates increased access to services that SMMEs require in the area of finance, training, markets, technology, infrastructure and information.

The United States Federal Government maintains a comprehensive set of goals for SMEs. SBA is dedicated to advocacy to procuring entities on behalf of SMEs. For example, negotiation of procurement preference goals results in agreements with federal agencies to consider innovative ways to promote utilization of the SBA's 8(a) programme. SBA helps the local buying activities utilize firms in SBA's 8(a) portfolio that had not yet received a federal contract award. The 8(a) initiative resulted in 150 first-time awards, valued over US\$ 92.5 million in FY 1998.

Legislation generated two pilot programmes managed by the SBA Office of Prime Contracts in the last few years. The first is the Women-Owned Business Procurement Pilot introduced to help achieve the Government-wide 5% goal for awards to women-owned small businesses. To assist agencies in achieving this goal, the SBA joined with 11 major federal agencies and other resource partners to establish a systematic approach to expand the pool of women-owned firms through outreach, training and marketing assistance. Each year a series of workshops are conducted at selected district offices in support of this pilot. In addition, SBA works to assure that women-owned firms receive a larger slice of the procurement pie by requesting that each Cabinet member commit to specific strategies to increase the women's share of their agency's contracts; requiring agencies to consider women-owned firms when selecting a contractor in the streamlined procurement process; working to get more women-owned firms registered on the *PRO-Net* database; and appointing a programme manager for the women's procurement issues.

The SBA Office of Procurement Policy and Liaison (OPPL) maintains contact with all Federal departments and agencies to ensure that small business concerns receive fair and equitable treatment from each agency. The office also plays a key role in the development of federal acquisition policy, legislation, and regulations that may affect the interests of the small business community. OPPL closely monitors procurement legislation and makes suggestions for revisions that would accomplish the goals while retaining provisions that encourage the participation of small business concerns. This Office also participates in the development of the Federal Acquisition Regulation (FAR) that governs Federal procurement procedures.

President Clinton has directed that 23% of all government contract awards be made to small businesses. This goal presents a variety of policy and procedural challenges to all federal agencies due to some of the challenges to small business resulting from procurement reform. SBA works with procuring entities to devise new approaches that will facilitate achievement of this goal.

In addition, the Federal Acquisition Streamlining Act of 1994 establishes a goal to award 5% of all government contracts to women owned businesses. Currently women receive approximately 2% of such awards. SBA works with federal agencies to devise strategies to assist agencies achieve this goal.

In order to meet SME goals, SBA maintains a staff of 45 procurement centre representatives (PCRs), plus 7 field staff with collateral duties in the programme. In FY 1997, PCRs reviewed approximately 42,000 acquisition packages. PCRs also counselled over 15,000 small business firms and supplied over 21,000 small business sources to contracting agencies. SBA has 14 breakout PCRs stationed at major Department of Defense activities around the country. Over 2,600 recommendations, with a value in excess of US\$ 384 million, were accepted for breakout in FY 1997.

## **b) Advice and marketing assistance**

Governments have implemented a number of initiatives to provide advice on procurement issues and marketing assistance to SMEs.

### *South Africa*

For example, the South African Government has established tender advice centres in a number of regions. These centres provide the following services to SMEs:

- Information and referral services;
- Tender counseling (pre-contract/post-contract);
- Assist SMEs to complete tender documentation;
- Assess SMEs training needs and coordinate training programmes;
- Evaluate the capacity of SMEs to deliver on contracts.

In addition, the Emerging Contractor Development Programme (ECDP) focuses on those contractors that have the required technical skills, but have been unable to obtain contracts from the public sector because of a lack of expertise in submitting quotations and tenders. The essence of the ECDP is the creation of an institutional infrastructure in each of the department's regional offices, to provide emerging contractors with access to specific categories of work opportunities, and to training and support programmes. Central to this infrastructure is a help desk within each Regional Office, which will be the primary focal point of the interface with the contractors.

South Africa has implemented a "Missing Link" programme to assist SME's in solving problems with specifications and standards. SMEs are offered courses on standards and specifications. The "link" component of the programme offers training programmes in various technical fields that are tailored to improving SME's and to equip them with the knowledge to manufacture high-quality products that conform to acceptable manufacturing practices. Training is covered in section 4.2.

The manufacturing sector has been targeted for economic development in industrial policy. The South African Government has created the national Manufacturing Advisory Centre (MAC) programme to assist SME manufacturers.

MACs are regional centres established to assist SMEs to improve their productivity and competitiveness in the local and international market places. The MAC programme is a "coordinated outreach" programme and its objective is to provide advisory and extension services to improve the performance of existing SME manufacturers with under 200 employees.

The MAC programme draws on resource and expertise from relevant service providers. There is also a focus on upgrading the capabilities of previously disadvantaged manufacturers. For this reason, there is a close relationship between MACs and Local Business Service Centres (LBSCs).

The CSBP has identified the need for improved access to information for the SME sector. The CSBP is in the process of developing a Business Referral and Information Network (BRAIN). In this initiative, information technology enables the collective memories of all those accessible through the referral system, plus information stored in books, videos and other media linked to the system, to collectively form a knowledge base for industry.

SMEs will be able to access BRAIN through face-to-face consultation, the telephone, a fax machine, the postal service or the Internet. Three types of delivery services will be provided:

- Internet access to search and fetch own information;
- Business information hotlines for instant information;
- Business information centres for face-to-face consultations.

The CSBP is developing BRAIN to serve approximately 50 medium-sized centres located at the metro level of local government. These centres will ensure that counselling and comprehensive training is available with  $\pm$  150 km radius of 90% of SMEs within South Africa.

### *India*

The Government of India has also created institutional support to guide and help SMEs. The National Small Industries Corporation (NSIC) provides assistance to SMEs. NSIC is a national organization with infrastructure and expertise to render assistance to SMEs in their various operations. It also provides training to entrepreneurs and workers, testing and quality control facilities for SME products and marketing assistance for SMEs. The Indian State Governments have separately and independently extended similar benefits to SMEs located in their territories.

Small-scale industries (SSIs) registered with the NSIC or with the Director of Industries for the States are treated as registered suppliers with all government procuring entities. No separate registration is required and no further verification of qualification is required in any pending procurement. Copies of bid invitations are supplied free of charge to SSIs on the registration lists and also to the NSIC for wider circulation among SSIs. Copies of drawings and specifications are also supplied free of charge to SSIs, even if they would generally be provided for a charge. The rationale for this assistance is to assist SSIs in marketing and to decrease their costs of contracting.

During public opening of bids, a representative of NSIC is permitted to be present and to take down information. This information is communicated to SMEs that may have submitted bids. The information is also useful to other SMEs that may want to participate in the future procurements.

### *Hungary*

In Hungary, the Institute for Small Business Development is a national government organ responsible for collecting and providing information on the SME sector. It is supervised by the Ministry of Economic Affairs. In its present form, the institute was founded in 1995 but actually continued the activities performed by its predecessor, which was set up in 1990.

The main tasks of the institute are the following:

- ◆ Monitor the environmental changes that influence the operation of SMEs;

- ◆ Analyse the development of the SME sector;
- ◆ Provide objective, reliable and accurate information to the public, decision makers and professionals.

The institute supports and organizes research on the various aspects of SME development, and performs statistical analyses relevant to SME assistance.

The Hungarian Foundation for Enterprise Development (HFED) was established in 1990 for the support of small-business development in Hungary. The Hungarian Government, many larger banks and associations of enterprises, provided the funding for HFED. The foundation operates independently as a non-profit organization. Its mission is to promote the development of the economy through the enhancement of the competitiveness of the SMEs. HFED offers a wide range of technical and financial-aid programmes.

The operation of the foundation is based on a network of local centres. The first 6 centres were founded in 1990; since then 14 more have been established, which now appear throughout the whole country. The centres are registered as foundations which is a non-profit status allowing independent operation as well as an opportunity to raise funds for themselves. The centres operate 150 offices throughout the country, which means that the services offered by the foundation are available locally for everyone in most of the smaller towns, too.

HFED organizes and operates national programmes in the following main fields:

- ◆ Development of educational material for entrepreneurs;
- ◆ Organization of training programmes;
- ◆ Support of research on the SME sector;
- ◆ Access to national and international electronic databases and information centres;
- ◆ Support programmes for innovation and export promotion;
- ◆ Support of the international mobility of entrepreneurs to participate in international information exchange forums;
- ◆ Support for participation in training programmes.

The operation of the local centres and offices operation is based on yearly business plans, which take into account the conditions and the potential of the local economy. The centres and offices offer low price or free services in the following fields:

- ◆ Local experts for consultation and advice;
- ◆ Training and development programmes;
- ◆ Access to local, national and international databases;
- ◆ Assistance in export marketing (catalogues, participation in fairs, etc.);
- ◆ Local development plans by sectors.

## *United States*

The US SBA administers a variety of technical assistance programmes designed to assist SMEs. Retired business executives assist small firms in counselling and training through SBA's Service Corps of Retired Executives (SCORE). This is a volunteer effort in which SMEs are assisted annually in the form of pre-business workshops, one-on-one counselling and seminars.

The US SBA funds Small Business Development Centres (SBDCs), which are educational or consulting institutions intended to provide training, counselling and other forms of technical assistance to SMEs. This is a programme of nearly US\$ 100 million in grant assistance, which is matched by the institution. The expertise of university, faculty, and staff are made available to small businesses through this programme.

Of the research and development budgets of major federal agencies, 1% is set aside for grants and contracts to small businesses under the Small Business Innovation Research (SBIR) programme. Eligible SMEs must have ideas and technologies that meet the needs and critical missions of principal US research and development institutions. The SBIR programme provides nearly US\$ 1 billion annually in financing the small-business community. It is the largest source of start-up or seed capital in the United States. The Government does not ask for ownership interests in these companies but expects that a certain percentage of these firms will generate important technologies as well as taxes and employment.

### **c) Cooperatives**

#### *Ceará, Brazil*

A recent example of innovation to mitigate the adverse effects of bundling on SMEs (discussed in Unit 3.4) can be found in the State of Ceará in Brazil (Tendler, 1997). It is an example of "demand driven" procurement in which the State buys from SMEs, while at the same time providing technical assistance to all phases of the businesses involved in procurement. In Ceará, the procurement of furniture for schools was organized in a manner that reduced some of the transaction costs associated with state agencies dealing with small firms. The State did not purchase from individual SMEs but through associations of small manufacturers. Technical assistance was provided to the firms by Brazil's small business assistance service (SEBRAE), which was paid a commission on the value of the contracts by the State. As a result, local manufactures were able to produce better quality furniture more cheaply than the State's traditional supplier, a large manufacturing firm in another State. The traditional supplier was able to charge significant premiums through exorbitant prices and transportation charges, because of the lack of competition. Purchasing through the association of small firms also enhanced quality control because it created peer pressure - if one producer produced inferior goods it imperiled the entire group's status.

Organizing the furniture producers also produced ripple benefits. The organization contained within itself a structure for disseminating money, enforcing obligations, gathering information, organizing training and dispensing aid. Some of the administrative burden of providing

assistance to the sector was thus transferred from the State to the sector, while at the same time enhancing productivity and the ability of the small firms in the programme to compete in other markets. The producer associations saw themselves as competitive entities able to compete on price and quality. Since the State was not obliged to accept the association's output, there were strong incentives for self-policing of quality and delivery.

This is not to say that the associations formed in Ceará were not political. A crucial and conscious strategy of the State agency and the governor responsible for creating the association was to create a political counterweight to the larger firms, to generate political support for SME development, and to end traditional problematic practices inherent in local procurement. Since the larger firms had been selling lesser quality goods at higher prices, the strategy was successful. However, the danger in this is clear. The associations could mobilize to demand a "fair share" of government contracts and this could turn into another form of patronage. Unfortunately, attempts to replicate the experiment in other parts of the region were unsuccessful. There is also evidence that local mayors have wrested some control in procurement decisions away from the State. A follow-up study to determine the current fate of the SMEs, their business association and other similar experiments in the area could turn this case into one that provides valuable lessons.

The Ceará case shows that targeting assistance towards helping SMEs to deal with all aspects of procurement can pay dividends, although the costs of doing so may be high if the incentive structures are poorly designed. Targeted assistance that involves training often has an added benefit of *transferring* skills to the SME sector, on a demand-driven basis, which makes improvements in the SME sector sustainable.

In order for programmes such as the one in Ceará to work, legal impediments to twinning or joint venturing by SMEs must be removed. In some countries, SME combinations may jeopardize the eligibility of participating SMEs for programme benefits.

#### **d) Community participation in procurement financed by the World Bank**

Similar to Ceará in idea but with a more direct basis for action are the Social Funds (SFs) and Social Action Programmes (SAPs) used by international financial institutions to fund basic investment and development programmes in marginalized communities in Africa. These projects combine poverty alleviation and job creation with project and sector objectives. The funds are applied in communities with high unemployment, where the vast majority of firms are either small or microenterprises and where the primary need is for basic projects. SAPs and SFs are used where procurements will involve a marginalized community in which firms are mostly SMEs, and more likely small or even microenterprises rather than medium-sized enterprises.

World Bank policies for procurement and disbursement were designed traditionally to facilitate supply of goods, works and services by large contractors in an approach suitable for large investment projects. The World Bank's Procurement Guidelines were revised to include consideration of procurement in social-sector projects. SFs fund local organizations, public or private, in a more flexible and transparent manner than regular government ministries. They are demand driven as in the Ceará case and respond to funding requests from local bodies, but neither identify nor implement projects.

SAPs, on the other hand, are designed as regular investment projects. The government still has to implement the project but the World Bank helps build local level capacity and works with local groups, both non-governmental organizations (NGOs) and governments. In many cases, governments simply lack the human and administrative infrastructure to identify, let alone implement, small aid projects in poor, often remote, communities. SFs fill a gap that exists in most government structures in Africa - namely the absence of mechanisms to support local government, NGOs and other grassroots organizations in carrying out participatory development activities.

SFs and SAPs are intended to organize people into firms and to assist them in obtaining work. Governments lack the resources to work with small contractors and small contractors lack the resources to work with governments. NGOs and development groups provide the missing capacity. The SFs and the SAPs fund work performed by these organizations.

Community participation programmes of the World Bank are ad hoc and not ongoing. Participation is for one time only or occasional. The programmes are not sustained projects. The modest goal is to use an existing project in a marginalized area - a project that has to occur anyway in the region - and use it to impart skills and work experience to SMEs, thus starting or augmenting capacity in the community for participation in other, hopefully private, projects. Future programmes by the World Bank or by the borrowing government are not guaranteed. Once a firm is established and has experience in performing a contract, it is easier for that firm to participate in future procurements on its own or to bid for other work. The firm now has work history and experience.

The most successful of these programmes is AGETIP in Senegal, which is now replicated in many West African countries. This public works and employment project created 11,103 jobs with an average duration of 30 days each. It has had low management costs and has involved many small-scale construction companies, often excluded from the implementation of public works in the past. Such a SF, if well integrated into governmental sectoral strategies, can help to create a functional partnership between central government and private and public organizations working at the local level.

In addition, the World Bank has identified conflicting or tedious bureaucratic procedural requirements resulting from the borrower's regulatory framework as a key constraint to effective project design. Innovations from these programmes include the use of vouchers in the Zambia Social Recovery project where community groups were given vouchers instead of having funds dispersed. These vouchers were redeemable only at specified retail outlets and only for items associated with the project. This eliminated the need for disbursement and monitoring and speeded payment to the merchants most of whom were small or microentrepreneurs.

### **Advantages and disadvantages of technical assistance**

There are several advantages to providing technical assistance to SMEs. Technical assistance is less interventionist than subsidies in the form of financial assistance,

preferences or set-asides (covered in sections 4.3 through 4.7) and require that SMEs maintain profitability without relying on government benefits designed to allocate government contracts directly to SMEs. Technical assistance does not require procuring entities to tailor procurement proceedings to goals other than best value, unless the goals for levels of SME contract awards (section 4.1.A) are mandatory. Most technical assistance is optional for SMEs and they may choose whether to take advantage of it.

The disadvantages of technical assistance are that it can be ineffective in assisting SMEs. Government officials may not have the expertise to provide business advice to entrepreneurs. The market may provide services, in the form of consultants, who may be more effective. Governments may wish to privatize or contract out for technical assistance to take advantage of this expertise.

In addition, SME advocates may be captured by SME interest groups and become obstacles to reform, blocking programme revision (see Unit 5.9). Conflicts of interest among public programmes competing for scarce public resources may occur. Governments have an information problem in that they may not be able to tailor goals in a manner that both assists SMEs and avoids allocating too many resources to SME programmes. Bureaucracies that provide advocacy, monitoring, goal setting and advice are costly. Competing interests and the public may disagree on what is fair and equitable.

Finally, large firms may not take seriously goals that are optional and not required to be met by law, and such goals may therefore be ineffective. On the other hand, mandatory goals may be inefficient and may conflict with public policy favouring free trade. A mandatory goal may be bad industrial policy.<sup>7</sup>

Table 15 summarizes these advantages and disadvantages, as well as the policy options associated with technical assistance.

## **4.2 Training**

Training is a means for transferring skills and competencies to individuals and groups by the use of classroom instruction and training materials, in line with the requirements of the client or accrediting organization. It can be an important method of assisting SMEs, as well as government officials in understanding how to implement SME programmes. Training can be viewed as a component of technical assistance. Because of its importance, however, it appears here as a separate section.

The full potential of any SME programme may not be realized without the training of both government officials and SME managers. A structured training programme to provide skills development and professionalism can be introduced at various levels.

The development of skills is the key to successful outcomes in any SME programme. Technical, managerial, commercial and administrative skills and competencies are required. These requirements need to be linked up with other government training programmes.

A structured training plan can be developed for each sector engaged in public procurement. Such a plan would consider the training required to transfer the necessary and appropriate skills to participants and the levels of existing capacity associated with various SME development programmes and as such should include:

- Activity lists of all training items.
- Schedules to show when the training of each activity should occur;
- Resources required in respect of each training activity and where such training will be carried out;
- Budgets for training;
- Management structure required to ensure its successful implementation;
- How the technology transfer will take place.

Another concept related to both training and to technical assistance generally is mentoring. Some governments have developed mentoring programmes designed to assist SMEs. Mentoring is analogous to one-on-one training outside of the classroom. A mentor, or mentoring organization, attends to the more specific needs of contractors as they go about their day-to-day business activities. It is unlikely that the needs of one contractor will be the same as the next. Therefore, whereas a trainer can be trained to impart skills and competencies in line with given material, the mentor will be required to possess the actual experience and knowledge of the line of business.

### **Advantages and disadvantages of training**

Training has the potential to be a very good programme on its own to assist SMEs. It may also serve as a complement to other, more directed programmes designed to assist SMEs. Effective training programmes lead to the transfer of skills and knowledge and can improve the productivity of both SMEs and government. It can be more cost effective than technical assistance, since one professional can reach more than one person at a time in a classroom rather than in a consultation to provide technical advice.

Effective training programmes, however, inevitably have various levels of usefulness to the participants. "One size fits all" may not be helpful for a segment of participants who need either more advanced or more elementary treatment of the subject. There are administrative costs associated with taking SME managers and government administrators out of their daily responsibilities to attend training sessions. On the other hand, isolated training sessions may not be enough for the participants, who would benefit from a sustained programme, although such a programme may be too costly and too intrusive on organizational efficiency.

There may be a lack of local expertise to conduct training. Bringing in internationally oriented instructors, however, is costly, and there is the risk that they will not be able to focus sufficiently on local conditions.

In addition, there are various difficulties associated with assessment and monitoring of training participants. Finally, programmes should be carefully tailored so as to avoid political battles about who should attend training sessions - attendance should be based on need and not on connections.

Table 15 summarizes these advantages and disadvantages of training.

### **4.3 Financial assistance and subsidies**

As identified in Unit 1, SMEs suffer from a number of relative financial hardships in comparison to large businesses. Their access to capital and financing is severely strained. This section examines the various techniques for providing financial assistance to SMEs.

One of the major challenges facing many SMEs is their ability to attract sufficient debt and equity capital. Many of these firms have not reached the creditworthy stage usually required by traditional financing sources. Others, having utilized their existing credit lines, find that their bank is unwilling to extend them further, even for performance on a contract. Efforts to raise equity capital from existing shareholders are often unsuccessful.

Some countries have determined that there is a need for institutions, somewhere between investment companies and commercial banks, to provide financial assistance to SMEs. The areas that the Guide covers are: (1) financial assistance schemes offered by governments; (2) bonding and guarantee reform and assistance; and (3) prompt payment reforms.

Programmes that provide subsidies should be designed in a manner that complies with the WTO Agreement on Subsidies and Countervailing Measures. Article 3.1 of the Agreement prohibits subsidies that are contingent, solely or as one of several other conditions, on either export performance or on the use of domestic or imported goods. There are a number of provisions that would have to be consulted, however, that may provide exceptions to this general prohibition. Article 8.2 of the Agreement, for example, sets out the criteria for when a subsidy designed to provide assistance to disadvantaged regions may be permissible. Article 27 provides for differential treatment for developing countries and it would have to be consulted. Notably, Article 27 provides for phasing out subsidies for some developing countries, but may not permit the addition of new ones. The bottom line is that the Agreement should be consulted so that programmes could be designed that do not violate it.

#### **a) Financing schemes**

This section sets forth examples of various government programmes designed to provide SMEs with financial assistance.

##### *South Africa*

South Africa has implemented the Khula Credit Guarantee Scheme. It is not specifically developed as a contract-financing scheme, but it provides guarantees to commercial banks seeking collateral when issuing loans to SMEs. The percentage of guarantees issued to disadvantaged entrepreneurs has risen from 20 to 50%; 633 guarantees were issued within the first year of operation (as opposed to about 1,470 under the SBDS over a 4-year period). The Government, nevertheless, believes that the scheme has suffered from a low level of utilization and it is currently under review.

## *United States*

The Small Business Administration administers a number of financial assistance programmes designed to assist SMEs. The US micro-loan programme provides financing for small business for up to 3 years for the purchase of equipment and current assets at favourable interest rates. The upper limit of the credit is rather low, so it may be useful only for start-ups and small enterprises. The applicants receive advice on business planning and help in the preparation of the credit application.

SBA's loan guaranty programmes provide term financing for working capital and asset acquisition. These programmes operate in partnership with commercial banks and local development companies. SBA provides guarantees up to 90%. Interest rates charged are capped 2 ¾ points over the prime rate or are tied to United States Treasury bonds. In FY 1998, SBA approved 47,216 loans for a total financing level of US\$ 10.8 billion.

Government contractors can obtain financing from venture capital sources as well as from commercial banks. SBA licenses small-business investment companies that may obtain financial leverage from SBA to undertake the underwriting and financing of small high-tech firms.

## *India*

There are a number of financial concessions provided to SMEs. These include providing land at concessional rates or free of cost for establishing new SMEs, and relaxed credit terms at lower than prevailing commercial rates for the acquisition of plant and machinery. Exemptions from certain statutory duties and levies like excise duty and sales tax are generally granted to SMEs. KVIC units are exempt from paying any penalty for delay in supplies.

To further provide financial support to SMEs, the Indian Government has issued a notification allowing 24% equity participation in SMEs by other industrial units. This opens another avenue of financing to SMEs in addition to promoter's capital, bank loans and government loans. KVIC units in India may receive a direct subsidy on their sales. The Government pays a specified percentage on the market rates at which the products are sold.

## *Hungary*

The HFED local centres offer assistance with credit finance and guaranties and low-cost industrial sites. The centres are also actively involved with the local branches of the participating banks in a number of financial programmes.

The PHARE Loan Programme of the European Community provides medium- and long-term financing up to 7 years. The upper limit of the loan is 10 times higher than in the case of the

micro loan package, so this programme serves the small and medium-sized enterprise as well.

The Start Guarantee Fund is available for those entrepreneurs who cannot provide the collateral required by the banks for the so-called start and Reorg-Start loan programmes. The guarantee fund secures a maximum of 80% of the loan.

The Loan Fund for Energy Saving provides loans for energy-saving development projects for a maximum of 6 years, while the TEK programme provides finance for energy-saving reconstruction of family homes.

## **b) Bonding and guarantee reform and assistance**

In Unit 1, the problems that SMEs sometimes encounter with guarantee requirements were examined. No matter the type of contract, whether it be for goods or services, governments almost always insure themselves against non-performance of the contractor. Before bidding on a project, contractors often must obtain a guarantee from a bank, insurance firm or other financial institution that provides insurance against the value of the contract.

For SMEs, performance guarantees have several advantages. Most importantly, the insurers are more concerned with the contractor's ability to complete the project than with its ability to repay the insurer if the guarantee is called. In the United States, performance guarantees are based wholly on the contractor's perceived competence and not on collateral. This type of reduction in collateral requirements would benefit greatly qualified SMEs. It also would assist the Government since assessment of qualifications is performed by the guarantor, thereby reducing transaction costs. An added bonus for SMEs in the United States is that payment of subcontractors also is guaranteed by the insurer. Since most subcontractors are SMEs, this is a substantial benefit.

Contract failures, resulting in performance bonds being called in, inevitably result from poor management, inadequate experience, inefficient operations, lack of proper job cost and accounting records and procedures, failure to arrange for proper financing, entering into hazardous ventures, lack of business acumen, erroneous tender submissions (mistakes in estimating of both an arithmetical and judgmental nature), and failure to allow for contingencies and unforeseen external factors resulting on unrecoverable cost increases.

Governments have adopted strategies and innovations to enable SMEs to obtain performance bonds and guarantees. Strategies that can be adopted to minimize the risk exposure of public bodies include:

- Minimizing risk through the grading of contractors.
- Provision of sureties / security as opposed to performance bonds.
- Establishment of government funds for guarantees or government self insurance.
- Increased retention fund payments.
- Separate materials and labour guarantees.

Reducing levels of performance bonds by means of contract classification on the basis of risk exposure.  
Guarantees underwritten by development agencies, contractor associations and the like.

In India, SMEs are exempt from payment of bid guarantees while submitting their offers, nor are they required to submit performance guarantee when the contract is awarded to them. Besides simplifying the bid submission and contract procedures for these units, these measures help the units to reduce their working capital requirements.

In the United States, the SBA acts as a reinsurer to surety companies unwilling to write for higher-risk smaller firms. This applies to commercial endeavours as well as to bonding activity required in government contract actions. Presently, SBA underwrites approximately US\$ 3 billion annually.

### **c) Prompt payment reforms**

In a number of countries, there have been persistent complaints that payments to SMEs are not made promptly by public purchasers. Delay in payment reduces the available working capital of an SME and affects its production capacity and profitability.

In India, the Parliament has recently approved an Act that seeks to compensate SMEs against delay in payment. Under the Act, the purchaser is liable to pay interest to the SME at a rate of 5% higher than the prevailing bank rate, if payment is delayed beyond 90 days.

In the United States, the Prompt Payment Act was enacted in 1982. It requires federal contracts to contain provisions on specific payment procedures and deadlines, and to provide for interest payments for late payment of invoices. In general, the Act requires invoice payments and contract financing payments (such as progress payments) within 30 days of receipt of an invoice that complies with legal and contract requirements. The period of time for payment is 14 days for progress payments under construction contracts. 31 U.S.C. § 3901 et seq. (Nash and Schooner, 1992).

### **Advantages and disadvantages of financial assistance**

To the extent that financial assistance amounts to a subsidy to an SME, it may be economically inefficient. Governments have to choose to accept initiatives that reduce efficiency and lower economic welfare overall in order to promote other social policies, such as assisting marginalized groups in society. There are costs associated with subsidies other than loss in efficiency as a direct result of the subsidy, including the costs associated with the implicit political market, such as costs associated with lobbying, rent seeking and transfers. If the costs of such subsidies are known and understood, then governments and citizens will be in a better position to evaluate this trade-off between efficiency and distribution.

Some financial assistance may not involve subsidies, or at least may involve a modicum of subsidization. For example, prompt payment reform or the use of performance guarantees may be market liberalizing if SMEs are paid more promptly for contract work successfully completed, or if a performance guarantee meets the government's needs in a procurement.

Table 15 summarizes the policy options associated with financial assistance and subsidies, and also the advantages and disadvantages.

#### **4.4 Subcontracting programmes**

Some countries have established programmes to encourage the use of SMEs in subcontracting with large business. In such programmes, the government awards a contract to a large firm with the requirement or goal that the large firm purchase  $x\%$  of the value of its intermediate inputs from SMEs. We will focus on two examples of subcontracting programmes, one in the United States and the other in South Africa. We will also discuss the restrictions on the use of offsets set forth in the WTO GPA.

The various subcontracting programmes used by governments are diverse and are usually designed around the concept of encouraging prime contractors to use SMEs as subcontractors.

##### **a) South Africa**

Subcontracting programmes are viewed as an effective means of involving SMEs in public procurement activities. Subcontractors account for more than 60% of the work in construction. The South African approach has been to integrate its subcontracting programme into its targeted procurement programme, which is examined in Unit 4.6. South Africa uses standardized "resource specifications" to identify socioeconomic objectives that contractors must meet in performing prime contracts. These resource specifications define "social deliverables". Contracts are awarded on the basis of the most advantageous tender, based on a balance of trade-offs between price, quality and social deliverables.

Resource specifications can be used to create subcontracting opportunities for targeted subcontractors. In South Africa, because of the terms and conditions under which it takes place, subcontracting has in the past not been attractive to emerging contractors or to those enterprises that have been historically disadvantaged. There are a number of reasons for this, the principle one being subcontract terms and conditions which are unfavourable to SMEs. South Africa has focused its efforts on mitigating these unfavourable conditions.

The resource specifications that cover the engagement of targeted enterprises as subcontractors require the tendering entity to enter into written contracts that do not contain any of the following provisions:

- A right of set-off in favour of the prime contractor.
- Rights given to the prime contractor or his agent with no recourse to independent adjudication in the event of a dispute arising.
- Payment procedures based on a pay-when-paid system.
- A dispute resolution procedure that does not include inexpensive alternative dispute resolution (ADR) procedures such as arbitration or mediation.

Unreasonable retention percentages and periods of retention.  
A requirement for a surety to be provided in contracts of value less than R 100,000.

Conditions that are more onerous than those that exist in the prime contract.

Prime contractors who use SMEs as subcontractors and who require any of the above-mentioned terms and conditions in the subcontracts will have credits towards their contractual goals denied on the grounds of non-compliance with resource specifications.

#### **b) United States**

The US has a long-standing and well-developed subcontracting assistance programme. It focuses on large businesses that are prime contractors to the Federal Government and that have one or more federal contracts over US\$ 500,000 (over US\$ 1,000,000 in construction of a public facility). These dollar amounts are the thresholds for a subcontracting plan required by Section 8(d) of the Small Business Act. All subcontracting plans must have separate and distinct goals for small business, small disadvantaged business, and women-owned small business. Beginning in FY 1999, all subcontracting plans must also contain a goal for "qualified HUBZone small business concerns." A HUBZone is a "historically underutilized business zone" that receives differential treatment under the HUBZone Act of 1997 in order to promote economic growth in the zone.

The Act requires federal contracts to contain provisions on specific payment procedures and deadlines and to provide for interest payments for late payment of invoices. In general, the Act requires invoice payments and contract financing payments (such as progress payments) within 30 days of receipt of an invoice that complies with legal and contract requirements. The period of time for payment is 14 days for progress payments under construction contracts ( 31 U.S.C. § 3901 et seq. (Nash and Schooner, 1992).

The subcontracting programme has two components. First, SBA's subcontracting specialists in the field, who are known as Commercial Market Representatives (CMRs), perform compliance reviews of prime contractors. Among other things, they examine the purchasing records of the large businesses to be sure that they are providing "maximum practicable opportunity" to small business in accordance with the law. Secondly, the CMRs counsel small businesses and refer them to specific prime contractors as may be appropriate. The CMRs also help the primes to identify small businesses with the products or services they need. In this way, SBA thus both monitors the performance of the primes and also attempts to match large businesses with small businesses.

The CMRs, however, have limited authority. Applicable statute and regulation give SBA the authority to perform compliance reviews, but the regulations provide a number of restrictions. The most important of these are: (a) SBA cannot require a prime contractor to use a particular small business; and (b) SBA cannot prescribe the amount of subcontracting (if, for example, the prime contractor prefers to use its own employees to do the work).

The SBA's view is that since the statute does not give SBA much of a stick, it will use the carrot approach. Since 1985, the SBA has developed incentives for large businesses and other major prime contractors, including universities, to improve their small-business programmes by providing formal recognition to those that excel. The SBA has two award programmes for this purpose: the *Award of Distinction*, which is awarded to deserving

companies throughout the year, and the *Dwight D. Eisenhower Award for Excellence*, its highest award, which is presented to no more than 4 companies at a special ceremony in Washington, D.C. during Small Business Week each May.

Although there may be some question as to the efficacy of such programmes, the SBA contends that they have been successful. Prime contractors such as the Boeing Company in Seattle have actually asked SBA to visit them and perform a compliance review so that they might be considered for an award. Awards to large business can serve the function of a signal to the market that the large business recipient is a "good corporate citizen". This has obvious marketing benefits for the large firm.

These programmes appear to have increased the level of SMEs utilization by large firms, although no proper statistical analysis has been performed. Subcontracts to small disadvantaged business, for example, remained at approximately 2% for several decades. Since the inception of the above awards programme in 1985, the percentage of subcontracts to small disadvantaged business has risen from 2.2% that year to 6.5% in FY 1996 (the most recent year for which SBA has statistics). In FY 1996, the figures are as follows:

Total subcontracts	US\$ 65.9 billion
Small business	27.0 billion (40.9%)
Small disadvantaged business	4.3 billion (6.5%)
Women-owned small business	2.4 billion (3.6%)

In FY 1997, SBA's commercial market representatives (CMRs) conducted approximately 1,800 compliance reviews of large business prime contractors. They also performed nearly 500 needs assessments to identify opportunities for small business. The CMRs also furnished large businesses with more than 4,600 small business sources (specific referrals) and counselled over 9,000 small firms, including 2,944 small disadvantaged firms and 2,166 women-owned small firms.

There are no econometrics or statistics using standard statistical techniques by which to assess the data. The numbers provided by governments tend to be input driven and therefore unrevealing. The need for adequate measurement of results is covered in Unit 5.

The SBA has initiated a number of new programmes in the subcontracting area. SBA is working with the US Office of Personnel Management (OPM) on a pilot programme that requires the six largest health providers in the Federal Employees Health Benefits Programme (FEHBP) to develop subcontracting plans with goals for the utilization of small business. The 6 providers in the pilot account for 75% of all federal employees. For the first 9 months of the initiative, the participating carriers subcontracted US\$ 357 million to small business.

In February 1998, SBA signed an agreement with General Motors, Ford, and Chrysler for a pilot programme to encourage subcontract awards to small disadvantaged firms, especially 8(a) firms. In May 1998, 140 8(a) firms attended a conference in Detroit for 8(a) firms that are

interested in doing business with the automakers. Representatives of the automakers discussed how best to conduct business with their companies.

The SBA Office of Government Contracting is also working with the US Office of Federal Procurement Policy (OFPP) to strengthen and clarify subcontracting regulations. At SBA's request, OFPP convened a working group to rewrite, simplify and consolidate all prior policy letters on subcontracting, some of which date back as far as 1980. There is currently a dispute between SBA and a number of large firms on procedures for determining the size of subcontractors of large firms. Large firms have found it difficult to comply with the SBA size standards. These size standards, explained in Unit 2, are the same standards that SBA applies in determining the size of firms that submit offers for prime contracts.

SBA has made the *Small Business Subcontracting Directory* accessible to the public on the Internet via SBA's Internet Web page, [www.sba.gov](http://www.sba.gov). In addition, it is developing a *Subcontracting Opportunities Bulletin Board*, which should be operational in the summer of 1999. The bulletin board will allow large businesses to list "sources sought" announcements for future contracts and requests for proposals for current procurements. The bulletin board will be accessible through the SBA Web page on the Internet.

Whether or not subcontracting provides effective assistance to SMEs may depend more on market structure than on the design of the programme by the Government. For example, there is a high degree of vertical integration and limited specialization among larger enterprises in Latin America and, hence, an underdeveloped subcontracting system (Berry, 1997). In Latin America, firms that could experiment with subcontracting appear to be resorting to imports rather than domestically subcontracting inputs. Though government intervention is often cited as an important catalyst in encouraging subcontracting by large firms with SMEs in East Asia, it does not appear that procurement was ever used as a policy instrument. East Asian nations were successful in improving technical capability and quality among SMEs, but to the degree it involved subcontracting, it was initiated by the large firms themselves rather than by the Government. There is, however, an experimental programme in Brazil, discussed in Section 4.1.C above, in which the state's SME organization, SEBRAE, has initiated a programme to upgrade the capabilities of small suppliers to meet the demands of large producers. It includes training for both contractor and suppliers on the technical and the behavioural changes necessary to create successful linkages.

The GPA currently permits "offsets" on a restricted basis. The GPA defines offsets as "measures used to encourage local development or improve the balance-of-payments accounts by means of domestic content, licensing of technology, investment requirements, counter-trade or similar requirements." GPA Article XVI, footnote 7. GPA Article XVI provides as follows:

1. Entities shall not, in the qualification and selection of suppliers, products or services, or in the evaluation of tenders and award of contracts, impose, seek or consider offsets.
2. Nevertheless, having regard to general policy considerations, including those relating to development, a developing country may at the time of accession negotiate

conditions for the use of offsets, such as requirements for the incorporation of domestic content. Such requirements shall be used only for qualification to participate in the procurement process and not as criteria for awarding contracts. Conditions shall be objective, clearly defined and non-discriminatory. They shall be set forth in the country's Appendix I and may include precise limitations on the imposition of offsets in any contract subject to this Agreement. The existence of such conditions shall be notified to the Committee and included in the notice of intended procurement and other documentation.

Under Article XVI, developing countries may negotiate offsets as part of their GPA accession package, but offsets "shall be used only for qualification to participate in the procurement process and not as criteria for awarding contracts".<sup>8</sup>

### **Advantages and disadvantages of subcontracting programmes**

Subcontracting programmes are likely to be effective if the purpose of sustaining the size of the demand that falls on SMEs and therefore to sustain the size of the market accessible to them. The overall effect of a subcontracting policy is similar to the one of the set-aside policy, discussed in section 4.7 below. There is, however, an advantage to subcontracting in that it de-links the government from political interplay with SMEs, although there may be political interaction at the level of programme formulation. The result is a likely gain in efficiency. Large firms are probably more efficient at selecting suppliers (among the SMEs) than the Government because of the political interplay, but, also because of better knowledge of the market that large firms have than to the Government.

Any government regulation of the contractual relationship between large firm and SME should be done carefully and judiciously. Regulation that increases the costs of prime contractors may deter them from hiring SMEs as subcontractors and may actually have an effect that is contrary to the intentions of the policy. SME opportunities may decrease rather than increase as a result of the government programme.

GPA Article XVI may deter developing countries from entering into the GPA. Relaxation of these requirements in any successor agreement covering procurement, however, may institutionalize the kinds of inefficiencies that Article XVI and other GPA articles are designed to prevent or restrict.

Notwithstanding their economic inefficiency, an argument can be made for offsets and domestic content requirements as a second-best trade policy. Since domestic content requirements are the least inefficient discriminatory trade policy, it may be preferable to have countries join the GPA and permit adoption of domestic content requirements rather than *not* have them join the GPA. Outside of the GPA, countries have used price preferences and other discriminatory policies extensively. These other policies are often more harmful and protectionist than the domestic content requirement. As a GPA contracting party, a country must renounce price preferences and set-asides, although they may adopt domestic content requirements that meet the GPA requirements. Since domestic content requirements are less harmful than price preferences, it may be preferable to have countries in the GPA that adopt domestic content requirements rather than have countries outside the GPA that adopt price preferences and other relatively more inefficient policies.

This discussion of normative economics of trade liberalization only concerns the *explicit* product market. It does not account for institutional waste and inefficiency in implicit political markets for protection. It also does not deal with the power of strong WTO contracting parties who negotiate reciprocal deals that allow them to keep price preferences and set-asides while still joining the GPA.

#### **4.5 Price preferences**

Governments have traditionally used margins of preference to assist SMEs. With margins of preference, a government allows a price preference margin of  $y\%$  in favour of SMEs. In a nutshell, preferences work as follows. Suppose that a large firm offers a price of 100 and an SME offers a price larger than 100 but smaller than  $100(1+y\%)$  for the same item. The government will purchase the item from the SME, in spite of the fact that the price is higher, if it has established  $y\%$  as a margin of preference in the procurement. For purposes of transparency, this margin of preference will be clearly identified in the invitation for tenders and the criteria for its application, as set forth in the invitation, will be followed by the procuring entity.

##### **a) Latin America**

Most Latin American countries grant a passive preference for national suppliers. If all other things are equal between two bids, the contract is given to national supplier or the supplier that incorporates the greatest portion of national supplies, or manpower. In Brazil, locally manufactured telecommunications and informatics products receive preferential treatment in government procurement and foreign firms may only bid to provide technical services if there are no qualified Brazilian firms. In Paraguay, government agencies must give a preference of 15% to Paraguayan bidders for construction of public works or the supply of services to the public sector.

##### **b) United States**

The United States maintains various preference programmes, the most notable of which are reflected in the Buy American Act, 41 U.S.C. §§ 10a-10d (1996). The Buy American Act was enacted in 1933. For goods, the Act requires that procuring entities apply a duty or premium on bids and proposals that offer foreign goods. The margin is 6% generally and 12% if the domestic firm is small. The Department of Defense sets its margins at 50%. The Act applies only to procurements that are not on the GPA schedule of the United States. The definition of "domestic" for purposes of determining the origin of goods includes the countries of the North Atlantic Treaty Organization (NATO) and other countries. The Buy American Act does not apply specifically to assist SMEs; but to all domestic concerns as defined by the Act and its implementing regulations.

The United States, as well as other countries, applies a rule of origin test to determine if a product is domestically produced. This test is similar to tests used to determine origin of products for customs purposes. In general, a product is produced domestically if at least 50%

of its value was produced in the country in question, or if it was substantially transformed in the production process of the country in question.

### **c) Hungary**

Procuring entities are required to provide national treatment to foreign bidders if national treatment is required by international agreement. However, if the price difference in the case of a local bidder is not more than (10%) and at least 50% of the value of the procurement produced locally, then this bid shall be treated as equal. This provision is criticized internationally, and it is unclear whether procuring entities are adhering to the preference scheme, given their low budgets.

When the bids are equal according to the announced selection criteria that bid should be preferred using the following order: (a) which contains product that gained the "environment friendly product" label; (b) in which case the bidder possess a quality-assurance system credited by any nationally accredited issuer.

### **d) India**

Cottage and small-scale units are entitled to a price preference of up to 15% on merit when competing with a large-scale unit. This price preference is permitted even when they compete with a state-owned enterprise, called public sector undertaking (PSU). Price preferences have been considered necessary because there are cases where the SSI units cannot stand on their own in competition with the large-scale sector and need protection.

Preferences may be somewhat different in India from other countries in that procurement officials have a significant degree of discretion as to when to use them. They are provided on a tender-by-tender basis. The procurement official has discretion to award a preference when he or she believes a preference would be necessary to assist the SMEs participating in a specific procurement. The procurement official bases his/her decision on records of past performance, whether SME bidders have the ability to perform the contract, whether they were competitive without preferences in prior procurements and other factors. The discretion of the procurement official is based on a qualitative analysis of whether SME bidders actually require assistance. It is not the intention of the policy that SMEs should have a claim to higher rates in public purchasing or that the purchaser should pay premiums regardless of the needs of the SMEs participating in the procurement in question. The purchaser may, where considered necessary, require the submission of a detailed breakdown of cost of production if there are reasons to believe that an SME is quoting a higher price only to obtain the price preference.

## Advantages and disadvantages of price preferences

Preferences are controversial, particularly from an international trade perspective. From an economic standpoint, the consequences of price preferences depend on market structure. The effect may be inconsequential if the SMEs operate in a sector characterized by constant returns to scale and perfect competition. Perfect competition requires a very large number of suppliers and many other conditions that rarely, if ever, exist. In a perfectly competitive market, none of the very many SMEs can charge a price higher than the price set by the market. They all sell exactly the same item and are price takers. Conversely, if product differentiation is feasible, then each supplier will differentiate its product from products offered by other suppliers. This differentiation will give each supplier some monopoly power over its product. Consequently, monopolistic competition arises as the market structure.

The likely effect of a price preference in such imperfectly competitive markets is perverse. Firms can discriminate on the basis of price between the two markets in which they sell - the government procurement market and the private market. They will charge the government a higher price than they charge to the private sector. Because of product differentiation, each producer can increase its price slightly without being outbid by its competitors. Moreover, price may not be the only factor that is evaluated in a procurement, and hence the market could be one characterized by monopolistic competition. Most, if not all, markets fail to meet the stringent requirements of perfect competition. Perfect competition is essentially an economic abstraction that does not exist in reality but that can be used as a benchmark to evaluate market structure when the conditions for perfect competition do not exist.

A preference policy is likely to reward inefficient firms, albeit indirectly. Inefficient firms are more likely to survive when the government segments the market with a price preference margin than when it segments the market with subcontracting programme or a set-aside programme. This indirect support to inefficient firms is likely to occur in both perfectly competitive and monopolistic competitive market structures, but it is more likely in the latter. The economic logic as to why price preferences support inefficient firms is straightforward. Inefficient firms can take advantage of the preference on price, which works like a premium on market prices. The preference allows firms that otherwise may not be in the market to stay in the market. Firms that may experience lower profits may make higher profits because of the preference. Firms that may experience a loss may either make a profit or reduce their losses as a result of the preference. If the price preference is very small, however, these effects may also be small. It depends on market structure and competitiveness.

The above discussion concerns the explicit market. There also may arise an implicit market for SME programmes themselves, which may result in inefficiency and a loss of savings to the government.

Preference schemes that give procuring officials discretion to provide them may be problematic in its lack of transparency and in providing SMEs with poor incentives to compete in public procurement. One potential disadvantage with this approach is that it may result in a moral hazard. An SME may have an incentive to make highly priced offers and to actively seek government assistance on the basis of its disadvantageous position as an SME. All preference programmes provide a similar poor incentive; programmes with discretion may simply illustrate the problem in a more pronounced way.

## 4.6 Targeted procurement

South Africa has developed a unique programme called targeted procurement, which may be characterized as an "indirect" or "percentage" preference, in that preferences are provided on the basis of how much SME participation is offered by a large firm. The preference goes hand in hand with the SME content requirement. That is, a firm is allowed a price preference margin that is larger the larger the value of intermediate inputs purchased from SMEs. Hungary also permits some limited use of targeted techniques.

### a) South Africa

Targeted procurement, or as it is sometimes referred to, affirmative procurement, is a form of procurement that has recently been developed in South Africa to provide employment and business opportunities for what have been determined to be marginalized individuals and communities. Through a variety of techniques, it provides opportunities for participation by targeted enterprises, even to those who may not have all the necessary resources, capacity or expertise to perform contracts in their own right. This is accomplished in a manner that does not guarantee contracts to such enterprises.

On small contracts having a value below a predetermined financial threshold, direct preferences are accorded to targeted enterprises to tip the scales in their favour. On contracts above a financial threshold, tenderers are required to compete on the basis of both the product and the process. Technical specifications are used to define the product and to set out the acceptance criteria relating to it. Standardized resource specifications are used to define social objectives and the acceptance criteria relating to "social deliverables." These specifications define the social deliverables that are to be realized through the process of delivery, and set out the manner in which they can be achieved, measured and monitored.

Contracts are usually awarded to the most advantageous offer, based on a balance between the tendered price and the tendered deliverables in respect of targeted groups. Targeted enterprises, depending upon the strategy that is adopted, may participate in contracts as prime contractors, joint venture partners, subcontractors, service providers, manufacturers or suppliers.

The South African Government has worked towards designing targeted procurement to be transparent and subject to auditing, and quantification and measurement of results. To obtain these features, the Government has adhered to long-standing procurement disciplines in structuring the programme, such as published specifications, evaluation criteria set forth in tender documentation and scoring in accordance with evaluation criteria set forth in the tender documentation.

**Table 11**            **Targeted procurement in South Africa: the attainment of socioeconomic deliverables**

Socioeconomic deliverables are achieved through a combination of :

- Classification of contracts which enables them to be packaged (unbundled) in a manner that facilitates the engagement of a range of targeted groups; or structured in a manner which permits targeted groups to participate.
- The use of resource specifications, i.e., performance specifications which define the socio-economic deliverables, set out the method by which deliverables can be attained, audited and verified and the means by which progress towards the attainment of the deliverables can be quantified at discrete intervals.
- The use of development objective / price mechanisms, e.g., a point scoring system in terms of which tenderers are awarded, in the first instance, points for their financial offers, and in the second instance, points for their offers to exceed specified, minimum socio-economic objectives, or, in the case of very low value contracts, for their current enterprise statuses.

### *Target groups*

SMEs can be targeted on a generic or area bound (localized) basis. Generic targeting in turn, can target either all SMEs within a country, or block of countries, or SMEs within demarcated political boundaries which are owned and controlled by marginalized individuals. SMEs owned and controlled by what the South African Government has defined to be marginalized individuals are called Affirmable Business Enterprises (ABE). Marginalized individuals can be defined on the basis of race, gender, ethnicity, disability and other criteria. Marginalized individuals can be targeted for employment on works and services contracts on the basis of gender, race, ethnicity, locality, age, disability, period of unemployment and other criteria.

In order to ensure that the target groups are unambiguously defined, the words and expressions in table 12 have been given the following meaning:

**Table 12 Affirmable Business Enterprises (ABEs) in South Africa**

<b>ABE</b>	<p>A business which adheres to statutory labour practices, is a legal entity registered with the Department of Inland Revenue and an independent and continuing enterprise for profit, providing a Commercially Useful Function and:</p> <p>(a) which is at least two thirds Owned by one or more Previously Disadvantaged individuals or in the case of a company, at least two thirds of the shares are owned by one or more Previously Disadvantaged Individual and;</p> <p>(b) whose management and daily business operations are in the control of one or more of the Previously Disadvantaged individuals who effectively own it; provided, however, that the annual average turnover excluding Value Added Tax (VAT) of the business during the lesser of the period for which the business has been operating and the previous three financial years does not the exceed prescribed annual turnover limits.</p>
<b>Control</b>	<p>The possession and exercise of legal authority and power to manage the assets, goodwill and daily operations of a business and the active and continuous exercise of appropriate managerial authority and power in determining the policies and directing the operations of the business.</p>
<b>Commercially Useful Function</b>	<p>The performance or real and actual work, or the provision of services, in the discharge of any contractual obligation, which shall include but not be limited to the performance of a distinct element of work which the business has the skill and expertise to undertake, and the responsibility for management and supervision of such work.</p>
<b>Executive Director</b>	<p>A full-time partner in a partnership, a director of a company established in terms of the Companies Act, 1973 (Act 61 of 1973) or a member of a close corporation registered in terms of the Close Corporation Act, who, jointly and severally with his/her other partners, co-directors or co-members, as the case may be, bears the risk of business and takes responsibility for the management and liabilities of the partnership, company or close corporation on a day to day basis.</p>
<b>NOTE:</b>	<p>Non-executive directors of public companies are specifically excluded. A sole proprietor may be regarded as being an Executive Director.</p>
<b>Owned</b>	<p>Having all the customary incidents of ownership, including the right of disposition, and sharing all the risks and profits commensurate with the degree of ownership interest's as demonstrated by an examination of the substance, rather than the form of ownership arrangements.</p>
<b>Previously Disadvantaged Individuals (PDI)</b>	<p>Individuals who, being South African citizens, are socially and economically disadvantaged by the legacy of the South African political dispensation prior to April 28, 1994. For the purpose of the Contract, the refutable presumption shall be made that individuals who</p>

	fall into population groups that had no franchise in national elections prior to the introduction of the 1984 constitution and the tricameral parliamentary system, are Previously Disadvantaged Individuals. It is incumbent on individuals to demonstrate their claims to fall into such population groups on the basis of identification and association with and recognition by the members of such group.
<b>Woman</b>	A female person who is a South African citizen and a female at birth.
<b>Women Equity Ownership (WEO)</b>	The collective ownership percentage of Executive Directors within an enterprise who are Women.

*Mechanics*

The South African Government has published six resource specifications that procuring entities are required to use in targeted procurement (table 13). Each specification has a measurable component that enables procuring entities to quantify and to monitor the amount of participation by the target group during contract performance. In each case, the value of the contribution is computed, in terms of a prescribed formula, as a monetary value (goal credits) and is expressed as a percentage of the total value of the goods and services provided, or works performed, in terms of the contract.

The goals associated with each specification are designed to be audited and verified during the performance of a contract. This permits reporting by public bodies on key indicators.

**Table 13 Targeted procurement in South Africa: Standard Resource Specifications**

<p>The following standardized resource specifications have been developed :</p> <p>TP1 (APP1) : Targeting of Affirmable Business Enterprises</p> <p>TP2 (APP2) : Structured Joint Ventures (Affirmable Partners)</p> <p>TP3 (APP3) : Structured Joint Venture (Targeted Partners)</p> <p>TP4 (APP4) : Targeting of Local Resources</p> <p>TP5 (APP5) : Engagement of Targeted Labour</p> <p>TP6 (APP6) : Targeting of Affirmable Professional Service Providers</p>
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Let us look at how South Africa uses resource specifications and targeted procurement in what it has determined to be "major contracts," or those contracts expected to exceed R 2 million (US\$ 350,000).

For such contracts, tenders are adjudicated on the basis of resource specifications that provide for the following:

Price	90 points
Tendered	—
participation goal	<u>10 points (variable)</u>
TOTAL	100 points

For example, the TP1 (APP1) specification is used to target ABEs. It facilitates the engagement of SMEs that are owned and controlled by previously disadvantaged persons (ABEs) in procurement activities alongside established contractors. The specification permits the setting of goals for ABE participation in contracts that can be met by contractors who are include for ABE participation in one or more of the prescribed ways in the performance of their contracts.

The APP1 Specification, in a practical and pragmatic manner, requires the contractor to "unpack" his contract into smaller contracts, to procure the services of targeted SMEs to perform such contracts and to administer such contracts. Accordingly, the APP1 specifications may be regarded as being an instrument for breakout procurement as it facilitates an increase in SME participation by targeted businesses in public-sector procurement activities.

The APP1 Specification is recommended for use on major contracts provided that:

- ◆ The nature of the goods and services that are required are such that there is a likelihood that a number of ABEs would be available to participate in the relevant activities.
- ◆ The contract duration is sufficiently long to permit monitoring and contract compliance procedures to be established and implemented. Generally, the minimum contract participation goal should be set between 0 and 10%. Maximum points should be awarded for the attainment of Contract Participation Goal of 40% or more.

**Table 14 Awarding of tenders in South Africa in terms of the TP1 (APP1) specifications**

Points awarded in respect of the financial offer are calculated as follows :		
	$N_p$	$= \frac{Z (1 - (\frac{P - P_m}{P_m}))}{P_m}$
Where	$N_p$	= the number of tender adjudication points awarded on the basis of price
	$P_m$	= the price of the lowest responsive tender adjusted to a common base / on a comparative basis, as relevant.
	$P$	= the price of the responsive tender under consideration adjusted to a common base / on a comparative basis, as relevant.
	$Z$	= a number, usually 90, reflecting the importance of price.
Points in respect of attaining socioeconomic objectives are calculated as follows :		
	$N_c$	$= \frac{X (D - D_s)}{Y - D_s}$
	Where $N_c$	= number of tender adjudication points awarded
	$D$	= the tendered Contract Participation Goal percentage in the tender under consideration.
	$D_s$	= the specified minimum contract participation goal percentage, usually 5 - 10%.
	$X$	= maximum number of adjudication points assigned for the socio-economic aspect of the tender (usually 10 points).
	$Y$	= Contract Participation Goal percentage above which no further tender adjudication points are awarded, usually 40%.
<b>NOTE :</b>	In design and build works contracts the 90/10 formulation can be changed to permit technical criteria to be scored.	

### *Public works initiatives*

The National Department of Public Works in South Africa (box 2) has embarked upon an initiative entitled "The Delivery of Targeted Procurement", which is aimed primarily at promoting ABEs in public procurement.

Direct preferences are accorded to ABEs in respect of low-value contracts. In contracts that generally have a value in excess of R 2 million, participation goals are set. Tenders are awarded in terms of a development objective/price mechanism, in terms of which 90 points are awarded for price and 10 points are awarded for the degree to which tenderers exceed minimum socioeconomic goals.

ABE participation in these contracts can take place in one or more of the following ways :

- Subcontracting parts of the contracts to ABEs;
- Subcontracting parts of the contracts to joint ventures with ABE partners;
- Obtaining supplies and materials from ABE suppliers;
- Obtaining manufactured articles from ABE manufacturers;
- Engaging ABE professional, technical or managerial service providers;
- Entering into joint venture arrangements with one or more ABEs.

Box 2. Case study : The experience of the National Department of Public Works

In August 1996, the State Tender Board approved that the National Department of Public Works could pilot the implementation of the Affirmative Procurement Policy (APP) on all its construction projects. For the period August 1996 to October 1997, 3,423 building and civil contracts totalling R 914.5 million were awarded, utilizing the APP specifications, a breakdown of which is tabulated below. (Quotations refer to low value contracts which were concluded without following the formal tendering procedures which are applicable to contracts having a monetary value above a certain threshold). Affirmable Businesses Enterprises (ABEs) (Black-owned SMMEs) were targeted. ABEs were defined in terms of racial ownership and control and average annual turnover within prescribed limits. Businesses which qualify for ABE status have to have at least two thirds ownership by Previously Disadvantaged Individuals.

An independent review of the department's records concerning the award of these 3,423 contracts was undertaken. A random sample of 898 records were electronically captured and analysed. Although this sample in number covered only 26% of the total departmental record, it represented 79% of the monetary value of the record and captured just over two thirds of the contracts which fell outside the quotation category and 80% of the contracts having a contract value in excess of R 2 million. The statistics generated by this review are tabulated below.

Various construction companies were approached in order to establish how much work was outsourced to ABEs (ABE participation) prior to the introduction of the. The general consensus was that ABE participation levels in the building industry prior to the introduction of the APP was around 3%. This being the case, the introduction of the APP on contracts having a value in excess of R 2 million has resulted in a 10-fold increase in ABE participation on departmental contracts at a cost premium of less than 0.7%. (Commentators at the time when the APP was launched had

predicted a cost premium of between 10 and 15%).\*\*

\*\* Note: The exchange rate for the South African rand to the US dollar, as of 13 February 1999, is US\$ 1 to R 6.10. This rate does not reflect the rate for the period August 1996 to October 1997.

Statistics pertaining to all tenders awarded (August 1996 to October 1997)

Contract value (rands)	Contracts awarded (No.)	Tender value	
		(Rand x 1 M)	(%)
0 - 45,000**	2,729	25.9	2.8
45,000 - 100,000	256	18.7	2.0
100,000 - 0.5 M	308	59.4	6.5
0.5 M - 2.0 M	75	73.4	8.0
> 2.0 M	55	737.1	80.7
TOTAL	3,423	914.5	100

ABE participation (August 1996 to October 1997)

Contract value (rands)	Cost premium (%)	Contracts awarded to ABEs (%)	Total tender value awarded to ABEs (%)
0 - 45,000	0.2	34	20
45,000 - 100,000	0.9	8	8
100,000 - 0.5 M	1.5	12	11
0.5 M - 2.0 M	1.3	12	11

> 2.0 M	0.7	-	30
TOTAL	0.8	-	28

A National Working Group comprising representatives of national departments, provincial public works departments and selected local authorities has been constituted to facilitate the flow of information and to provide inputs and direction in the process of delivery. A website ([www.pwdprocure.co.za](http://www.pwdprocure.co.za)) has been established to disseminate information and to serve as a library. Furthermore, a Geographical Targeted Procurement Management System (GTPMS) is being developed to monitor all aspects of targeted procurement on a geographic basis.

The Department of Public Works has developed another initiative, within the broader Delivery of Targeted Procurement initiative, called the Strategic Projects Initiative, which is aimed at the development and promotion of the sustainable growth of the construction capacity of Blacks at the prime contractor level.

The Department believes that appropriate mentoring on financial gearing, project resourcing and risk management is critical to the ongoing success of a new construction enterprise, and that a carefully structured mentoring programme will contribute significantly to addressing these issues. The Department intends to mobilize initial seed funding for this exercise. In the medium term, it is envisaged that this will be funded by appropriate business associations and the current beneficiaries of this programme. Several options are being explored to provide easier access to finance, plant and materials, with the Department facilitating interactions between local and overseas interested parties.

## **b) Hungary**

The assessment of tenders may be based on one of the two alternative approaches:

- ◆ Lowest cost principle; or
- ◆ Highest value principle.

The criteria applied are required to be included in the tender announcement. If the bids are assessed using the highest value principle, then the order of importance for the decision criteria should also be published in the announcement.

It is possible to set criteria in a way that supports the following economic or social policy objectives:

- ◆ Employment development including job creation;
- ◆ Development of undeveloped regions;
- ◆ Environment protection;
- ◆ Increasing the potential of SMEs to participate in public procurement.

Hungarian procuring entities appear to have the authority to take into account SME participation in a procurement. There are, however, no specific measures included in the public procurement or other acts or government decrees that would support the meeting of this socioeconomic objective. The law provides the opportunity, but in reality it is difficult to see any positive sign of preferences given to SMEs. In practice, the larger enterprises are favoured.

## **Advantages and disadvantages of targeted procurement**

Targeted procurement is essentially a variant of a price preference policy. Rather than a price preference based on SME status, a bidder, regardless of size or status, obtains a price preference margin that varies with the value of intermediate inputs from SMEs. Targeted procurement thus shares the advantages and disadvantages of a price preference.

### **4.7 Set-asides**

#### **a) United States**

Set-asides, which reserve a certain percentage of government procurement contracts or total spending for a limited pool of applicants, are one tool that could be used to increase SME participation in government contracts. We will look at two approaches to set-aside programmes, one in the United States and the other in India.

The Federal Government has an established programme of setting aside procurements for competition exclusively among small business concerns. As explained in the US Federal Acquisition Regulation (FAR), "[t]he purpose of small business set-asides is to award certain acquisitions exclusively to small business concerns. A "set-aside for small business" is the reserving of an acquisition exclusively for participation by small business concerns. FAR 19.501(a).

US Federal procuring entities are required to adhere to the "rule of two" when deciding whether to set aside a procurement. The rule of two is set forth in two parts, one for procurements exceeding the threshold of US\$ 2,500 but not exceeding US\$ 100,000, and the other part for procurements exceeding the threshold of US\$ 100,000.

FAR 19.502-2 for lower threshold procurement provides as follows:

- (a) Each acquisition of supplies or services that has an anticipated dollar value exceeding \$2,500, but not over \$100,000, is automatically reserved exclusively for small business concerns and shall be set aside unless the contracting officer determines there is not a reasonable expectation of obtaining offers from two or more responsible small business concerns that are competitive in terms of market prices, quality, and delivery. If the contracting officer does not proceed with the small business set-aside and purchases on an unrestricted basis, the contracting officer

shall include in the contract file the reason for this unrestricted purchase. If the contracting officer receives only one acceptable offer from a responsible small business concern in response to a set-aside, the contracting officer should make an award to that firm. If the contracting officer receives no acceptable offers from responsible small business concerns, the set-aside shall be withdrawn and the requirement, if still valid, shall be resolicited on an unrestricted basis (emphasis added).

FAR 19.502-2 for higher threshold procurements is a bit more restrictive and provides as follows:

(b) The contracting officer shall set aside any acquisition over \$100,000 for small business participation when there is a reasonable expectation that (1) offers will be obtained from at least two responsible small business concerns offering the products of different small business concerns ; and (2) award will be made at fair market prices. Total small business set-asides shall not be made unless such a reasonable expectation exists (emphasis added).

Set-asides may be either total or partial. A total set-aside is one in which all quantities sought in the procurement are reserved for exclusive small business competition. A partial set aside is one in which a portion of the quantities sought in the procurement are reserved for exclusive small business competition. FAR 19.502-3.

Regulatory procedures exist for SBA involvement in advocating set asides to procuring entities and for monitoring procuring entities. Representatives of the SBA procurement centre play an advocacy role that is reflected in the FAR and in SBA regulations for recommending set-asides and for appealing unfavourable decisions made by procuring entities.

Currently set-aside programmes are intended solely for small business concerns regardless of the minority participation in their management or their disadvantaged status. Set-asides should be distinguished from the 8(a) programme, discussed above.<sup>9</sup> In functional or economic terms, the 8(a) programme is similar to the set aside programme. The economic effects of both of the programmes are similar; it is just that the beneficiaries of the programmes are different. The programmes are different from legal or bureaucratic perspective and not from an economic perspective.

The US Government for a time implemented a programme substantially similar to the set-aside programme, which was known as the small disadvantaged business (SDB) set-aside programme. In this programme, firms that were both small and owned and controlled by minority individuals could compete in procurements reserved for them. These small disadvantaged businesses could have been 8(a) firms, but they were not required to be so designated and vetted by the SBA. The small disadvantaged business set aside programme, like the above set-aside programme for small businesses generally, required bidders to self-certify their eligibility in their bids, and this eligibility would not be questioned unless the procuring entity or SBA had reason to question it, or if a competing bidder filed a protest challenging the eligibility of the bidder, pursuant to law and regulation that provided rules and procedures such protests (see Unit 2 above for a discussion of eligibility). The SDB set-aside programme was suspended by the Federal Government as a result of a recent United States

Supreme Court case calling into question programmes designed to assist disadvantaged groups when those programmes are not designed specifically to remedy actual past discrimination.<sup>10</sup>

## **b) India**

When it announced its public buying policy in 1952, the Government of India reserved certain items for procurement from the Khadi and Village Industries Commission (KVIC), and other items were reserved for procurement from the small-scale sector. The items selected were such that the needs of public buying programme for these items were fully met from these two sectors. In case of other items, the public buying policy recommended a price preference for the cottage and the small-scale industries sector. The price preference however, was dependent on circumstances and merit of each case and was not to be given automatically. section 4.5 above discusses these price preferences.

These programmes have continued to remain at the core of Indian public procurement policy for four and half decades, though the policy acquired more features over the course of time. In subsequent reviews of the policy, the list of reserved items has been revised and the price preferences have also been defined and quantified. An important modification was made in the review conducted in 1989, when Women Development Organizations were brought at par with KVIC. A Women Development Organization is defined as an organized group of women artisans and workers, engaged in the production of goods falling under the ambit of cottage industry. The Government, through this modification, supported the products of such groups under the overall policy of assisting women workers, especially because they are located in geographic areas that the Indian Government has determined to be economically deprived.

The Indian Government established a standing review committee at the highest level in the Government for periodically reviewing the list of items reserved for exclusive procurement from the small-scale sector. This committee was made responsible for suitable additions of new items and the deletion of old items from the list. As of the latest review, 356 items are reserved for exclusive procurement from the small-scale sector.

For the cottage-industry sector, set-asides are exclusive. The KVIC is the sole agency to whom bid invitations are sent and KVIC may nominate one or more of its units to supply the item. In the case of the small-scale industry sector, the reserved items are purchased through competitive bidding. The eligibility criterion for the competing units is their registration as a SSI unit by the nominated authorities. For the cottage-industry sector, the KVIC is not required to disclose the criteria of its selection to the purchaser. In case of SSI units, however, the norms of competitive bidding apply and transparency in procurement is required.

### **Advantages and disadvantages of set-asides**

Let's take a brief look at the advantages and disadvantages of set-aside programmes. In this analysis, we will focus on the United States 8(a) programme, which is essentially a "set-aside" programme for small businesses owned and controlled by minority individuals in the United States. Two points should be remembered when reading the analysis. First, it is highly

controversial, and secondly, its method of analysis can be applied to *any* set-aside programme, not only to the United States 8(a) programme.

The attraction of the set-aside option is that it produces the quickest, most visible gains and could provide entry for SMEs into procurement. On the other hand, it risks compromising quality, price, and delivery targets because the suppliers may be less efficient than larger companies. Some commentators have concluded that there is no evidence that set-asides produce efficiency gains and at best ambivalent evidence that they promote equity or fairness in the United States. The inherent danger in creating programmes mandating a level of involvement is that political pressures make them almost impossible to monitor effectively or to discontinue once they have either proven successful or unsuccessful. The economic danger is that they foster rent seeking as opposed to efficiency-maximizing behavior.

In the United States, set-asides for SMEs have been in existence for over three decades. With respect to the 8(a) and other programmes which are focused on participation by small firms owned and controlled by minority individuals, they arose from a perceived need to correct the non-economic problems preventing minority participation in public procurement caused primarily by discrimination. The 8(a) programme, for example, is designed, at least in part, to increase the proportion of federal procurement going to minority firms and to give these firms work experience. This is a prerequisite that most lack because of past and current discrimination. Given the opportunity, these firms will gain the experience necessary to compete on an equal basis with firms that have not suffered from discrimination.

Minority participation in central government procurement has increased under the set-aside programmes. This fact corresponds with findings in other studies of an apparent relationship between affirmative action programmes and increased levels of minority participation in local government procurement (Enchautegui, et al., 1997). Further, it appears from anecdotal evidence that the United States set-aside programmes have been responsible for much of the increase in central government procurement, though there is research suggesting that gains for minority and socially disadvantaged SMEs may have come at the expense of non-minority SMEs. Thus, the programme is widely recognized, even by its critics, for achieving part of its policy objective. Therefore, in a *political* analysis, the set-aside programme may be judged successful. Whether it promoted equity is another matter, and one which is to be determined by governments.

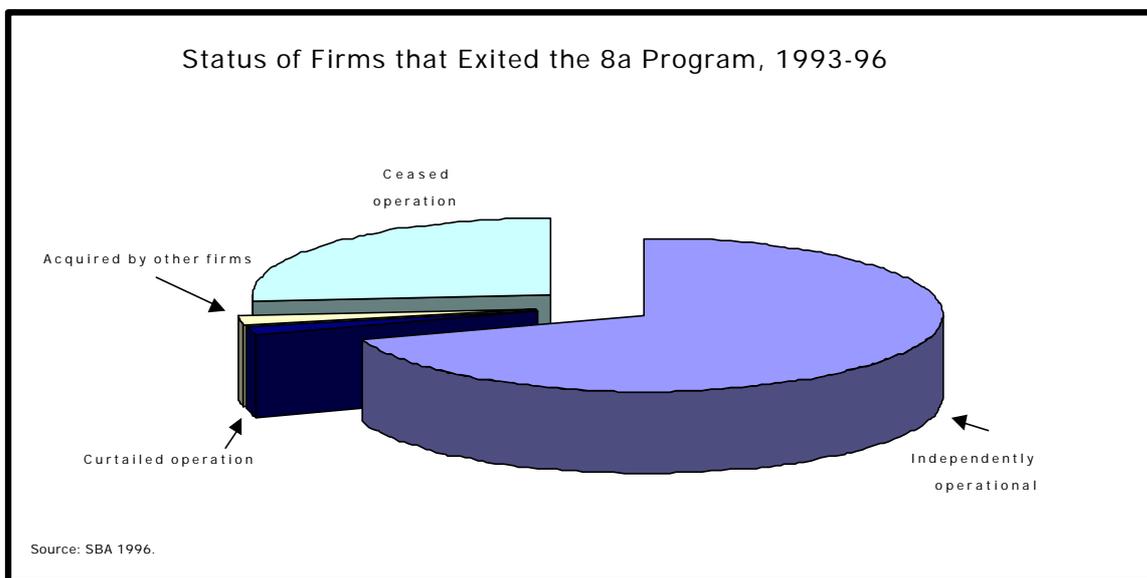
One indication of the relative level of success may be gathered by examining firms that "graduated" from the 8(a) programme. Firms must leave the programme after either 9 years or reaching a certain size or volume of business depending upon the firm's standard industrial classification. In its most recent audit of the 8(a) programme, the SBA surveyed a sample of firms that graduated from the 8(a) programme between 1993 and 1996. The results are shown in figure 4, which indicates that about one third of those leaving the programme went out of business, substantially curbed their operations or were acquired by other companies.

#### **Figure 4**

No further quantitative data is available from the SBA upon which to judge the relation between the 8(a) programme and the status of firms leaving the programme. Thus, it is impossible to know if those firms now "independently operational" owe this status to having participated in the programme. Though SBA figures indicate that in 1996 total revenue for firms that reported revenue exceeded US\$ 4.4 billion and total 8(a) government contract revenue was approximately US\$ 1.6 billion, or 37.6% of the firms' total revenue. The large number of firms still operational is at least an indication that most firms were not simply created to take part in the programme and then dissolved once their eligibility expired. On the other hand, the SBA audit revealed that income from 8(a) contracts accounted for over one-third of participating firm's profits (United States Small Business Administration, 1996).

Defenders of the programme also claim economic benefits accrue from set-asides. According to the SBA:

The most direct measure of benefits to the economy and to the Federal Government is through the market value of goods and services produced and the number and



quality of jobs provided. The ... areas in which 8(a) certified businesses are contributing to the gross domestic product, the Nation's tax base, employment, and the individual wealth and well-being of all Americans (United States Small Business Administration, 1996).

Some contend that this claim should be treated with some skepticism. Critics argue that many of the reported benefits would also have accrued without the 8(a) programme. Non-minority firms would have paid taxes, hired employees and contributed to GDP. They would have done so without the cost of administering the 8(a) programme - over US\$ 21 million for 1996.<sup>11</sup> Thus, the programme may not have produced significant efficiency gains for the United States Government. An alternative analysis to SBA's is that for US\$ 21 million in government expenditure in 1996, the Government steered roughly US\$ 5 billion in 27,000 contracts to 6,500 firms.

There is always the danger that set-aside programmes will become too political and too unwieldy as a rational policy instrument. Some assert that the United States programmes are designed to meet political ends and have become highly politicized. The debate surrounding

the programmes, including how to reform them, seems to focus on political, not economic, issues.

Another problem is that set-aside programmes will be captured by interest groups. Set-asides amount to legally created monopolies. Many developing countries are in the process of dismantling inefficient import-substitution policies. These governments may not want to start new programmes that may in time prove to be as ineffective and as difficult to dismantle as the import substitution policies.

**Table 15 Targeted assistance**

<b>Policy</b>	<b>Goal</b>	<b>Potential effects (advantages &amp; disadvantages)</b>
<b>Technical assistance</b> <ul style="list-style-type: none"> <li>• Goal setting and advocacy</li> <li>• Advice and marketing assistance</li> <li>• Cooperatives</li> <li>• Community participation – donor-financed procurement</li> </ul>	<ul style="list-style-type: none"> <li>• Increasing awareness</li> <li>• Promoting SMEs</li> <li>• Supporting SMEs</li> </ul>	<b>Advantages</b> <ul style="list-style-type: none"> <li>• Less interventionist</li> <li>• Rewards SME efficiency</li> <li>• Optional features</li> </ul> <b>Disadvantages</b> <ul style="list-style-type: none"> <li>• Ineffective?</li> <li>• Interest group capture</li> <li>• Information problems</li> <li>• Conflicting public policies</li> <li>• Costly to government</li> <li>• Problematic goals</li> </ul>
<b>Training</b>	<ul style="list-style-type: none"> <li>• Human capital development</li> <li>• SME managers</li> <li>• Government administrators</li> </ul>	<b>Advantages</b> <ul style="list-style-type: none"> <li>• Relatively cheap</li> <li>• Develops skills</li> </ul> <b>Disadvantages</b> <ul style="list-style-type: none"> <li>• One size fits all</li> <li>• Administrative costs</li> <li>• May not be enough</li> <li>• Need for local focus</li> <li>• Potential for abuse</li> </ul>
<b>Financial assistance and subsidies</b> <ul style="list-style-type: none"> <li>• Financing</li> <li>• Bond/guarantee Reform/assistance</li> <li>• Prompt payment reform</li> </ul>	<ul style="list-style-type: none"> <li>• Alleviates significant SME constraints</li> </ul>	<b>Advantages</b> <ul style="list-style-type: none"> <li>• Direct SME assistance</li> <li>• Some policies efficient</li> </ul> <b>Disadvantages</b> <ul style="list-style-type: none"> <li>• Inefficient subsidies</li> <li>• Check for GATT compliance</li> <li>• Implicit political market</li> </ul>
<b>Subcontracting programmes</b> <ul style="list-style-type: none"> <li>• Voluntary or mandatory</li> <li>• Distinguish goals</li> </ul>	<ul style="list-style-type: none"> <li>• Increase level of SME participation in public and private markets</li> </ul>	<b>Advantages</b> <ul style="list-style-type: none"> <li>• Sustains demand on SMEs</li> <li>• Similar to set-sides</li> <li>• De-links some political interplay</li> <li>• Second-best trade policy</li> </ul> <b>Disadvantages</b> <ul style="list-style-type: none"> <li>• Costs and inefficiency</li> <li>• Implicit political market</li> <li>• Hard to dismantle</li> </ul>
<b>Price preferences</b>	<ul style="list-style-type: none"> <li>• Targeted assistance in procurements</li> </ul>	<b>Advantages</b> <ul style="list-style-type: none"> <li>• Direct SME assistance</li> <li>• Awards to SMEs</li> </ul> <b>Disadvantages</b> <ul style="list-style-type: none"> <li>• Very likely inefficient</li> <li>• May reward inefficient SMEs</li> <li>• Implicit political market</li> <li>• Poor incentives</li> <li>• Hard to dismantle</li> </ul>
<b>Targeted procurement</b>		
<b>Set-asides</b>	<ul style="list-style-type: none"> <li>• Reserve procurement</li> <li>• Limit competition to SMEs</li> <li>• Or award single source</li> </ul>	<b>Advantages</b> <ul style="list-style-type: none"> <li>• Quickest potential SME gains</li> <li>• Visible gains to SMEs</li> </ul> <b>Disadvantages</b> <ul style="list-style-type: none"> <li>• Unclear if effective</li> <li>• See above on subcontracting</li> </ul>

**Unit 5**

## POLICY IMPLEMENTATION

This Unit provides guidance on the implementation of public procurement programmes designed to assist SMEs. It provides an institutional model that governments can follow to initiate, develop, implement, maintain and if necessary modify or abolish procurements to assist SMEs.

### ***Learning Objectives***

*By the end of this Unit, you should be familiar with:*

- ◆ *Approaches to implementing programmes in public procurement that are designed to assist SMEs to become more competitive enterprises;*
- ◆ *Means to initiate policy formulation within a given government and polity in the area of public procurement programmes designed to assist SMEs;*
- ◆ *Guidance on public administration and public management in order to implement programmes in public procurement that are designed to assist SMEs;*
- ◆ *Essential steps in formulating SME public procurement programmes;*
- ◆ *Advantages of viewing the policy process as a cycle, and to start at the beginning of the process - at the commitment level - once it has been determined that modification or even abandonment is necessary.*

Unit 5 provides an institutional model for establishing and administering SME public procurement programmes. There are 9 steps to the model (fig. 5), which are covered in Unit 5.1 through 5.9.

- ◆ Determining commitment;
- ◆ Establishing a baseline institutional capacity;
- ◆ Assessing and implementing the necessary legal and regulatory structure;
- ◆ Assessing and implementing the organizational structure;
- ◆ Implementing guidelines;
- ◆ Training government officials and SME managers;
- ◆ Measuring results;
- ◆ Reviewing and evaluating programmes;
- ◆ Modifying and abandoning programmes as necessary for achieving goals.

These 9 steps represent a "closed loop," in that when a government gets to the last step, modifying and abandoning programmes as necessary for achieving goals, it will inevitably come back to the first step - determining commitment.

## 5.1 Commitment

Commitment is an important first step in devising and implementing sound and credible public procurement programmes designed to assist SMEs. As explained by the Chief Economist of the World Bank, Joseph E. Stiglitz, "[t]he more widely accepted the premises and appropriateness of reform, the more sustainable will that reform be"(Stiglitz, 1998b). In order for programmes to be successful, a government must find a credible commitment within both its institutions and polity. Government has to "take ownership" of a programme in order for it to be ultimately successful. There has to be political endorsement, potential reorientation of government officials and a willing SME sector. Various segments of the polity may have significant input into the constructing of the programme, including SMEs, associations and interest groups with interests in assisting SMEs as well as those that may be opposed to SME assistance programmes, chambers of commerce, the professions and community organizations.

Clearly, the question of commitment to a particular programme is a matter of policy for government. The premise of this Guide is not to express any policy preferences, but to identify the consequences of policy decisions. Each country must make its own choices on whether to have public procurement programmes designed to assist SMEs and to determine its own priorities in the area of SME assistance. In this section, the Guide in particular provides the "how to" aspects of devising and implementing policy, without making any judgements on what that policy might be.

There are two models of citizen participation in establishing policy: (1) a political model, based on the idea of participatory pluralism and in giving people a voice in public policy; (2) an economic model, which is concerned with the inefficiencies associated with the use of the political process to divert scarce resources from one group to another. Governments should be aware of these two paradigmatic models in order to understand them so that they may attempt to eliminate or mitigate the disadvantages they expose and in order to emphasize their advantages.

### *Political model*

In this model, interest groups serve a positive role in providing information to law and policy makers. The input of citizen groups is viewed from a positive perspective, as the development of a forum for public participation and deliberation beyond the ballot box. Lobbying government is an essential part of the democratic process. In the political model, law and policy makers serve the public interest, and draft laws that are based on community consensus. The political model has no real concern as to whether or not legislation or regulation results in taxes to one group and subsidies to another. It is all part of the democratic process. Other names for the political model are the civic republican approach and the public interest approach.

### *Economic model*

While not hostile to democracy or public participation in law and policy making per se, this model views the role of interest groups in the process of law making in a negative light. "It is well accepted today that governments of many developing countries are either captured by powerful interest groups - local elites or foreign capital - or are better described as predatory than protective" (Laffont, 1998). The basic goal in the economic model is economic efficiency. This Guide has explained the concept of rent seeking in Unit 1. The economic model yields significant insights into the workings of SME programmes in public procurement.

The synthesis of these models can be found in the works of Stiglitz (1998a, b, c), who contends that some development economists "seek increases in living standards - including improved health and education - not just increases in measured GDP. We seek sustainable development, which includes preserving natural resources and maintaining a healthy environment. We seek equitable development, which ensures that all groups in society, not just those at the top, enjoy the fruits of development. And we seek democratic development, in which citizens participate in a variety of ways in making the decisions that affect their lives." (Stiglitz, 1998a) In this model, government may act as a complement to markets. The fundamental issue that confronts policy makers in this Guide is how to structure such a complementary role.

The key aspects of commitment are that it should be *credible* and *consensual*. Given the above models of public participation, how can a credible commitment to particular SME programmes be identified and made into a sound policy with implementing law and guidance? The major components for building credible commitment in a consensual manner depend very much on the country in the country in question. The key concepts are the following:

#### *Establish a credible legal and policy environment*

As a prerequisite to achieving may be even greater where success in SME assistance, there should be a credible legal and policy environment, in which contract and property rights are respected, the government views its role as one in which it attempts intervention to make Pareto improving changes to alleviate information problems and externalities, and in which public law may be prepared in accordance with established norms of public participation. "The lack of credibility associated with weak governments is a major problem for developing countries" (Laffont, 1998). Although there is a risk of capture by special interests when there is public participation, this risk also exists when authoritarian structures of policy formulation are used and in fact there is less transparency in the policy formulation process.

#### *Identify potential participants<sup>12</sup>*

Key to the process of obtaining commitment is to identify persons and organisations that have an interest in the programme and that would be able to provide information and assistance. An important aspect of identifying potential participants is to determine whether the support of the participants is necessary for or conducive to programme success.

### *Disseminating information*

Governments will have to disseminate information to potential participants, including through public meetings, presentations and seminars.

### *Consultation*

Obtaining input from participants is integral to the process of devising a programme that will be successful. Those negatively affected by the programme should be consulted, as well as those positively affected.

### *Collaboration*

Collaboration between government, SMEs and industry groups is also integral to the process of devising a successful programme. A strong participatory programme will take into account the views of all those affected by policy, even large businesses that may be net losers in some instances. Significant components of collaboration include: analysis and identification of strengths and weaknesses collaboratively; articulating and deciding policy objectives collaboratively; formulating strategy in terms of framework, direction, priorities and institutional settings collaboratively; and formulating tactics for implementing SME programme types.

### *Using pilot programmes*

Pilot programmes may be a good vehicle to experiment with programme design. It provides public bodies with the means to test programmes and to modify them on a relatively less complicated basis prior to full-blown policy implementation.

## **5.2 Baseline institutional capacity**

There are two related strands of thinking about government which are relevant to developing appropriate SME programmes in public procurement.

First, there is the idea of government as a service provider, a "consumer oriented" government that treats constituents as consumers and which focuses on delivery of results rather than on the process of bureaucracy. The emphasis is on management rather than on administration. These approaches attempt to model government after the private sector. Two prevalent examples of this are the "Reinventing Government" initiatives of the United States Government during the Clinton Administration and the "Citizens Charter" initiatives of the United Kingdom government started by the Major government, and continued by the Blair government.

The ability to deliver results, however, depends in large part on a second issue that has been identified as a particular hurdle for governments in developing countries - the ability to enforce government policy and monitor and audit programme effectiveness (Laffont, 1998). In some countries, there may be a shortage of "the human capital of capitalism" - legal, managerial, economic, accounting, statistical [and other disciplines] required to effectuate and operate a market economy and from a public sector perspective to regulate or otherwise address its dysfunctions and limitations effectively" (Trebilcock, 1996). It may be difficult or impracticable to achieve effective delivery of results in a government programme designed to assist SMEs if the institutions that are required to implement the programme are absent or weak.

How should a country balance the goal of effective programme delivery against the constraint of problematic institutions? A country should "baseline" its institutional capacity before devising a programme to assist SMEs. Simply put, a baseline provides information on what a government can realistically do and expect from a programme. It provides data on pre-programme institutional capacity. As explained by Langseth et al. (1997) in the context of civil service reform in Uganda:

Typically, the ability of any civil service reform programme to meet its goals is difficult to ascertain because of the lack of a "baseline" description of pre-reform services. Knowing the baseline can help a country set realistic goals for improving service delivery to the public. As part of civil service reform, government has to monitor these baseline indicators in order to measure the progress of reform. This information can assist government at a central and district level . . . to respond more effectively to the ultimate beneficiaries of government services - the public. The indicators can also facilitate the task of [results oriented management], upon which governments . . . increasingly focus, as well as contribute in the medium term to the introduction of performance appraisal systems.

Thus, what can be accomplished and the way it is accomplished depends on the institutions in a given country. What can be implemented depends on the capacity of public and private institutions. If institutions are weak, then simpler programmes may be preferred. A survey and evaluation of the institutional capacity of government and of SMEs should be performed. The limitations would also have to be identified, along with an examination of the limitations caused by a government's lack of information and planning techniques for implementation.

### **5.3 Legal and regulatory structure**

Policy is implemented in a country's given legal system. The kinds of legal instruments that will be required to implement an SME assistance programme will depend on the manner in which such programmes are implemented in the country in question. SME programmes are typically implemented in legislation, which is law promulgated by a legislature in the form of a statute or code. Some countries will adopt regulation that will provide more detail than legislation. Depending on the legal system, regulation may or may not require authorization in legislation or in a constitution. For a few countries, for example, India and South Africa, SME programmes are identified in the highest form of law for a country - in its constitution. In contrast to constitutional provision, in some states, SME programmes may be implemented

solely by an executive branch of the government, through circulars, guidance, or executive orders, without or with a bare minimum of legislative authority.

Law provides operational detail for programme implementation, although, as we shall discuss in section 5.5, even more guidance may be necessary to make SME programmes operational at the grass roots levels of government and industry. Law serves another important purpose, however - that of signalling the public on appropriate policy. For example in the United States, the statement of policy that is set forth in the Small Business Act, and reproduced in Unit 1 sends a signal to both the public bodies that enforce and implement small business programmes as well as to industry, on the government's small business policy. This statement of policy can be used to interpret the more detailed provisions of the law that establish specific programmes.

On the other hand, the signals sent in a legal system are not perfect. It is well accepted that it is difficult to aggregate citizen preferences, and that the real preferences of the populace are ultimately unknowable. Popular participation in law making, as outlined in section A above, improves the situation but is not perfect. In addition, there may be no real way to discern whether a contemporary citizenry agrees with a statutory provision enacted long ago, although periodic renewal of programmes may help to alleviate this difficulty but not totally eliminate it. Ultimately, in some countries it is difficult to modify or dismantle government assistance programmes because of interest group pressure in the country in question.

The Model Law on Procurement of Goods, Construction and Services of the United Nations Conference on International Trade Law (UNCITRAL) may be illustrative, since it is being adopted, as amended, in various developing and transitioning countries. In general, the Model Law favours open procurement and international competition. Article 34 of the Model Law does provide, however, for limited use of preferences that are authorized by law and set forth in a transparent manner in the procurement documentation. There is not much if anything else in the Model Law that concerns socioeconomic policy.

The World Trade Organization Government Procurement Agreement (GPA) and regional trade agreements should be assessed, since they are either present or putative treaty obligations of countries. The GPA in general is hostile to SME programmes in public procurement with the possible exceptions of offsets for developing countries in defined circumstances, and where a country has sufficient bargaining power to be able to exempt its SME programmes from GPA coverage.

## **5.4 Organization**

A significant aspect of SME programme development is in the choice of the appropriate institutional structures for the public management of SME programmes. Should responsibility for oversight and advocacy be in a separate organization or should procuring entities perform these responsibilities? Some public body or combination of public bodies has to "own" the programme. In the United States, the SBA serves in an advocacy role for small businesses, as well as in an oversight and regulatory role. In other countries, these goals may be separated out as involving distinct areas, and to avoid the appearance of conflicts of interest. Some level of regulatory oversight and advocacy outside of the procuring entity may be

appropriate, since the primary mission of procuring entities tends to be value for money and efficiency in expenditure of public funds. To the extent that the SME assistance may conflict with efficiency or value for money goals in public procurement, a distinct public body may be appropriate.

The kinds of organizations that are appropriate and the powers that they will possess will depend on the baseline of institutional capacity for a given country, and on the resource constraints within the country's system of public finance. If institutional capacity is significant and resources are relatively abundant, an independent body may be prudent. If, however, conditions are such that institutional capacity is weak and resources are relatively limited, then programmes that rely on either minimal or no entities independent of procuring entities may suffice. There are a number of points in the continuum between these two as well, which depend on the two factors of institutional capacity and resources.

## **5.5 Implementing guidelines**

In addition to a legal or regulatory framework, a more detailed and rudimentary set of guidelines may be necessary to ensure that the law or regulation is "operationalized" to the level of the particular government departments that will actually implement the programme. Such guidelines would fill in the interstices left by the law, and will provide the requisite operational detail for public bodies to be able to put the programmes into operation.

One potential pitfall to bear in mind in the preparation of such guidelines is the trade-off between rules and discretion. Discretion has the advantages of encouraging innovation, risk-taking and the exercise of judgement. If, however, institutions are weak, these advantages may be disadvantages, in which case a rule-based system with increased transparency may be better.

## **5.6 Training**

Training is an important element in the success of SME programmes. It is well-established that training is a key component in the development of institutional capacity and human capital generally. Training also positively relates to rule compliance, in that public officials tend to comply more with law, regulation and direction that they understand and can apply than with law, regulation and direction that is confusing, unknown or difficult to apply.

Two important audiences for training exist: (1) government managers; and (2) SME managers. Training should be based on local conditions and be offered at local levels.

## 5.7 Measurement of results

Many countries that already have SME programmes lack good sources of data or means to measure success of the programmes. Measurements and data collection efforts should be devised to ensure that programmes are evaluated on the basis of effectiveness and not merely on inputs. The lack of rigorous statistical measures is particularly acute in developing and transitional economies. Data collection is costly for governments and SMEs.<sup>13</sup> The data, however, can result in future cost savings for both governments and SMEs.

Data not only need to be collected in well accepted and unbiased ways, they should also be assessed based on established credible measures. Programme success has to be: (1) defined in accordance with the public participation process outlined in section 5.1 above; and (2) measured on the basis of the agreed-upon definitions. The definition of success should be *credible*, which means that it must withstand the scrutiny of being a rational policy designed to make people better off, and *durable*, which means that it must be able to withstand "changing political vicissitudes" (Stiglitz, 1998a, b and c).

A standard method for assessing the credibility of government programmes is cost-benefit analysis. This is a well-accepted method for measuring success of programmes, based on project analysis and public economics. Cost-benefit analysis takes into account the issue of scarce resources that dominates public policy discussion. It is based on a weak notion of efficiency known as "Kaldor Hicks" efficiency.

According to this notion, the test of whether a programme should be undertaken is whether those persons made better off by the programme are made sufficiently better off than those who are made worse off. Kaldor Hicks is based loosely on that of wealth maximization. It should be contrasted with the strong notions of efficiency found in the concepts of "Pareto optimality" and "Pareto superiority."

A programme is Pareto superior if, as a result of the programme, some people are better off and no one else is worse off. Pareto optimality occurs where any movement away from a particular resource allocation would make at least one person worse off. In political markets, Pareto optimality represents a unanimity principle, that is, if at least one person objects to a programme, then the programme cannot be established. As can be seen, Kaldor Hicks is based on a potential compensating principle: it permits comparisons across persons so long as aggregate wealth is increased. Note that these concepts look at opportunity costs and not merely at accounting costs.

Cost-benefit analysis is the method applied by the World Bank and other international donors to assess the viability of projects to be financed. It is also used by a number of governments to assess the effects of regulation in the economy. In the United States, statute requires that the US Office of Management and Budget subject most regulations to cost-benefit analysis.

The Standing Committee on Government Procurement, a WTO based body, has data collection as one of its institutional goals under the GPA. Currently the Standing Committee lacks the capacity and resources to conduct substantial data collection. One potential way to alleviate some of the constraints on government for information collection is to repose some institutional responsibility in an international organization such as the WTO.

## 5.8 Evaluation and review

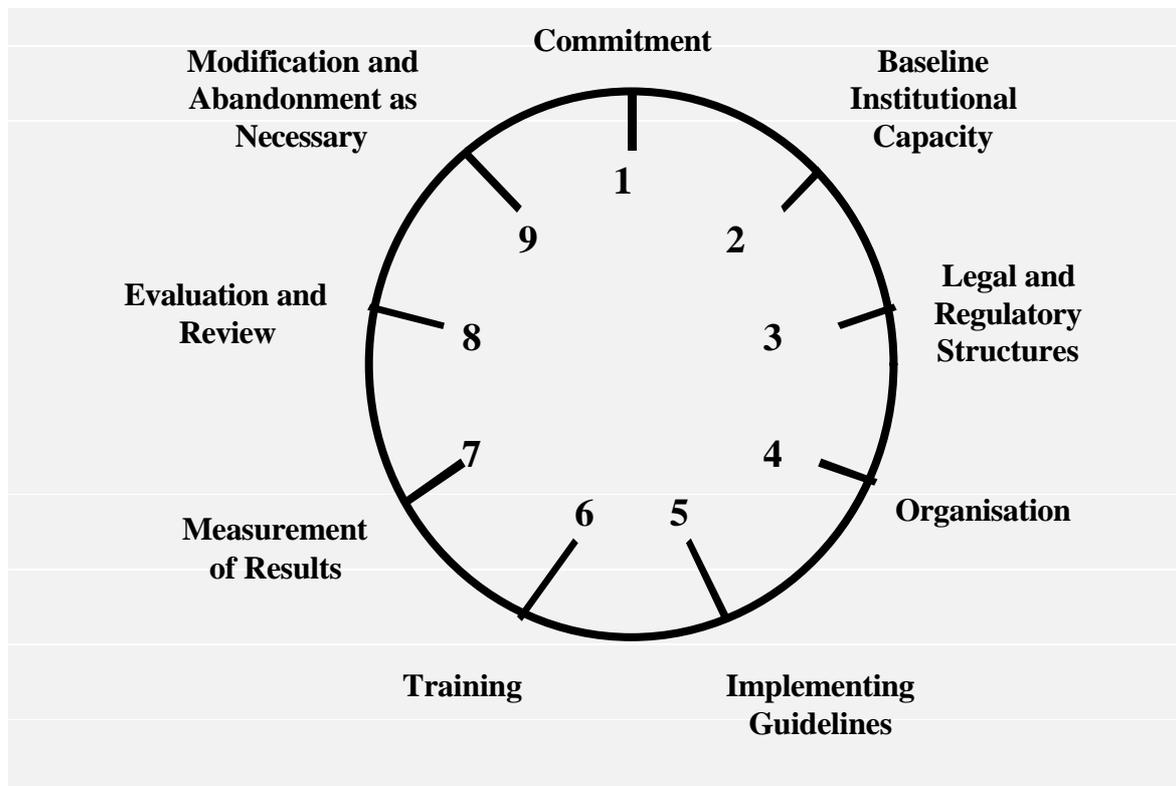
Governments should be prepared to evaluate SME programmes on a periodic basis. The relevant law or regulation can set the time period or the public bodies in charge of the programme can set it. The data to be used and the measurements to be taken will depend on the findings as set forth in section 5.7. The time periods between assessments may be a function at least partly of the institutional capacity of the Government.

### 5.9 Modification or abandonment as necessary

Governments should adapt and be prepared to modify or even abandon programmes that are ineffective. Programme reform is often difficult not for policy reasons, however, but for political reasons. Procurement programmes often have a "ratchet" effect - they are relatively easy to create but very difficult to change or dismantle once they are in place (Kovacic, 1992). This is perhaps the most difficult of the steps. Government, however, has to be ruthless in shedding unsuccessful programmes and in keeping and improving successful ones.

When a government reaches this stage, it loops back to step 1, set forth in section 5.1, "Commitment". Governments can undertake programme revision based on the criteria and methods in that section, to ensure adequate information, public participation and accountability.

**FIGURE 5 INSTITUTIONAL MODEL**



## **CONCLUSION**

This Guide has attempted to show how SMEs can play an important role in the growth and development of countries. It is our hope that we have shown how SME policy can facilitate export-led growth in the developing and transitional economies. No less significant, the Guide also has attempted to identify the various drawbacks to public procurement programmes intended to assist SMEs. To this end, the approach of the Guide has been one of "full disclosure", but does not sacrifice the coverage of a heterogeneous set of views from a diversity of sources. We trust that the Guide will be useful for governments, policy makers, SMEs, industry associations and others in devising and evaluating SME policy and programmes.

## **ANNEX A**

### **SME INVOLVEMENT IN PUBLIC PROCUREMENT IN HUNGARY**

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### *SME Involvement in Public Procurement in Hungary*

The first government body for the coordination of small and medium-sized enterprise (SME) support programmes in Hungary was established in 1990, and in 1995 public procurement regulation began with an act adopted by Parliament. These two issues represent a relatively new phenomenon in the Hungarian economy. The public procurement system operates quite smoothly compared to its short lifetime, which allows us to draw some conclusions based on real, if limited, experience. Unfortunately, the novelty of the new regulation has a negative consequence on the availability of detailed statistical data which do not facilitate a thorough economic analysis. But hopefully this paper will contribute to the awareness of the problem, thus helping other researchers in their work.

The basic legal instrument on public procurement in Hungary is Act XL of 1995 on Public Procurements. Aside from a short historical period in the 1930s when public spending was regulated by the Public Supply Directives, there were no coherent rules for the public institutions to follow. The new act follows the pattern of regulation applied in the European Union (EU), adopting mostly the rules in force in the EU with some exceptions on the preferences.

The public procurement rules apply, in general, for all those organizations that receive funds from the state budget or the national welfare system, at least to the extent of the utilization of those funds. Therefore, the rules are applied in the following cases:

- (a) state, local governments, municipal minority local governments, local minority governments, association of municipal local governments, central budgetary organs, budgetary organs of local governments, segregated state funds, national pension and health insurance funds;
- (b) public bodies and public foundations;
- (c) foundations and social organizations established by the organizations listed in paragraphs (a) and (b) or receiving more than one third of their assets from them, or non-profit organizations, insurance associations, water management associations and their affiliates if the organizations listed in paragraphs (a) and (b) possess a determining part of control in them;
- (d) organizations subsidized from the central budget to the extent of the subsidy received; organizations receiving guarantees from the central budget;
- (e) organizations established according to Section 685, paragraph of Act IV of 1959 on the Civil Code of the Republic of Hungary or local government institutions if they have

exclusive licenses by the law to provide national, regional or local public services in the whole market affected by the procurement.

The minimal value limits for the application of public procurement procedure are set yearly in the state budget act. The limits are kept very low, compared to the practice of the EU, in order to provide maximum protection for public spending. This practice has been widely criticized by the various sides involved in the public procurement procedure. A very low limit decreases considerably the flexibility of decision-making in public organizations as the procedure is lengthy and there is only very limited room for adaptation to changing needs once the procedure is under way. Although the act allows the public organizations to use accelerated procedures in case of urgency if it is not the fault of the organization itself, but it is still a limited opportunity. At the same time, the 125/1996 Government Decree on the Detailed Rules of the Centralised Procurement of Central Budgetary Organs allows discount or urgent buys with permission up to 10% of the yearly procurement value of the given good, thus increasing flexibility. Unfortunately, the low value limits are not very favourable for the SMEs either as the smaller companies are forced into the time-consuming and costly procedures if they want to gain access to the public procurement market.

### **YEARLY THRESHOLDS IN FT MILLION**

<b>Procurement</b>	<b>1998</b>	<b>1997</b>	<b>1996</b>
Goods	15	12	10
Building and construction	30	24	20
Design and planning	7.5	6	5
Services	7.5	6	5
Pre-qualification limit for construction projects	240	240	200

In order to make the comparison easier, the yearly average currency rates for 1 ECU in 1996 and 1997 are: Ft 191.15 and 210.93, respectively. ( Source: Hungarian National Bank <http://www.mnb.hu>).

#### **Institutional structure of public procurement and its legal environment**

The Public Procurement Council was established to monitor and administer public procurement activities. The Council is responsible only for the Parliament and is financed from the state budget. The main tasks of the Council are to:

- Monitor the enforcement of the rules;
- Express its opinion on the drafts of regulations concerning public procurement;
- Monitor the performance of procurement contracts, define qualification criteria for bidders;
- Appoint and/or relieve the chairman of the Arbitration Committee and the Commissioners;
- Provide for the publishing of the Public Procurement Bulletin;
- Promote the education and training for the participants of public procurement;
- Maintain relationships with similar foreign and international organizations;
- Prepare its annual report to Parliament.

In addition to Act XL of 1995 the other regulations concerning public procurement are the following:

- 125/1996 Government Decree on the detailed rules of the centralized procurement of central budgetary organs;
- 128/1995 Government Decree on the rules and fees of publication in the Public Procurement Bulletin;
- 25/1996 Decree of the Minister of Interior on the centralised procurement procedure of the Ministry;
- 1/1996 Decree of the Minister of Environment and Regional Development on the detailed technical contents of documents for building and construction procurement tenders.

### **Types of procedure**

Act XL of 1995 establishes three procedures for public procurement: open procedure; procedure by invitation; and procedure by negotiation. All of these procedures are open in the sense that the calls should be published and all eligible applicants are entitled to participate. Nevertheless, it is forbidden to change the type of an ongoing procedure.

In the open procedure, the issuer publishes the decision criteria for the bids, the deadlines for their submission; and the final decision. The conditions published in the invitation are binding for the issuer, and the bid is binding for the bidder.

Procedure by invitation is applied when the number of eligible bidders is limited due to the nature of procurement and there are at least 5 qualified bidders on the list of qualified bidders.

Procedure by negotiation is applied when:

- The open procedure or the procedure by invitation was not successful;
- The contract can be fulfilled only by one particular person due to technical, artistic or copyright concerns;
- The result of the procurement is utilized exclusively for research or development purposes;
- In emergencies, when the deadlines prescribed in the open procedure or in the procedure by invitation could not be met;
- It is impossible to define the service as exactly as required in the other procedures;
- When the change of supplier in the case of a parts exchange or development of a formerly procured object would result in technical incompatibility or excess costs;
- Due to unforeseeable circumstances a complementary service or construction work is needed;
- The favourable conditions of the procurement prevail only for a short period of time;
- The target of the procurement is real estate.

Distribution of procedures in the period between 1 November 1995 and 31 December 1996:

- 2,252 open procedures (69.5 %);
- 194 procedures by invitation (6%);
- 795 procedures by negotiation (24.5%);
- 3,241 procedures total (100%).

### **Criteria for assessing bids and preferences applied**

The assessment of bids may be based on one of the two alternative approaches:

- The lowest cost principle; or
- The highest value principle.

In any case, the criteria applied should be included in the tender announcement. If the bids are assessed using the highest value principle, then the order of importance for the decision criteria should also be published in the announcement.

It is possible to set criteria in a way that supports the following economic or social policy objectives:

- Employment development including job creation;
- Development of undeveloped regions;
- Environment protection;
- Increasing the potential of SMEs to participate in public procurement.

The last policy objective shows that the regulator wanted to take into account the specificity of the SME sector. At the same time, there is not any specific measure included in the public procurement or other acts or government decrees that would support the meeting of this economic policy objective. In theory, the opportunity is given but in reality it is difficult to see any positive sign of preferences given to SMEs. In practice, the larger enterprises are favoured.

In the case of foreign bidders, national treatment shall be provided with respect to the international agreements Hungary signed. However, if the price difference in the case of a local bidder is not more than 10% and at least 50% of the value of the procurement were it to be produced locally, then this bid shall be treated as equal. This provision is criticized internationally, nevertheless, due to the low budgets of the public organizations; it is difficult to suppose that this preference would prevail.

When the bids are equal according to the announced selection criteria, that bid should be preferred using the following order:

- That contains the product that earned the environment friendly product label;
- In which case the bidder possesses a quality assurance system credited by any nationally accredited issuer.

## **Definitions of SME size categories**

The following definitions of size categories are based on the government recommendations presently used for official statistical purposes. The definitions correspond to the ones used in the EU; the difference is in the value limits, which are about half of the EU thresholds.

<b>Microenterprise</b>	Less than 10 employees
<b>Small enterprise</b>	10-49 employees with Ft 700 million turnover or Ft 500 million balance-sheet total maximum
<b>Medium-sized enterprise</b>	50-249 employees with Ft 4000 million turnover or Ft 2,700 million balance-sheet total, maximum

## **Support of SMEs**

### **Institutional support for SMEs**

#### **Institute for Small Business Development**

The Institute for Small Business Development (ISBD) is a national government organ responsible for collecting and providing information on the SME sector and is supervised by the Ministry of Economic Affairs. The institute, in its present form, was founded in 1995, but actually continued the activities performed by its predecessor, which was set up in 1990.

The main tasks of the institute are the following:

- Monitor the environmental changes which influence the operation of SMEs;
- Analyse the development of the SME sector in Hungary;
- Provide objective, reliable and accurate information to the public, decision makers and professionals.

This institute supports and organizes research on the various aspects of SME development, and performs statistical analyses. It has published its Annual Report on the State of Small and Medium-sized Enterprises every year since 1996.

### ***Hungarian Foundation for Enterprise Development***

The Hungarian Foundation for Enterprise Development (HFED) was established in 1990 for the support of small business development in Hungary. The funding was provided by the Hungarian Government, many larger banks and associations of enterprises. The foundation operates independently as a non-profit organization.

The mission of the foundation is to promote the development of the economy through the enhancement of the competitiveness of the small and medium-sized enterprises. The HFED also offers a wide range of professional and financial aid programmes.

The foundation's operation is based on a network of local centres. The first 6 centres were founded in 1990 and 14 more have been established since then, and now appear throughout the country. They are registered as foundations which is a non-profit status allowing independent operation as well as an opportunity to raise funds for themselves. The centres operate 150 offices in the whole country which means that the services offered by the foundation are even available locally for everyone in most of the smaller towns.

HFED organizes and operates national programmes in the following main fields:

- Development of educational material for entrepreneurs;
- Organization of training programmes;
- Support for research on the SME sector;
- Provides access to national and international electronic databases and information centres;
- Support programmes for innovation and export promotion;
- Support for the international mobility of entrepreneurs to participate in international information exchange forums;
- Support for participation in training programmes.

The operation of the local centres and offices is based on yearly business plans, which take into account the conditions and the potential of the local economy. The centres and offices offer low price or free services in the following fields:

- Local experts for consultation and advice;
- Training and development programmes;
- Credit finance and guaranties;
- Low-cost industrial sites in incubator houses;
- Access to local, national and international databases;
- Assistance in export marketing (catalogues, participation in fairs, etc.);
- Local development plans by sectors.

### **Chambers in Hungary**

The chambers are organized on the basis of compulsory membership and function as authorities in fields such as registering entrepreneurs, establishing standards for professions and organizing examinations in various professional fields. It is organized by sectors: commerce and industry; artisans; and agriculture. The local chambers form the basis of the national chambers, which represent the interests of the member organizations.

### **Chamber of Commerce and Industry**

The Chamber of Commerce and Industry provides information for the member companies in a number of fields. It also develops assistance programmes, providing access to experts and consultation in marketing as well as in technical or legal matters. In addition, it deals with ethical issues and helps its members to settle disputes.

A classic function of this chamber is to maintain negotiations with the Government in the fields affecting the business of the member companies. The chamber provides expert advice on the laws and regulations for the Government, the parliamentary committees and the local governments. A highly emphasized task is to participate in the preparation of the access to the EU through collecting and distributing information and building relationships with partner organizations in the EU and other countries.

## **Chamber of Artisans**

This chamber, because of its organization, represents micro and small enterprises. Therefore, it is an active participant in the negotiations in the matters of the SME sphere. It emphasizes the continuous enhancement of the prestige of artisan work through setting standards in production, quality and education.

The Chamber of Artisans deals with the preparation of regional and local development plans. Developing training and education programmes, including teaching material and examination criteria, are also important tasks. There are many services available for the members in the framework of the numerous support programmes.

## **Chamber of Agriculture**

The main tasks of this chamber are the following:

- Provide economic, legal and technical information for its members;
- Build relationships with foreign chambers;
- Promote research, technical development and infrastructure development projects;
- Participate in vocational education;
- Register entrepreneurs;
- Prepare rules and norms for onerous behaviour in the market;
- Represent the interests of the members;
- Offer suggestions for laws and regulations.

## **Chambers with international membership**

There are more than 20 chambers formed to promote trade between Hungary and other countries and represent the interests of the Hungarian affiliates of the foreign parent companies. They help their members to find information on the Hungarian economy, the legal system and business opportunities. One major activity is the organization of conferences, presentations and business meetings to help partners understand each other culturally and to understand other business practices.

## **National Committee for Technological Development**

This government agency was established in 1962 with the goal to promote the technological modernization of the Hungarian economy and improve the competitiveness of Hungarian products and services. The committee, in cooperation with the local chambers, set up programmes to support the technological development of the SMEs.

## **ITD Hungary**

This is the Hungarian Government's Investment and Trade Development Agency. It was established by the Ministry of Industry, Trade and Tourism in 1993 to promote international economic relations and business endeavours having direct impacts on the development of the Hungarian economy.

ITD Hungary concentrates on the following activities:

- Foreign investment promotion;
- Operation of the foreign trade service network abroad in 30 countries;
- Export promotion, trade consulting;
- Operation of the Euro Info Centres;
- Publication of business guides and information booklets in Hungarian and foreign languages;
- Business services.

ITD offers all of its services to SMEs, but the Euro Info Centres may hold the greatest importance for small businesses, providing them with information and advice on trade, business opportunities in the EU, and on European laws and regulation.

The list of the supporting institutions is far from complete. There are still many organizations, associations and companies supporting the SME sector nationally or locally. This indicates that the importance of the SME sector in the development of the economy and society has been widely acknowledged in Hungary. Unfortunately, although the development in the number and quality of the programmes targeting the sector is astonishing, there is still room for further development, especially for the involvement of the SMEs in public procurement. Fortunately, the need to improve the prevailing public procurement system is acknowledged. The Government is willing to make the necessary corrections in order to ensure equal treatment and more opportunities for the SMEs. The concrete measures of the government package are still being negotiated, but hopefully the package will be accepted soon - in early 1999.

### **Financial support for SMEs**

#### **Loan Guarantee Association**

This association was formed with the participation of the Loan Guarantee Company, HFED, and the Agribusiness Loan Guarantee Foundation in order to develop cooperation among the organizations dealing with guarantee schemes for the SME sector and to represent the loan guarantee organizations nationally and internationally.

#### **Loan Guarantee Company**

With the help of this company, entrepreneurs who could not receive loans otherwise because of inappropriate pledges but whose business plans are good and acceptable for the banks, may obtain bank loans.

The goals of the loan guarantee programme are:

- To serve a broad base of the SMEs with guarantees to obtain bank finance;

- To utilize the funds available for guarantees as efficiently as possible;
- To protect the funds utilized in order to make them available in the long term.

This company is very successful in its mission and has accumulated vast experience during its 5 years of operation.

### **Agribusiness Loan Guarantee Foundation**

This foundation was established in 1991 with considerable help from the PHARE Programme. Its purpose is to increase the access of SMEs, which are in the agriculture and food industry, and to finance and improve the conditions of the available finance.

### **HFED centres**

HFED centres are also actively involved with the local branches of the participating banks in a number of financial programmes.

The *Micro Loan Programme* provides financing for small businesses for up to 3 years for the purchase of equipment and current assets at favourable interest rates. The upper limit of the credit is rather low, so it may be useful only for start-ups and the small enterprise. The applicants receive advice on business planning and help in the preparation of credit application.

The *PHARE Loan Programme* provides medium- and long-term financing up to 7 years. The upper limit of the loan is 10 times higher than in the case of the Micro Loan package, so this programme serves the small and the medium-sized enterprise as well.

The *Start Guarantee Fund* is available for those entrepreneurs who cannot provide the collateral required by the banks for the so-called start and Reorg-Start loan programmes. The guarantee fund secures a maximum of 80% of the loan.

The *Loan Fund for Energy Saving* provides loans for energy-saving development projects for up to 6 years, and the TEK programme provides finance for the energy-saving reconstruction of family homes.

Hungarian Export-Import Bank, Ltd., and Hungarian Export Credit Insurance, Ltd.

These two institutions were founded in 1994 to promote Hungarian export and import activities. The Hungarian Eximbank focuses mainly on foreign trade development with the Central and East European countries. The bank provides several services to its Hungarian and foreign customers in the following main fields:

- Credits and loans;
- Guarantees;
- Factoring;
- Services related to creditworthiness.

Small enterprises may use the services offered by the Eximbank through their own banks, while medium-sized or large enterprises may turn to the bank directly.

The Hungarian Export Credit Insurance, Ltd. offers insurance against several categories of risk involved in foreign trade. The following risks are covered by insurance:

- Commercial risk;
- Political risk of trade;
- Risk of unfair treatment in tenders;
- Political risk of capital investments abroad.

Hungarian Development Bank, Ltd.

This bank was established in 1997 to enhance the modernization of the economy, to participate in regional development programmes, to handle state development funds and to raise funds abroad. It offers long-term loans with favourable conditions to SMEs for investment in technology, production, and research and development. Regional Development Associations were formed with the participation of the bank to finance the development of the

local small and medium-sized enterprises and to offer financial services to the local and municipal governments.

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## **ANNEX B**

### **SMEs and Public Procurement**

#### **Lowering Transaction Costs to Increase Participation\***

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and presented at the UNCTAD Workshop on Procurement, 5-6 November 1998.**

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## **SMEs and Public Procurement**

### **Lowering Transaction Costs to Increase Participation**

This paper examines the role of the international financial institutions (IFI) in 117 procurement programmes and considers whether that role should become more activist in order to encourage SME development. The paper looks at general procurement policies in countries of the Organisation for Economic Co-operation and Development (OECD) and in developing countries, as well as programmes designed to funnel contracts to SMEs. It examines policy options for governments interested in increasing the percentage of government contracts for SMEs. It also discusses different operations of international financial institutions (IFI) that could further this goal and discusses the extent to which IFIs can or should influence government procurement policies. The paper concludes with a checklist of issues that IFIs might address should they be interested in incorporating SME components into future procurement operations.

There are three distinct levels of government or IFI involvement in procurement policy that affect or achieve SME-related policy goals. At the most basic and least controversial level, governments and IFIs may correct biases against or remove barriers to SME participation in procurement. This includes reforms and improvements of the institutions and processes that constitute government procurement. While this will benefit all private-sector firms, it should have a more significant impact on SMEs. Because SMEs have fewer resources, anything that makes the process easier and lowers the cost of involvement will have a greater relative result for them. Second, governments may target procurement-related assistance towards SMEs, usually training, to enable their participation. This assistance may be neutral—that it is not subsidized—in which case it should not give a particular advantage to SMEs, or it may be subsidized, in which case the policy will not only provide an advantage for SMEs but will also introduce a distortion into the procurement procedure. Finally and most controversially, agencies may mandate, target, or set aside procurement funds specifically for SME involvement.

Since goods and services that the State purchases from the private sector account for a significant portion of GDP, policy makers interested in assisting SMEs have long viewed access to government procurement as a potentially powerful instrument of small business policy. However, even in the industrial countries, using procurement to help SMEs has proved difficult and in no country can procurement policy be judged an efficient means of helping the SME sector. Reasons for this arise partly from the information and transaction costs associated with government purchases of goods and services, partly from the nature of the way the public and private sectors interact, and partly from bureaucratic inertia.

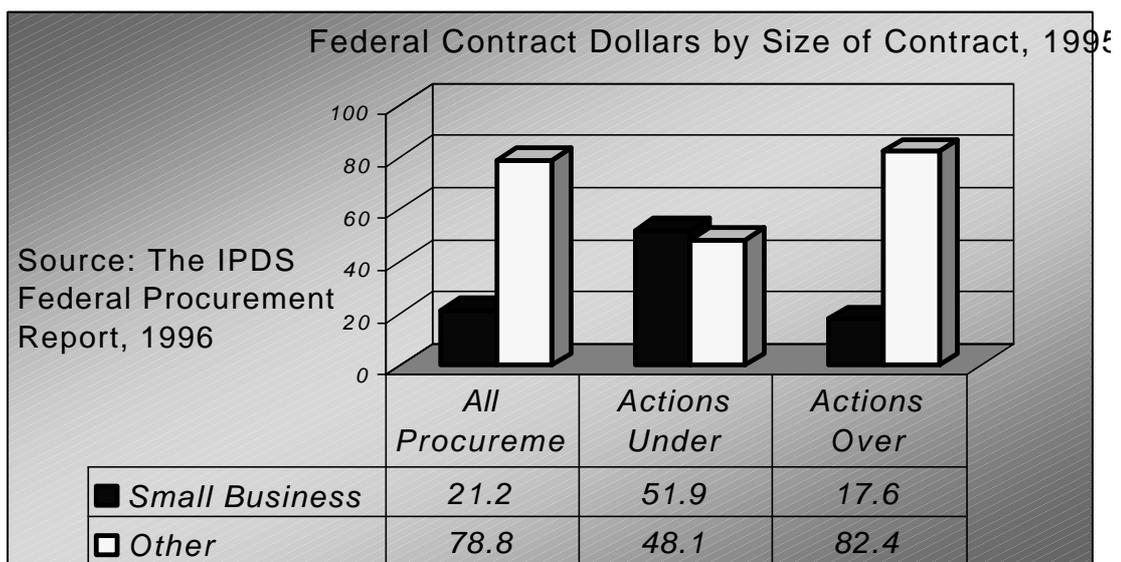
#### **Procurement levels**

In most EU member states, procurement purchases are estimated at 10 to 15% of GNP, or 25 to 30% of public expenditure. The economic importance of public procurement in Europe should not be understated: public authorities and utilities subject to European Community rules each year spend some ECU 720 billion on goods and services. In 1994, this number represented 11.5% of the GDP of all 15 member states of the EU, or the combined economies of Belgium, Denmark and Spain. Similarly, according to calculations by the Organization of American States (OAS) and the Inter-American Development Bank, the equivalent of 20% of Latin America's GDP is spent by governments on procurement. They estimate that within the North American Free Trade Agreement (NAFTA), total

central government procurement is close to US\$ 1 trillion (OAS, 1995). The central government's component of all government procurement amounts to about 35% in the United States, 30% in Canada and 74% in Mexico (McKenna and Cuneo, 1993). Procurement in East Asian countries is estimated at anywhere from 20 to 40%, but the extreme degree of decentralization in many of the regional governments makes the data particularly unreliable. The Africa region suffers from similar decentralization issues, as well as from a general lack of resources to gather such statistics.

In fact, determining the extent of procurement in most countries is an inexact science at best, while determining the amount targeted to SMEs is virtually impossible because governments do not keep accurate statistics on overall procurement, let alone the amounts from SMEs.<sup>2</sup> This is not a matter of pure neglect. Government procurement is decentralized in most countries between many ministries and increasingly between states and municipalities, which makes judging the role played by SMEs more difficult. Within the IFIs themselves, the ability to track procurement dollars is similarly complicated because the "Headquarters" is responsible for initiating the contracts while the local offices supervise the operations. Nevertheless, given the sheer dollar amounts spent on procurement, an examination of the issues related to the role of SMEs, combined with hard data on the distribution of contracts, is very timely.

### Procurement policies in the industrial and developing countries



Even in the industrial countries, programmes to facilitate SME involvement vary widely. Most countries concentrate on lowering barriers to SME participation primarily by trying to lower participation costs through information dissemination and on-line bidding. Only the US and Japan use procurement policy systematically and programmatically to target the SME sector.<sup>3</sup>

The US has arguably the most advanced and *activist* programmes for targeting SME procurement. Goals for SME participation in federal procurement are set by statute. Currently, the goal is 20% and will rise to 23% by the year 2000.<sup>4</sup> In FY 1995, of the US\$ 202.3 billion in contract actions

<sup>2</sup> For example, 1993 data from the Asia-Pacific Economic Cooperation (APEC) show public procurement in Japan to less than 1% of GDP!

<sup>3</sup> In the US, procurement policy is used to assist *only small enterprises*, defined according to the SIC code for each sector of the economy. There is no programme for medium-sized enterprises.

<sup>4</sup> The SBA advocated for a goal of 25% but this was rejected by the Federal Budget Office (OMB)

awarded by the federal government small businesses won US\$ 6.7 billion, or 33%, including US\$ 42.9 billion in direct contract awards from the federal government and US\$ 3.8 billion as subcontractors to prime contractors working directly for the Federal Government. This is an increase from the previous year's 31.4%. In FY 1993 and FY 1992, the small firm shares were 29.9% and 30.8%, respectively.<sup>5</sup> The Small Business Administration (SBA) negotiates compliance targets for federal agencies and departments and aggressively monitors their performance. The SBA also enters into prime contracts with federal departments and agencies, and then subcontracts to small businesses. The federal Government also uses set-asides to target procurement toward non-minority SMEs.

The US Government has invested extensively in on-line information dissemination. All contracting information is available electronically and some bidding documents may be filed on-line. Despite an earlier failure, the government is in the process of moving to an exclusively electronic procurement system.<sup>6</sup> By providing information this way, the Government has significantly lowered the cost of participation for SMEs. The SBA also keeps electronic registries of qualified SMEs interested in bidding for government contracts.

Set-asides for SMEs do not exist in the EU, but most countries provide targeted assistance to SMEs.<sup>7</sup> This includes assistance in completing bid documents, obtaining financing, and technical assistance in complex technological bids. Some countries also provide assistance in helping SMEs coordinate bidding for contracts. The push towards electronic procurement is, however, the focus of EU activities. The EU Report on Procurement recommends the introduction of electronic trading and the achievement of a "critical mass" at least 10% of public-sector procurement done electronically by the year 2000. The most important of these initiative for reaching this goal is ELPRO, the Electronic Public Procurement System for Europe, developed in response to an EU paper on problems facing SMEs in government procurement. The EU is also taking steps to correct other problems identified in the paper including speeding payment to firms.

Within Europe, Sweden has adopted an aggressive electronic procurement implementation plan for public, central and local government procurement where 95% of the procurement volume of frequently ordered goods and services, generally smaller value purchases, and 50% of other general goods and services is to be procured and ordered electronically by the year 2000.<sup>8</sup>

The administrative structures of government procurement systems in APEC member economies were in most cases mandated by the constitutional structure of the country. Federations usually have a federal system which may or may not be directly applicable to state and other sub-federal procurement activities. Regional government and municipalities, with their own fiscal resources usually have their own procurement systems. The degree of decentralization varies widely. For example, while both Hong Kong (China) and Singapore are city economies, Singapore has a much higher degree of decentralization of procurement activities. Centralized procurement in Singapore is applicable only to a very limited number of products such as paper and rice. In contrast, Hong Kong (China) adopts a central purchasing system for all goods except for low-value purchases.

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Washington Post, 7 August, 1997.

<sup>5</sup> US SBA, [The State of Small Business](#), 1996. US, GPO. 1996. Annex C.

<sup>6</sup> GAO Report: [GAO/NSIAD-97-26](#), 3 January, 1997

<sup>7</sup> A search of EU [Europe database](#) produced found no mention of set-asides or off-sets, nor did major EU publications on procurement; see for example: European Commission. DG XV. [Special Sectoral Report N° 1: Public Procurement](#), Brussels, November 1997, or [Public Procurement in the European Union: Exploring The Way Forward](#) Communication adopted by the Commission on 27 November 1996.

<sup>8</sup> Government of Sweden. [Electronic Trading for Local Authorities, County Councils and Central Government](#). 21 June 1997.

Information on policy in Africa is difficult to come by. South Africa has implemented relatively advanced policies that differ very little from those of the EU. In the rest of the region, however, corruption has become a major problem and government policies on procurement are haphazard and inconsistent.<sup>8</sup> The region suffers from a devastating shortage of human capital, institutional shortcomings, and of competent officials in particular.<sup>9</sup>

Since the purchase of goods and services by governments is so large, and therefore of consequence to international trade, it would appear to be an area that should be covered by mandates of the World Trade Organization (WTO). However, only recently has the WTO moved to more fully incorporate government procurement.

The first Agreement on Government Procurement (GPA) was signed in 1979 under the GATT and though it has been amended and expanded, it still does not apply to all government procurement procedures, and most strikingly the GPA itself does not apply to all WTO members. Rather it applies only to those countries that adopt the agreement. Furthermore, even when countries have signed, procedures are complicated. Determinations must be made regarding whether a procurement contract is covered by the GPA. Then it must be determined if the procuring agency is covered, if there is a threshold level and, if the contract is for a service, whether that service is covered.

Finally, each country that is party to the GPA is allowed to append General Notes to the end of their schedules, which provide for a number of exceptions, and these must be consulted to determine if the procurement is subject to some other exception. These general notes allow for the expected exceptions for health and national security, but also include allowances for discriminatory practices such as the US small business and minority set-asides.

Article XVI of the agreement also includes a special exemption allowing developing countries to use offsets—measures used to encourage local development or improve the balance-of-payments accounts by means of domestic content, licensing of technology, investment requirements, counter-trade or similar requirements. Consequently, rather than limiting a country's scope of action, the GPA only makes exemptions transparent. This pattern is repeated in bilateral and regional trade agreements where countries simply agree to either reciprocate or accept each other's procurement exemptions. Thus, there is a great deal of room for maneuver in implementing these policies.

### **Advantages and disadvantages of set-asides**

Set-asides, which reserve a certain percentage of government procurement contracts or total spending for a limited pool of applicants, are one tool that could be used to increase SME participation in government contracts. On first consideration, the attraction of this option is that it produces the quickest, most visible gains and could provide entry for SMEs into procurement. On the other hand, it risks compromising quality, price, and delivery targets because the suppliers may be less efficient than larger companies. There is no evidence that set-asides produce efficiency gains and, at best, ambivalent evidence that they promote equity, or fairness, which in the US case would be redress of past and current discrimination, and elsewhere might be lack of opportunity for indigenous groups. The inherent danger in creating programmes mandating a level of involvement is that political pressures make them

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<sup>8</sup> Technology Policy Practice in Africa, Ogbu, Oyeyinka, and Mlawa eds. IDRC, 1995.

<sup>9</sup> For example, the World Bank has a major educational programme to improve accounting teaching and certification in sub-Saharan Africa.

almost impossible to monitor effectively let alone discontinue. The economic danger is that they foster rent seeking as opposed to efficiency-maximizing behavior.

Only the US, and to a lesser extent Japan, has extensive experience in using set-asides. In the US, set-asides for SMEs, and particularly for socially disadvantaged or minority SMEs, have been in existence for over 3 decades. They arose from a perceived need to correct the non-economic problems preventing minority participation in government procurement caused primarily by discrimination. The set-aside programme is designed to increase the proportion of federal procurement going to minority firms and to give these firms work experience. This is a prerequisite that most lack because, it is argued, of past and current discrimination. Given the opportunity, these firms will gain the experience necessary to compete on an equal basis with firms that have not suffered from discrimination.

Minority participation in central government procurement has increased under the set-aside programme. This fact corresponds with findings in other studies of an apparent relationship between affirmative action programmes and increased levels of minority participation in local government procurement (Enchautegui et al., 1997). Further, it appears from anecdotal evidence that the SBA set-aside programme has been responsible for much of the increase in central government procurement, though there is research suggesting that gains for minority and socially disadvantaged SMEs may have come at the expense of nonminority SMEs.<sup>10</sup> Thus, the programme is widely recognized, even by its critics, for achieving part of its policy objective. Therefore, in a *political* analysis, the set-aside programme may be judged successful. Whether it promoted equity is another matter.

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<sup>10</sup> SBA [Bundled Contract Study FY 1991-1995](#) by Eagle Eye Publishers, Vienna, VA, 1997, under contract No. SBA HQ-95-C-0020. "The combined small business share of the number of awarded contracts has declined since 1992 (60.5 to 58.9 percent), while the dollar share is up (16.5 percent to 17.8 percent). SDB (small disadvantaged business) gains mask OSB (other small business) losses, as in market share SDB gained (3.5 to 5.9 percent) while OSB lost (12.9 to 11.9 percent)".



One indication of the relative level of success may be gathered by examining firms that “graduated” from the set-aside programme. Firms must leave the programme after either 9 years or on reaching a certain size or volume of business depending upon the firm’s industrial classification. In its most recent audit of the set-aside programme, the SBA surveyed a sample of firms that graduated between 1993 and 1996. The results are shown in the accompanying figure, which indicates that about one third of those leaving the programme either went out of business, substantially curbed their operations or were acquired by other companies.

No further quantitative data is available from the SBA upon which to judge the relation between the set-aside programme and the status of firms leaving the programme. Thus, it is impossible to know if those firms now “independently operational” owe this status to having participated in the programme. Though SBA figures indicate that in 1996 total revenue for firms that reported revenue exceeded US\$ 4.4 billion and total set-aside government contract revenue was approximately US\$ 1.6 billion, or 37.6%, of firms' total revenue.<sup>11</sup> The large number of firms still operational is at least an indication that most firms were not simply created to take part in the programme and then dissolved once their eligibility expired. On the other hand, the SBA audit revealed that income from set-aside contracts accounted for over one-third of participating firm’s profits (US SBA, 1996).

Defenders of the programme also claim economic benefits accrue from set-asides. According to the SBA:

“The most direct measure of benefits to the economy and to the Federal Government is through the market value of goods and services produced and the number and quality of jobs provided. The areas in which 8(a) certified businesses are contributing to the gross domestic product, the Nation’s tax base, employment, and the individual wealth and well-being of all Americans (US SBA, 1996).

This claim has to be treated with some skepticism. Undoubtedly, many of the reported benefits would also have accrued without the set-aside programme. Non-minority firms would have

<sup>11</sup> SBA 1996.

paid taxes, hired employees, and contributed to GDP. They would have done so without the cost of administering the set-aside programme—over US\$ 21million for 1996.<sup>12</sup> Therefore, even according to the SBA’s own analysis, the programme does not appear to have produced significant efficiency gains for the US Government. Instead, for US\$ 21 million in 1996, the Government steered roughly US\$ 5 billion in 27,000 contracts to 6,500 firms.

Furthermore, since the minority set-aside programme in the United States is designed to meet political ends, it has become highly politicized. The debate surrounding the programme, including how to reform it, is centred on political, not economic, issues. The set-aside programme has become a genie that once released has grown beyond the control of its creators. This is a powerful lesson for governments that are considering creating set-aside programmes.

### **SME share of procurement**

Even when there are specific set-asides for SMEs, the evidence indicates that larger companies obtain the lion’s share of contracts. This is primarily because transaction costs for both sellers and public procurement officers are often lower when the companies supplying the governments with goods and services are large. Since many of the costs are fixed regardless of firm size, SMEs start at a disadvantage in public sector procurement.

From the perspective of the SME, the costs, which do not include those associated with the actual production of the goods or services, are:

- Registering and qualifying as a supplier to the Government. Some of these conditions can be onerous and automatically exclude smaller businesses;
- Obtaining information on the goods or services being sought by the State;
- Cost of preparing a bid;
- Costs of supplying a performance bond or guarantee;
- Costs of complying with inspections at various stages of the process;
- Costs of financing goods and services supplied since many governments are notoriously slow payers;
- It is difficult or impossible to take legal action against the government.

For government procurement officers, the cost of dealing with SMEs include:

- Cost of evaluating a small bidder;
- Cost of monitoring many small suppliers rather than one large one;
- Costs of monitoring quality control from many small suppliers;
- Risks of a small company defaulting and the associated costs of dealing with default.

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<sup>12</sup> This figure includes field office expenses (US\$ 15.5 million) and management and technical assistance (US\$ 2 million), in addition to the US\$ 4 million budgeted for programme administrative costs (US SBA, 1996)

As a result, transaction costs on both sides of the buyer-seller relationship are high and SME participation is therefore low. The following discussion explores these issues in more detail.

## **Government and SME procurement**

The rising devolution of political power and control of procurement presents both opportunities and problems for the greater involvement of SMEs in government procurement. Municipalities and states often buy in quantities that are more manageable by smaller businesses. Where procurement is decentralized to local government, lower transportation costs often allow local SMEs selling to local governments to compete more effectively with larger firms. Local government officials may also better know the capabilities of local producers. In turn, there is a greater chance that SME owners know government officials—a case of familiarity breeding facility. Besides economic considerations, there is a greater political incentive for local governments to buy locally, and this could mean greater involvement of SMEs. Local governments should have a clear incentive to favour the local producers.

However, the problem with purchasing by local governments is that they often lack qualified staff. For much of the developing world and Eastern Europe, this problem continues to present difficulties. While many central governments have increasingly decentralized authority and money, this move has not always been matched by stronger capability at the local level. As a result, the attendant problem, especially for agencies with unqualified or inexperienced staff, is that decentralized, local procurement is harder to monitor, so that transaction costs rise.

Most government agencies at the central as well as at state and municipal levels require that potential bidders on contracts be pre-qualified. This policy ensures that companies can successfully complete the procurement contracts upon which they bid. However, the qualification criteria and the process that must be completed are often so onerous and time consuming that most SMEs are discouraged from even entering the bidding for procurement contracts. In order to discourage SMEs less, it might be useful to have different pre-qualification processes at different levels of government or for different values of contracts. It seems clear that larger, more complex projects should require a more extensive qualification process than smaller, local projects. Conversely, having the same pre-qualification requirements for all sizes of contracts imposes unnecessarily high transaction costs on all parties. It is quite conceivable that smaller companies could supply low-value contracts more efficiently than large ones.<sup>13</sup> However, for low-value contracts, fewer companies will be willing to bid if the qualification process is time consuming or costly. That is, the higher the cost of entering the process as a percentage of the potential profit, the riskier that process becomes. Most IFIs and governments recognize these issues in that there are different requirements for contracts of different sizes. However, there is little standardization across regions or even across countries within the same region and not much transparency in procedures.

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<sup>13</sup> Many scandals in the US Government over procurement costs, including toilet seats supplied to the Defense Department, result from large companies mechanically applying overhead accounting costs to low value items. Since larger companies' overheads are higher, items that have low value incur large "add-ons." This would not happen if smaller firms were used in procurement of such items. The example is illuminating because the Defense Department has particularly rigorous pre-qualification requirements that might well discourage SMEs bidding on contracts.

One solution could be to give banks and insurance companies that guarantee government contracts a bigger role in determining appropriate qualifications for bidders on larger contracts. Not only would this remove the responsibility from governments, but it would likely make for greater uniformity and transparency in all government contracts. For smaller contracts, the question of whether pre-qualification is necessary at all must be addressed. In the private sector, small suppliers of large firms do not have to go through pre-qualification; rather experience reveals the ability and reliability of smaller suppliers. Furthermore, in some industrial countries, larger firms assist small suppliers to ensure that their quality and delivery standards are met. This approach holds much promise for involving SMEs in government procurement. The guarantee issue has ramifications beyond the SME sector. No matter the type of contract, whether it be for goods or services, governments almost always insure themselves against non-performance of the contractor. Before bidding on a project, contractors must obtain a guarantee from a bank, insurance firm, or other financial institution, providing insurance against the value of the contract.

### **Contract guarantees**

There are two main types of guarantee: those based on *performance* and those based on *demand*.

Under *performance guarantees*, a financial institution warrants that all the terms of the contract between the Government and the contractor will be successfully completed. The guarantee, which in the United States normally costs about 1% of the amount guaranteed, contains the criteria as well as the adjudicating conditions that determine success. Non-compliance must be confirmed by a third-party or by the guarantor. If the contractor is found to have failed to have completed the contract as specified, then the guarantor has the option to either pay the Government the amount guaranteed or to find and pay another contractor to complete the project. The amount guaranteed varies from 100% in the United States to 30% or less in Europe, where other forms of guarantee are included to reach the total value of the contract. Asia has shown the fastest growth in performance-guaranteed contracts, while this type of guarantee is not widely used in Latin America, mostly because of statutory issues.

*Demand guarantees* typically cover a smaller portion of the contract. They require a payment to the Government ranging from 5 to 15% in the event of non-performance. Demand guarantees are exactly that. They are payable upon demand and thus can be called without identifying the specific conditions that the contractor violated. Thus, the Government can declare that the conditions of the contract have not been met and demand payment from the guarantor. The only recourse for either the contractor or the guarantor is to take legal action.

For SMEs, performance guarantees have several advantages. Most importantly, the insurers are more concerned with the contractor's ability to complete the project than with its ability to repay the insurer if the guarantee is called. In the United States, performance guarantees are based wholly on the contractor's perceived competence and not on collateral. This type of reduction in collateral requirements would greatly benefit qualified SMEs. It also would assist the Government since the pre-qualification is performed by the guarantor, thereby reducing transaction costs. An added bonus for SMEs in the United States is that payment of ors also is guaranteed by the insurer. Since most sub-contractors are SMEs, this is a substantial benefit.

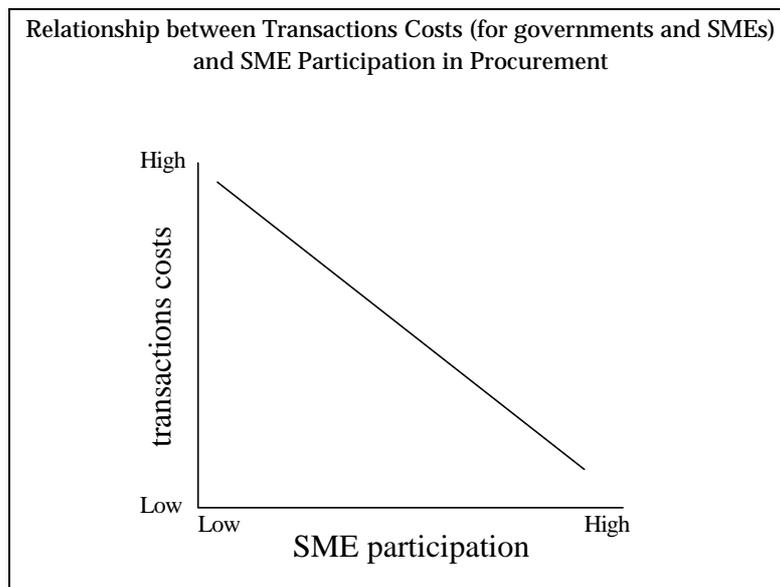
### **Reducing transaction costs**

A disadvantage for government agencies in contracting with SMEs is the high transaction costs inherent in dealing with small firms. Rather than contracting with one large firm, contracting agencies must duplicate their efforts with several smaller ones. This raises a number of issues:

What methods can be used to reduce these transaction costs and bring more SMEs into the procurement arena?

Should these methods be direct or indirect?

How far should IFIs go in influencing local government policy or even bypassing local policy entirely in the name of SME assistance?



One of the indirect possibilities is to foster SME cooperatives and business organizations. These associations can counter the disadvantage of higher costs and increase SME involvement in government procurement by significantly lowering the high cost of contracting with many small producers that usually discourages government from considering smaller firms.

## Overview of procurement regimes in Latin America

The general process of public procurement, gleaned from available information, indicates that procurement regimes are similar amongst governments of Latin America and adhere to standard government practice throughout the world. Generalizations are difficult and more so here. Yet, in the case of procurement policy even examining a specific country's official public procurement regime may not give an accurate picture. Theory and practice must be recorded and examined side by side to produce an accurate picture.

In any event, available information allows at best an estimate of actual practice. Public procurement in Latin America has not been the subject of extensive analysis or research. Indeed, for four countries in the region, Colombia, Panama, Uruguay and Venezuela there is no definition of the term procurement in national legislation.

The best attempt at a regional overview is a 1998 Inter-American Development Bank inventory of regional procurement procedures.<sup>14</sup> The quantity of information omitted in the inventory is striking. Literally, the absence of information speaks volumes about the state of research on public procurement in the region. However, the document is a first pass at the subject and will be revisited and revised during subsequent Summits of the Americas and meetings of its working group on government procurement. Though it may come to light that procurement regimes are advanced and well functioning this is doubtful given the diminished and declining levels of government spending in general and spending on procurement systems and resources in particular. A more likely picture to emerge is along the lines the US Foreign Service economic officer's report on Nicaragua.

GON (*sic*, government of Nicaragua) officials admit that in practice the procurement, process works imperfectly. One contract from the ministry of finance confided that, although the procurement law takes legal precedence over its regulations, they are inconsistent on several important points. The law allows procurement based on one bid, while the regulations require public tenders with only one offer to be nullified. The law does not allow private tenders, whereas the regulations specifically include them. Neither document covers consultancy contracts. The ministry of finance official commented that, although the ministry's central registry is supposed to include all potential contractors, ministries keep their own registries and draw from them for their procurement. One official at the *contraloria* confided that most ministries get around the need to use the ministry of finance registry by relying on the pre-qualification process. According to many observers, past procurement practice lacked transparency. Many business contacts have commented that winning gon contracts in the past often depended on payoffs and personal ties. Sources also complain that procedural irregularities were common in previous years. *U.S. Embassy Managua June 20, 1997. Government Procurement in Nicaragua: The Process and The Opportunities.*

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<sup>14</sup> National Legislation, Regulations and Procedures Regarding Government Procurement in the Americas. DRAFT. No. 7 February 1998. Working Group on Government Procurement, Free Trade Area of the Americas. Regional Operations Department 1, Regional Support Services Sub-Department, Office of Procurement Policy and Coordination, Department of Integration and Regional Programs, Division of Integration, Trade and Hemisphere Issues, The Inter-American Development Bank, Washington, D.C.

## **Centralization**

Decentralization of public procurement to ministries, departments, and State-owned enterprises (SOEs) is universal with one or two exceptions in smaller countries in the Caribbean.

## **Public competitive bidding levels**

All public procurement regimes in Latin America use both open (bids accepted from all parties) and private (by invitation) bidding and, in limited circumstances, direct purchasing. The method employed varies with the amount of the expenditure, size and complexity of the good or service as well as the universe of suppliers. The amount at which public bidding for contracts is required varies widely. For example, in Colombia the limit above which procurement must be by public bidding is from 25-1,000 minimum monthly salaries or about US\$ 4,000-160,000. In Guatemala, public competitive bidding is mandated for all purchases over US\$ 161,000, while next door in El Salvador public bidding is required for purchases over US\$ 10,000. Each country allows direct purchasing without bidding for a narrow range of circumstances including a limited universe of bidders and national emergency. A few countries, most notably Chile, permit negotiation in place of bidding in some circumstances.

## **Guarantees**

Guarantees are most commonly required for foreign firms though some countries require them for all firms. Guarantees are often required with the bid as an indication of "seriousness". In a few countries such as Ecuador, a 5% guarantee is required for all government contracts, but the military does not accept insurance guarantees. In other countries such as Nicaragua, guarantees do not appear to be used. The average throughout the region appears to be a 1 to 5% guarantee, or bond, accompanying a bid and a 10 to 15% guarantee upon acceptance.

## **Pre-qualification**

Pre-qualification requirements are used by most countries. Formal requirements are rare and usually reserved for complex and large projects. Most countries allow a case by case application of pre-qualification requirements determined by the ministry or department conducting the procurement.

## **Registration**

Most countries in the region have some form of registration for suppliers. In a few countries, the registry is centralized usually in the ministry of finance, as in Chile. In most countries, there are several registries in addition to a central registry, for example as mentioned in Nicaragua. In the remaining countries, such as Peru, firms must register with individual ministries. In Colombia, firms must register with the local chamber of commerce to be qualified, classified and rated. In Jamaica, registration is by product or service rather than by ministry; for example all firms selling office supplies to the Government must register with the purchasing department of the ministry of finance. Registration is most commonly limited to certain time enrolment periods, for example, once a year in Uruguay. A few countries have open enrolments.

## **Entities covered**

Procurement rules generally cover both the Government and SOEs, such as PEMEX in Mexico. However, in Ecuador the State-owned oil company is exempt. In many countries, for example Argentina and Chile, the military is exempt from government procurement regulations.

## **Preferences**

Most countries grant a passive preference for national suppliers. If all other things are equal between two bids, the contract is given to the national supplier or the supplier that incorporates the greatest portion of national supplies or manpower. In Brazil, locally manufactured telecommunications and informatics products receive preferential treatment in government procurement, and foreign firms may only bid to provide technical services if there are no qualified Brazilian firms. In Paraguay, government agencies must give a preference of 15% to Paraguayan bidders for construction of public works or the supply of services to the public sector.

## **Foreign assistance**

Procurements executed with funds provided by international agencies and foreign governments are generally subject to the rules of the institution providing the funds. Procurements executed with multilateral funds, for example the World Bank, are subject to that institution's rules concerning competitive bidding and participation even though the actual procuring is done by the local government. In the case of procurement rendered with foreign assistance funds, this is generally carried out according to conditions of the funding, usually requirements to use contractors or suppliers from that country. In several countries, this is an important consideration, for example in Nicaragua, approximately 45% of government projects are financed by bilateral assistance.

## **Electronic procurement and technology**

Only two countries in the region have electronic procurement systems - Brazil and Mexico. In Chile, a few ministries use electronic systems to disseminate bid information and announcements. In only a handful of other countries, Costa Rica for example, has the concept been given consideration.

## **Examples of innovative procurement initiatives**

### **Brazil: demand driven initiatives**

The most notable example of this innovation is in the State of Ceará in Brazil (Tendler, 1997). It represents an interesting example of "demand driven" procurement in which the State buys from SMEs while at the same time providing technical assistance to all phases of the businesses involved in procurement. In Ceará, the procurement of furniture for schools was organized in a manner which reduced some of the transaction costs associated with State agencies dealing with small firms. The State did not purchase from individual SMEs but through associations of small manufacturers. Technical assistance was provided to the firms by Brazil's small business assistance service (SEBRAE), which was paid a commission on the value of the contracts by the State. As a result, local manufactures were able to produce better quality furniture more cheaply than the State's traditional supplier, a large manufacturing firm in another state. Purchasing through the association of small firms

also enhanced quality control because it created peer pressure; if one producer produced inferior goods it imperiled the entire group's status.

Organizing the furniture producers also produced ripple benefits. The organization contained within itself a structure for disseminating money, enforcing obligations, gathering information, organizing training, and dispensing aid. Some of the administrative burden of providing assistance to the sector was thus transferred from the State to the sector, while at the same time enhancing productivity and the ability of the small firms in the programme to compete in other markets. The producer associations saw themselves as competitive entities able to compete on price and quality. Since the State was not obliged to accept the association's output, there were strong incentives for self-policing of quality and delivery.

This is not to say that the associations formed in Ceará were not political. A crucial and conscious strategy of the State agency, and the governor responsible for creating the association, was to create a political counterweight to the larger firms to generate political support for SME development, and to end traditional clientalist practices inherent in local procurement. Since the larger firms had been selling lesser quality goods at higher prices, the strategy was obviously successful. However, the danger in this is clear. The associations could mobilize to demand a "fair share" of government contracts and this could turn into another form of patronage. Unfortunately, attempts to replicate the experiment in other parts of the region were unsuccessful. There is also evidence that local mayors have wrested some control in procurement decisions away from the State. A follow-up study to determine the current fate of the SMEs, their business association, and other similar experiments in the area could turn this case into one that provides valuable lessons.

The Ceará case shows that targeting assistance towards helping SMEs deal with all aspects of procurement can pay dividends, although the costs of doing so may be high if the incentive structures are poorly designed. Targeted assistance that involves training often has an added benefit of *transferring* skills to the SME sector, on a demand-driven basis, which makes improvements in the SME sector sustainable.

Targeted assistance appears to be the best compromise between achieving efficiency goals and creating distortions. This approach minimizes distortions because it does not create new and unique advantages for SMEs. Rather, it helps level the playing field between large firms and SMEs. Finally, the effectiveness of these programmes is easily identified—an increase in SMEs winning competitive open bidding.

## **Social funds in Africa:**

Similar to Cear in idea but with a more direct basis for action are the Social Funds (SFs) and Social Action Programmes (SAPs) used by IFIs to fund basic investment and development programmes in marginalized communities in Africa. These projects combine poverty alleviation and job creation with project and sector objectives. These funds are applied in communities with high unemployment, where the vast majority of firms are either small or microenterprises and where the primary need is for basic projects. World Bank experience has demonstrated that procurement and disbursement are essential issues during the preparation and implementation of any project that involves community participation. However, World Bank policies for procurement and disbursement were designed to facilitate supply of goods, works, and services by large contractors and suppliers in an approach suitable for large investment projects but not always in the social sector or other smaller projects.

The World Bank's 1994 Procurement Guidelines therefore, include specific discussions of procurement in social sector projects. SFs fund local organizations, public or private, in a more flexible and transparent manner than regular government ministries. They are demand driven as in the Cear case and respond to funding requests from local agencies, but neither identify nor implement projects. SAPs, on the other hand, are designed as regular investment projects. The Government still has to implement the project but the World Bank helps build local level and works with local groups, both NGOs and governments. In many cases, governments simply lack the human and administrative infrastructure to identify, let alone, implement small and projects in poor often remote communities. SFs fill a gap that exists in most government structures in Africa.-.namely the absence of mechanisms to support local government, NGOs and other grass-roots organizations in carrying out participatory development activities.

The most successful of these is AGETIP in Senegal, which is now replicated in many West African countries. This public works and employment project created 11,103 jobs with an average duration of 30 days each. It has had low management costs and has involved many small-scale construction companies, often excluded from the implementation of public works in the past. Such a SF, if well integrated into governmental sectoral strategies, can help to create a true partnership between the central government and private and public organizations working at the local level.

The World Bank has identified conflicting or tedious bureaucratic procedural requirements resulting from the borrower's regulatory framework as a key constraint to effective project design. Innovations from these programmes include the use of vouchers in the Zambia Social Recovery project, where community groups were given vouchers instead of having funds dispersed. These vouchers were redeemable only at specified retail outlets and only for items associated with the project. This eliminated the need for disbursement and monitoring and speeded payment to the merchants most of whom were small or microentrepreneurs. This has wider application for targeting government procurement toward micro and small enterprises.

## **Buenos Aires: procurement at the municipal level**

Changes in the procurement practices of the city of Buenos Aires provide an illustrative example of the way that procurement practices can be reformed to address these types of bureaucratic requirements, thus easing the constraints for SMEs and producing substantial savings for the Government. In early 1996, Buenos Aires, which has a procurement budget of around US\$ 1 billion (30% of the total city budget) undertook an overhaul of its procurement procedures and practices. It

had evidence that prices on many municipal contracts were as much as 30% higher than those on the open market.

First, officials set out to eliminate “closed procurements,” where only a limited number of companies were allowed to bid for a contract, and greatly expanded commercial advertising of upcoming contract opportunities. Predictably, the number of companies submitting bids increased. Secondly, officials began using a database of “reference prices.” Before awarding a contract, officials check the latest market prices for any product or service and compare it with bid prices. When the city requested new proposals for an expiring contract to provide food services to 29 metropolitan hospitals, 34 companies offered competitive bids. The new contract was awarded for just under US\$ 32 million, or 47% less than the US\$ 59 million paid to the previous contractor for the same services.

Comparable savings materialized as the city awarded contracts in other sectors. Buenos Aires saved 37% on food services for public schools, 45% on garbage collection and public lighting maintenance, and 60% on contracts to run communal kitchens. Overall, the city saved US\$ 200 million in the first full year following the procurement reforms. The city also improved its relationship with suppliers by overhauling its payment system so that contractors were paid on time. Deficiencies in the previous system, in which payments were decentralized and issued by the unit that had purchased a service, led to chronic payment delays that contractors ultimately used to justify their higher prices. The city has now centralized the payment system through the creation of a single account managed by the general treasury office. This example, which is based on an article from the May 1998 issue of the Inter-American Development Bank’s publication *America*, provides some guidance for local governments hoping to reduce contract costs, and demonstrates that if contracts are awarded without competition, with little publicity and inconsistent rules for bidders, prices will be inflated.

### **Information costs and transparency for SME procurement**

In the more technologically advanced economies, governments can also reduce the transaction costs associated with gathering information. Even when detailed bid information is published in newspapers and trade journals, it is often not readily accessible to SMEs. It is beyond the capacity of many SMEs to undertake the time-consuming and expensive examination of various sources of information. Electronic dissemination, either through the Internet or by fax, is far more efficient.

The appropriateness of this approach depends upon the level of technological penetration. Use of telematics (combination of computers and telecommunications) based solutions is at the opposite end of the spectrum from the use of SAFs. On a national level electronic procurement systems are used by governments in the most developed countries as one would expect; however, the systems are also beginning to appear in more advanced developing countries, for example Mexico.

Moving to greater use of digital and electronic dissemination of information is an essential reform in the way government does business. It allows the government to reach more businesses with more information at less cost to both businesses and the government. It also makes the government more open and accessible to all business, not just those with staff dedicated to government relations.

The costs of increasing or introducing digital and electronic dissemination for the government are not high. They are usually more a diversion or reapportionment of current expenditure for dissemination while investment in technology and hardware are ancillary to general modernization and capital investment. Further, models in the industrialized world based on open systems and off-the-shelf

technologies are becoming readily available, for example General Electronic's Trading Process Network. In the US and other (more) developed nations, SMEs are being driven into electronic procurement by large private-sector firms. The US retail giant Wal-Mart now sources exclusively on-line and is soon to expand this to its foreign suppliers. SMEs that wish to work with Wal-Mart, or increasingly any large firm, are left no choice but to adopt electronic commerce. At the same time the drop in computer and telecommunications prices and the availability of open Internet-based systems has made the choice easier for SMEs.

The importance of using open Internet systems cannot be overstressed. The first attempt by the US Government to implement an electronic procurement system - the Federal Acquisition Computer Network or FACNET, was a failure because it was a closed or proprietary system. A brief review of what happened illustrates several important points about electronic procurement. A 1993 US Government review predicted that adopting electronic commerce for small purchases could save the Government US\$ 500 million a year. The Government then mandated the creation and use of FACNET for purchases between US\$ 2,500 and 100,000. Two years later less than 2% of federal procurements in the specified price range were accomplished through FACNET, and over 75 % of the procurements were actually below the US\$ 2,500 threshold. Moreover, barely 1% of all government contractors registered in the FACNET database.

The system failed because it was proprietary. In order to use it, firms had to invest in technology and software that would only work with FACNET. By contrast, open systems like the Wal-Mart and the new federal system allow users to format data once and gain access to other systems.

A more successful example is ELPRO, the European electronic public procurement system that will build and demonstrate on a number of sites (including a "virtual procurement region") regional procurement information, and partnership and business information networks. They are targeted at SMEs and include a range of free and paid-for Telematics services, from fax-on-demand services, electronic data-interchange and Internet services to demonstrate ways of establishing SME support networks on any Telematics environment in Europe. This will enable procuring entities to generate Telematics, support services for local SMEs at the same time as capturing the efficiency benefits of electronic procurement for themselves.

The ELPRO example from the EU, while perhaps the most ambitious attempt to lower information costs, is not unique. Every industrialized nation has a programme similar in design if not in scope. Moving to greater use of digital and electronic dissemination of information is an essential reform in the way government does business. It allows the government to reach more businesses with more information at less cost to both businesses and the government. It also makes the government more open and accessible to all business, not just those with staff dedicated to government relations.

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A good example of how this could work in developing countries is provided in Mexico, where the Government recently initiated an Internet-based procurement system, named *Compranet*. This system also includes limited access to state procurement. The move towards electronic and digital dissemination, bidding, and registration also has a secondary benefit for the SME sector in that it

increases the use of technology. In the longer term this has the potential to make SMEs more competitive locally and internationally.

Finally, governments can remove specific barriers to SME participation, for example in insurance pooling. Where the cost of obtaining insurance may be prohibitively expensive for SMEs, often precluding their bidding on government contracts, the government can help pool all bids or bidders, thus spreading the risk and lowering rates for SMEs without raising the rates for other participants. This puts SMEs on an equal footing with larger enterprises that have lower insurance costs.

## How small is too small when determining a threshold for competitive bidding?

If government were to adopt recent advances in electronic commerce, the answer is no amount is too small. Any purchase of standard goods can be competitively bid, processed, and paid for in less than 5 minutes.

The following scenario illustrates how. A government agricultural extension agent needs to purchase test tubes. The employee opens a web browser, and goes to the government, ministry, or agency procurement site. This can be done at home, at the office, or in the field. Once at the site the employee enters a password, and other relevant information, perhaps a departmental code, project budget number, or whatever is deemed necessary. The employee either goes to the laboratory equipment page or enters a few key words in a search interface. Depending upon how well the user constructs the search, and the availability of the product, there will be either a short or a long list, which can be further winnowed. The user selects the product description that best fits the need, enters a delivery address, and then enters his or her government credit card information. The bidding program at the government procurement office verifies that the user, budget, address, and credit card information match. It then automatically compares prices for the selected item from a catalogue of suppliers and factors in shipping costs to determine the best or, perhaps the three best options. The user is then returned a few options for delivery time and price. The user selects his choice and payment is made to the vendor.

From the vendor perspective, the system has several advantages. First, most SMEs are moving to electronic commerce to work with large firms. Wal-Mart, General Electric, automakers, and major retailers have embraced electronic commerce and are demanding that sub-contractors and vendors use it. If the central government adopts an open standard\* then SME would likely already have taken the necessary steps to take part in government procurement or would soon be doing so. The cost of entering government procurement then becomes essentially insignificant. Firms that are not doing this would likely not be selling to the government in the first place. Second, the use of electronic funds transfers, of which credit cards are an example, means no delays in payment. The infrastructure and institutions, banks and credit card companies, for using this electronic payment system is already in place. The system is funded and this funding mechanism is accepted any merchant accepting credit cards pays a percentage of sales. This system is also less susceptible to human intervention in the procurement process since purchase decisions are made autonomously by computer as opposed to budget officers.

From the government's perspective, the system has several advantages. It automates much of the procurement process reducing the cost and speeding the process. It provides a digital trail for audit and supervision. The system also opens government procurement to more firms increasing competition and lowering prices. The infrastructure—the hardware and more importantly the software—is commercially available. For example, Microsoft and Lotus already provide most of what is needed in prepackaged software. An open system would work on a variety of platforms allowing all branches of government and vendors to access the system without upgrading or changing hardware and little or no change in software. Similar systems are extensively used in the private sector. In fact, a government system could work as nothing more than an interface with established private procurement centers. For example, the government could link to Wal-Mart's collection of vendors. Though, this might not work for small individual purchases it holds promise for larger departmental purchases and is a model of public-private linkages.

\* An open standard or system is one that can exchange information with another system. For example, HTML, the code behind web pages, which can be used on Unix, Macintosh, and Windows systems.

## **Role of the international financial institutions**

The goal of IFI procurement should remain efficiency, not promotion of a particular policy. However, identifying whether there might be any built-in biases that make procurement by SMEs more difficult is useful. In some cases this could be achieved by clarifying the rules that govern procurement and guarantees. In other specific and narrowly defined cases, components of the program could be targeted toward SMEs. In other cases, a more proactive role in promoting information dissemination could bring SMEs into bidding for IFI projects.

In terms of built-in biases, the issue is more one of subcontracting than of procurement. For example, there is a high degree of vertical integration and limited specialization among larger enterprises in Latin America and hence, an underdeveloped subcontracting system (Berry, 1997). Firms that could experiment with subcontracting appear to be resorting to imports rather than domestically subcontracting inputs. Though government intervention is often cited as an important catalyst in encouraging subcontracting by large firms with SMEs in East Asia, it does not appear that procurement was ever used as a policy instrument. East Asian nations were successful in improving technical capability and quality among SMEs, but to the degree it involved subcontracting, it was initiated by the large firms themselves rather than by the Government. There is, however, an experimental programme in Brazil in which the state's SME organization, SEBRAE, has initiated a programme to upgrade the capabilities of small suppliers to meet the demands of large producers. It includes training for both contractor and suppliers on the technical and the behavioural changes necessary to create successful linkages.

A good example of how targeting could occur without compromising efficiency is provided by an Inter-American Development Bank project: the National Highway Program Loan to Trinidad and Tobago. The loan includes a component for the routine maintenance - landscaping and small repairs - of the entire national road network. Due to the nature of the work, most of it will be performed by local SME contractors and microenterprises. The loan description states that it will include works that "will be contracted out to district contractors, microenterprises and roadmen".

There are further possibilities for IFI involvement to promote SMEs in contracts of this type. For example, IFIs could make the Government and executing agency aware of any SME and microfinance support programmes in advance and attempt to incorporate these as part of the contract. Payment for these services should be demand driven and be linked to successful SME participation.

More generally, it is clear that while IFIs should not use procurement as an instrument of SME promotion, it is nevertheless incumbent upon them to help make the processes as transparent as possible and to remove barriers to SME participation. The extent to which IFI requirements should

take preference over local government ones depends on the level of development in local policy. In general, IFIs should not presume to dictate policy unless it is clear that the existing system is wholly inefficient, corrupt or unnecessarily limiting. IFIs might, even in these cases, prefer to negotiate or discuss other options with the Government. Although rigid rules for procurement are undesirable, guidelines for procurement officers regarding issues that could discourage SME participation might be desirable. Some identified in previous sections include size-appropriate prequalification, performance guarantees and information dissemination. Furthermore, there is the potential for coordination between programmes aimed at assisting SMEs through technical services and training and procurement arising from IFI loans. A pilot or experimental programme in this area could reveal important lessons for future promotion of SMEs in the area of procurement.

Currently, the international development community has little information on the full-range of effects of its procurement and the procurement carried out by projects it funds. This hampers the evaluation of procurement procedures generally and, in particular, makes assisting SMEs in this area much more difficult. Therefore, the IFIs should sponsor the collection of information on procurement and SME involvement. This information could help design better support programmes and remove barriers to SMEs participation in procurement.

### **A checklist of issues for evaluating SME involvement in projects**

1. Does the project have SME components?

If no, is this because the project is inappropriate for SME participation? If so, no further consideration is required.

If no, is this because of artificial constraints, for example project bundling? If so, the appropriateness of the constraints needs to be explicitly defended on efficiency grounds.

2. If the loan is open to participation from SMEs, is there coordination between the IFI, the Government and local SME-assistance programmes?

Is there demand among SMEs for assistance? How is this demand evident?

If so, is there provision for technical assistance by the financing agency, local support organizations, or businesses?

3. Have SME support or business groups been consulted in project, loan, and bidding preparations?

Is there a role for these organizations in the dissemination of information?

Is there a role for these organizations in identifying and pre-qualifying participants?

Is there a role for these organizations in organizing procurement?

4. Has the bidding process been rationalized for SME involvement?

Simplified paperwork

Elimination or restructuring of guarantees

Lowered cost of involvement including government fees

Initiatives to reduce costs of participation

Review of antitrust or other legislation that may prevent joint participation

5. Does the financing institution accept either demand or performance guarantees. Has this been widely publicized?

6. Are the thresholds, below which guarantees are not needed, widely known?

7. Is the standard dissemination procedure for information on contracts appropriate and sufficient to encourage SME participation?

Language

Regional news sources

Radio or other sources

8. Has the use of technology to provide information on the contract been addressed?

Appropriateness

Technological assistance or advice to Government in conjunction with other loans

Technological assistance or advice to SME sector in conjunction with other loans

9. Have financing issues been addressed?

Have steps been taken to ensure timely payment for contracts?

10. Are there IFI programmes for SME assistance that could be involved in procurement?

Have the anti-corruption and dispute procedures been widely publicized?

Are the procurement policies in place unnecessarily biased against SMEs? If so, is there a place for meaningful discussion with the Government?

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## **ANNEX C**

### **PUBLIC PROCUREMENT MARKET OPPORTUNITIES FOR SMALL AND MEDIUM ENTERPRISES (SMEs) IN SOUTH AFRICA\***

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## **Public Procurement Market Opportunities for Small and Medium Enterprises in South Africa**

### **INTRODUCTION**

#### Small business in the South African context

South Africa's 40 million people are spread over 2,000-odd local authorities, with about 6% of the population living in urban areas and 40% in rural villages and on farms. It has been estimated that there are 800,000 small, medium and micro enterprises in South Africa, aside from the 2 to 3 million people involved in different self-employment "survival activities".

Accordingly, in the South African context, reference is usually made to small, medium and microenterprises (SMMEs) and not exclusively to small and medium enterprises (SMEs).

The small business sector absorbs nearly 44% of the people formally employed in the private sector, and it contributes about 32.7% to the country's gross domestic product (GDP). Given the significant increase in the number of registered enterprises since the 1994 General Elections, the sector holds further promises in order to generate economic growth.

However, millions of people are trapped in survivalist activities with incomes below the poverty level. Various research reports clearly show that many black entrepreneurs are confined to low value-added activities with little prospect of graduating to higher levels of production.

The breakdown of employment as reflected in Appendix 1 shows that employment derived from this sector is relatively low when compared to other countries.

The case for employment creation and wealth distribution through small business is based on sound economic sense. Small businesses are labour intensive, need relatively little capital and use local resources. By channeling scarce capital resources to the small business sector, particularly in a developing economy like ours, employment opportunities can be maximized and people are enabled to contribute to the development of the economy.

The findings with respect of the contribution of small and medium-sized enterprises to the GDP and employment are presented on Appendix 2 and 3. The numbers refer to the formal economy and do not take into account the so-called "informal sector". The size classes are consistent with the national definition, with "small" including "very small", but excluding "micro" and "survivalist". State owned enterprises have been included in the analysis.

A report by an international consulting company confirmed earlier studies, that South African manufacturing was generally un-competitive, with a few exceptions in sectors that processes competitive primary products.

The reasons for poor performance by most of South African manufacturers included:

- Poor productivity of capital and labour due to weak management and undertrained workers;
- A low level of commitment by industry to human resource development, research and development, and the promotion of best practice;
- Low levels of rivalry due to protection from imports and partly to uncompetitive practices;
- Poor supply-chain relationships, a very weak small and medium firm sector;
- Excessively high input costs;
- A lack of sophistication in export marketing;
- Industry associations focused on milking the Government rather than providing services to members.

In the current macroeconomic context, it is imperative that significant investment is made in SMMEs in order to create both short- and long-term capacity for labour absorption and output growth, as well as to improve income generation and redistribution. These objectives are recognized in the main development and macroeconomic strategies adopted by government; i.e., the Reconstruction and Development Programme (RDP) and the Growth Employment and Redistribution Strategy (GEAR).

#### **GEAR'S PROVISIONS FOR SMALL AND MEDIUM-SIZED ENTERPRISE DEVELOPMENT**

The promotion of small, medium and microenterprises (SMMEs) is a key element in the Government's strategy for employment creation and income generation. Due to obstacles of the past, the SMME sector is severely under-developed. A major effort will be made to operationalize and implement the policies outlined in the White Paper on small business promotion. The relevant legislation is under consideration and various programmes and institutions have been established to give effect to the strategy, including :

- The Small Business Centre attached to the Department of Trade and Industry;
- Ntsika Enterprise Promotion Agency to provide non-financial assistance;
- Khula Enterprise Finance Limited for wholesale loans;
- Khula Credit Guarantee Limited for loan guarantees;
- A pre-shipment export finance guarantee facility to expand access to working capital; and
- The Competitiveness Fund for consultancy advice on technology and marketing.

The Simplified Regional Industrial Development programme will be continued in a modified form as a grant programme tailored to the needs of small and medium-sized firms.

## Meeting new challenges

Unlike many other developing and industrialized countries, South Africa did not have a comprehensive, targeted small-business support strategy prior to the mid-1990s. The search for a new small-business support strategy started in April 1994, when the new Government was elected into power. In a country-wide consultation process key principles of such a new strategy were debated and resulted in the drafting of a discussion paper in September/October 1994. This paper was to pave the way for a two-pronged process, viz.

The preparation of a Government White Paper on a national framework for small-enterprise promotion in South Africa;

The shaping of a 10 to 20-year process of restructuring the small-business sector of the country so that it can become a vibrant, strong subsector of equal significance to big business, the parastatal sector, Government and civil society.

It was already clear at that stage that, given the neglect of the sector (and, in particular, target groups like women, the disabled, the youth and those rural areas as well as those formerly politically disadvantaged), this task would be vast, and visible success would initially be slow.

It was also realized at the outset that success in such a transformation of the small-business sector demanded top-down and bottom-up initiatives. Government would have to give the initial impulses, but lasting success would depend on the response and commitment at grass-roots level.

The discussion paper, realized at the end of October 1994, was the start of an intensive phase of consultations, decision-making and institution-building. Thus,

During November/December 1994 the draft document was widely discussed throughout the country, with recommendations forming the basis of the revision which resulted in the White Paper on a National Strategy for the Development and Promotion of Small Business in South Africa, passed by Government in March 1995.

At the end of March 1995, 2,000 representatives from small businesses and SMME-support agencies all over the country (and visitors from overseas) met in Durban to discuss and endorse that national framework during 2 days of intensive workshops.

Immediately after the President's Conference on Small Business, the Centre for Small-Business Promotion (CSBP) was established at the Department of Trade and Industry, as part of a new Chief Directorate; its task was to co-ordinate the implementation of the framework within central Government, to mobilize the necessary funds and supervise the establishment of other new institutions, proposed in the White Paper.

Following the establishment of the centre, two key wholesale implementation agencies were established (Ntsika Enterprise Promotions Agency, or Ntsika, for non-financial support and Khula Enterprise Finance Agency, or Khula, for financial support); legislative, legal

and financial factors delayed the process of formation so that both institutions only functioned formally in 1996.

A National Small-Business Enabling Act was passed by Parliament in 1996, laying the legal foundation for Ntsika and the National Small Business Council (NSBC) and providing clear definitions of different types of small, medium and microenterprise.

The fifth of the institutional pillars proposed by the White Paper, the National Small-Business Council (NSBC) also became operational in 1996, as the umbrella body to integrate the Provincial Small-Business Councils established in each of the 9 provinces as legitimate voices for small business interests.

Parallel to all these developments the different provincial governments each set up a small-business desk, i.e., a section within their economic affairs departments to monitor and strengthen the implementation of the new national support strategy and to supplement it with regional initiatives.

### **Developing support programmes**

The White Paper had proposed the development of a wide range of support programmes for small enterprises. These were to address the key issues discussed at the 1995 conference and identified by entrepreneurs. They included improvements in the access to information, advice, finance training, markets and export opportunities, upgrading of business infrastructure, streamlining of the regulatory framework and improved networking.

While the new institutions created in 1995/96 were busy with the very basic task of getting established (i.e., attracting and training staff, developing systems and building and implementation capacity), they also started to develop some of the programmes that were to address these issues. In this regard, the following are significant:

During 1995, Government as co-shareholder of the Small-business Development Corporation (SBDC), was also involved in the restructuring of the SBDC, according to which the State's share was reduced to 20%, and arrangements were made for the eventual transfer of funds from the SBDC to the State (to be used for, among others, the funding of Khula).

Ntsika, which is the implementation agency of the Department of Trade and Industry's small-business development strategy, initiated the national Local Business Service Centre (LBSC) programme, supporting 27 accredited service centres by early 1996.

Khula adjusted the SBDC's old bank-credit-guarantee scheme to become a new credit-guarantee scheme, accessible to micro- and small-loan suppliers; it also developed new programmes for the strengthening of microfinancing through non-governmental organizations (NGOs).

The Centre for Small-Business Promotion initiated a process of public-sector procurement review that resulted in a Green Paper revising tender procedures as well as the whole approach of state departments towards SMMEs; it also started a general review process of legislation affecting small enterprises.

The National Small-Business Council, which initially was slow to get going due to a lack of funds, was heavily involved in networking with the different provincial councils and the evolution of a common approach towards the role of the NSBC and the provincial councils.

Parallel to these broad issues and policy thrusts, each of the new institutions became involved in a range of other projects and programmes considered for SMME support. Some of them were proposed by NGOs, others by private-sector institutions, some by foreign donor agencies and several directly by the new support agencies or by government departments.

Proposals included, for example:

Establishment of Manufacturing Advisory Centres (MACs);

Support for small farmers;

New training programmes to strengthen entrepreneurship in secondary and tertiary training bodies;

Tax and other incentives to stimulate the establishment of new industries;

Incentives to encourage exports;

Support programmes to assist women entrepreneurs;

Steps to reduce the disadvantages disabled people face in business;

Programmes to help small building contractors strengthen their ability to compete for larger contracts;

The development of a central information-exchange system giving access to all associated support agencies (like Local Business-Service Centres).

The development of each of these programmes is a complex task, which requires consultation with all interest groups, joint planning with different service suppliers and the handling of funding issues as well as implementation tasks.

There are also references to certain core programmes which are, in fact, in place; for example

Local Business-Service Centres;

Export support;

Credit-guarantee facilities.

## **Development and promotion of small business in South Africa**

### **White Paper on the National Strategy for the Development and Promotion of Small Business in South Africa**

The White Paper on National Strategy for the Development and Promotion of Small Business in South Africa (1995) had as its primary objective the creation of an enabling environment for small enterprises. Its underlying objectives were to :

- Facilitate greater equalization of income, wealth and economic opportunities;
- Create long-term jobs;
- Stimulate economic growth;
- Strengthen the cohesion between small enterprises;
- Level the playing fields between big and small business.

The elements of a support framework are identified as being:

- Creating an enabling legal framework
- Streamlining regulatory conditions
- Access to information and advice
- Access to marketing and procurement
- Access to finance;
- Physical infrastructure;
- Training in entrepreneurship, skills and management;
- Industrial relations and the labour environment;
- Access to appropriate technology;
- Encouraging joint ventures;
- Capacity building and institutional strengthening;
- Differential taxation and other financial incentives.

The White Paper makes the observation that “small enterprises usually regard market constraints and the inability to sell their products and services as one of the most serious obstacles to the starting of business and growth beyond mere subsistence level” and goes on to state that Government will address this issue by:

- Making the Competition Board more accessible to SMMEs and to take the necessary reform steps to prevent restrictive practices;
- Considering steps which could include tax incentives, procurement quotas, voluntary commitments, etc. to motivate the big business sector to systematically expand its links with small enterprises;
- Propagate and encourage the simplification of tender procedures;
- Further adjust public procurement practices at central, provincial and local government levels and by parastatals in order to facilitate the granting of some

proportion of contracts to black-owned or controlled enterprises, and encourage small business tendering for such contracts.

- Facilitate, where necessary the ability of small enterprises to meet the conditions of such contracts.
- Encourage the development of more appropriate small enterprises export-support programmes.
- Providing access to raw materials and quality services at reasonable prices.

The White Paper concludes that the funding support programmes in an economically responsible way constitutes the biggest challenge of the whole national strategy. In this regard, a few fundamental principles are put forward, which could help to meet the financing challenge viz.:

- Funds have to be mobilized from the widest possible range of sources, including local public and private sources, as well as foreign assistance.
- In order to achieve the type of breakthrough envisaged in this White Paper, allocation for SMME support in the central Government's budget should increase to at least about 1% of total budget spending for the next decade.
- SMME support has to be closely integrated with all other development support programmes of the RDP.
- All the programmes have to be based on strict financial discipline and have to be structured in a way that self-help and own financial contributions by entrepreneurs are encouraged and gradually increased.
- All targeted assistance should include sunset clauses and safeguards against built-in cost escalation.

## WHITE PAPER ON NATIONAL STRATEGY FOR THE DEVELOPMENT AND PROMOTION OF SMALL BUSINESS IN SOUTH AFRICA

### **Key objectives of the national small-business strategy**

Create an enabling environment for small enterprises;  
Facilitate greater equalization of income, wealth and earning opportunities;  
Address the legacy of apartheid-based disempowerment of Black business;  
Support the advancement of women in all business sectors;  
Create long-term jobs;  
Stimulate sector-focused economic growth;  
Strengthen cohesion between small enterprises;  
Level the playing fields between bigger and small business as well as between rural and urban businesses;  
Prepare small businesses to comply with the challenges of an internationally competitive economy.

### **Ten key principles underlying the Government's national small-business strategy:**

The strategy is based on a joint vision for big, medium and small business in South Africa.

All the segments of the small business sector – survivalists, micro, small and medium enterprises - need attention.

The business efficiency and competitiveness of the whole small-enterprise sector has to be developed, with due recognition of social, financial and other compliance standards relevant to an internationally competitive economy.

An integrated support strategy has to give attention to both the supply and demand side of small-business activities.

Black advancement in the enterprise sector is a key factor in all spheres of the strategy; special emphasis also falls on other marginalized or disadvantaged groups.

The scarcity of public funds demands careful prioritization of support programmes and the skilful matching of different resources.

Support policies will be sector focused and targeted with strict control of the application of public funds and full recognition of the market orientation of our economy.

The institutional framework for small-business support has to be restructured in order to reflect the evolving institutional diversity, the provincial thrust of policy implementation and effective bottom-up and top-down cooperation and coordination.

Ultimate responsibility for the national strategy rests with the Department of Trade and Industry.

The private-enterprise sector, cooperatives, NGO's, business associations and foreign assistance programmes all have a critical role to play in an integrated small-business strategy.

### **Defining and classifying small business**

Small business is a term used to describe a diverse range of activities, differing in terms of size and sector, ownership structure and formality, as defined and classified for the following reasons:

Policy makers and service providers need to know which target groups they should assist so that they can develop better policies and services for small businesses.

Small-business owners need to know in which target group they fall so that they can determine for which support measures they qualify.

Researchers need a common understanding of what small business is so that they can measure and compare its performance in different regions and sectors and with other countries.

For example, survivalist enterprises are best served with interventions that complement the community development approach, whereas microenterprises need increased access to finance and information to help them graduate into the small-enterprise league. Formal small enterprises need an individualized package of technical assistance, training and credit resources.

The National Small Business Act (Act 102 of 1996) provides the first national definition of small business. The act describes a small business as a separate and distinct business entity. It cannot be part of a group of companies. If it does have subsidiaries and branches, they must all be included when measuring its size. A small business should be managed by its owner or owners and can therefore be a natural person, a sole proprietorship or partnership, or a legal person such as close corporation or company.

The definition in the Act includes agricultural activities and activities of professionals. In this respect it is essential to determine the criterion to distinguish between self-employed on the one hand, which should be considered as included in the definition, and casual labour, which should be excluded: Self-employment should be performed for own account and risk. By applying this criterion, it becomes clear that economic activity based on an authoritative relation, such as domestic work and selling goods for somebody else, should not be considered as self-employment.

The Act classifies small businesses into 4 categories: micro, which includes survivalist enterprises; very small; small; and medium. Therefore, reference is usually made to small, medium and microenterprises (SMME's) in the South African context and not exclusively to small and medium enterprises (SME's). To classify small businesses, the Act has adopted the employment, turnover and assets and the enterprise must comply with all three.

A description of the different size classes is indicated in table 1:

**TABLE 1: THE SOUTH AFRICAN SMME SECTOR**

(Extract from the State of Small Business in South Africa)

The National Small Business Act (Act 102 of 1996) classifies SMMEs according to five size categories, ranging from survivalists to medium-sized.

***Survivalist enterprise***

Survivalist enterprises are enterprises with no paid employees and minimal asset value. These enterprises generate income below the minimum income standard or the poverty line, and their main aim is to provide minimal subsistence means for the unemployed and their families. Most entrepreneurs in this category are involved in hawking, vending, subsistence farming, etc. In the National Small Business Act, the survivalists sector is considered to be part of the micro-enterprise sector.

It is estimated that the survivalists sector constitutes 23,3% of all enterprises recorded in South Africa and contributes approximately 3,0% of total employment. This category has great potential for the absorption of unskilled labour, as has been confirmed by the correlation between the unemployment rate and the amount of self-employment in unregistered, mainly survivalists, enterprises that prevails in informal settlements and rural areas. The largest number of South Africa's survivalists enterprises are located in KwaZulu - Natal, Gauteng, the Eastern Cape, and the Northern Province (23%, 21%, 17% and 11% respectively).

***Micro enterprise***

Micro enterprises have a turnover below the VAT registration limit (presently R150 000 per annum) and have less than 5 paid employees. These enterprises tend to lack formality in terms of registration for tax-purposes, labour legislation, business premises and accounting procedures. Examples of micro-enterprises are spaza shops, mini taxis, and household industry. Micro enterprises without employees constitute approximately 31,0% of all enterprises and are estimated to contribute 3,9% of total private sector employment, while micro enterprises with 1 - 4 employees constitute approximately 16,4% of all enterprises and contribute about 6,8% of employment. The largest numbers of micro-enterprises are located in Gauteng, KwaZulu-Natal, the Western Cape and Eastern Cape (34%, 18%, 14% and 10% respectively).

***Very small enterprise***

Very small enterprises employ fewer than 10 paid employees - but in the mining, electricity and manufacturing and construction sectors, fewer than 20. They operate on the formal market and usually have access to modern technology. The smallest of these enterprises is self-employed owners with no employees, such as artisans and professionals. Very small enterprises make up an estimated 19,7% of all enterprises recorded and account for 13,3% of employment. The largest concentrations of very small enterprises are found in Gauteng (42%), the Western Cape (16%) and KwaZulu-Natal (15%).

***Small enterprise***

Small enterprises have fewer than 50 paid employees and are more established, with more complex business practices. Usually, the owner does not manage the enterprise directly, and a secondary co-ordinating mechanism has been put in place. Growth from a small to a medium-sized enterprise requires an accumulation of resources as well as a set of appropriate incentives for enterprise expansion. Small enterprises constitute an estimated 7,6% of all enterprises and contribute 19,9% of employment. Almost 50% of small enterprises are located in Gauteng (46%). A further 16% and 12% are located in KwaZulu-Natal and the Western Cape, respectively.

***Medium enterprise***

Medium-sized enterprises are enterprises with up to 100 paid employees - although in the mining, electricity and manufacturing sectors, up to 200. Although usually still controlled by an owner/manager, the ownership and management structure is more complex. Often the decentralisation of power to an additional management layer and a greater division of labour are the main differences between small and medium-sized enterprises. A more complete separation of ownership and management is often the natural barrier between medium and large enterprises. Medium-sized enterprises make up 1,4% of enterprises recorded and account for approximately 13,8% of employment. Medium-sized enterprises are concentrated in the metropolitan areas of Gauteng, KwaZulu-Natal and the Western Cape.

For practical purposes, the number of employees has been made the most important criterion, except for microenterprises where turnover is the most important. The turnover and asset criteria are flexible enough to take into account large differences across various sectors of the economy.

In general, the quantitative criteria are set at lower level than in industrialized countries, in order to target those groups that need assistance most. The most important criteria are given in the descriptions of the different classes.

The distinction between survivalist enterprise on the one hand, and more, dynamic microenterprises on the other, can be somewhat subjective. A firm criterion to distinguish the more dynamic enterprises is to single out microenterprises with paid employees, as against microenterprises without paid employees.

International experience shows that the formulation and implementation of small-business policies can be seriously hampered if there are insufficient reliable data available. Data on small business can be derived from registers. Enterprises in South Africa are required to register for the following purposes:

For value-added tax (VAT) if the turnover is higher than R 150,000 per year;

For employees' tax, if somebody is employed with a remuneration of more than R 15,000 per year;

Individuals and companies need to register for income tax;

With the Unemployment Insurance Fund (UIF) if somebody is employed with an income of less than R 5000 per month;

With the Registrar of Companies if it wants to operate as a company or close corporation;

With district, metropolitan and regional councils for purpose of service levies.

The data that derive from these obligations can be used to assess the state of small business in South Africa, although it should be interpreted with caution. Enterprises follow a natural 'birth and death' process. Due to administrative problems, the databases are not properly maintained, and contain a large number of inactive enterprises.

For instance, the numbers on close corporations, and to a lesser degree companies, are significant overestimates owing to the considerable amount of dormant and shelf entities. Furthermore, a large number of close corporations and companies are solely used for tax and property purposes.

Less than 40% of all enterprises registered with the Registrar of Companies are registered as active cases for VAT purposes.

The available data from enterprise registers point to the fact that there were approximately 200,000 formal employers in 1995, and less than 300,000 enterprises with a formal turnover exceeding the VAT limit of R 150 000.

The combined data sources further demonstrate a very positive development of the small-business sector. This trend is depicted below and shows that companies and close corporations (CC) have increased significantly.

	1995	1996
Legal entities registered	310,000 CC's	374,000 CC's
	179,000 Companies	195,000 Companies
Employers registered for UIF	210,000 Employers	225,000 Employers
Employers registered for employees tax	177,000 Employers	196,000 Employers
Value-Added tax vendors	400,000 VAT vendors	473,000 VAT vendors
Individuals with income out of Business, trade, profession or farming	702,000 Individuals	930,000 Individuals

### Major constraints

The Reconstruction and Development Programme cites 4 major constraints which small, medium and microenterprises face: the lack of access to markets, credit, skills and supportive institutional arrangements. These constraints need to be addressed to enable SMMEs to play their rightful role in the economy and to reach their potential.

Procurement can provide market access to targeted groups and as such can be used to create business opportunities for SMMEs. The degree to which SMMEs can access these opportunities is, however, dependent upon how supply-side constraints are addressed. In this regard, a critical look at past progress and identified needs shows a few important gaps, which need increased attention:

Most business organizations are too weak financially and operationally to be able to provide effective support to their members; this is a serious gap since business and sector organizations are critical links as between the grass-roots level of small and microenterprises and the many specialized service suppliers.

All too often big business only pays lip service to the need and problems of small enterprises, but in day-to-day business deals still prefers to negotiate with larger firms.

Financial and other service suppliers frequently hide behind the principle of no cross-subsidization if it comes to costing the risk of doing business with small enterprises, especially emergent entrepreneurs; at the same time cross-subsidization is acceptable to those same firms, if it comes to the competition for lucrative large contracts; a long-run view about the development of small-business clients should encourage these institutions to invest into their future customers.

Educational institutions still have a long way to go before their training programmes sufficiently highlight self-employment and entrepreneurial issues.

We are still at the very start of comprehensive sector-focused support programmes for small and microenterprises; for example, in the fishing, clothing' crafts and light-engineering sectors, progress is slow because success demands support packages rather than merely better access to training information or finance.

Very little progress has been made with the support of rural-based small enterprises, in particular in more distant, densely populated and often poverty-stricken areas of the Northern Province, KwaZulu-Natal and the Eastern Cape.

SMMEs are scattered all over the country; they are in cities, towns, villages, clusters of traditional huts, on farms, in flat buildings and in informal settlements. Any serious attempt to address the needs and concerns of these entrepreneurs has to start with an understanding of their situation and their needs as well as how they perceive small-business development.

These are just a few examples. They all point to the longer-run need to help change patterns of business behaviour, ways of interaction of small and big enterprises and attitudes towards SMMEs. Many of these gaps or shortcomings cannot be overcome by just adding support programmes or throwing public money after the problem. We have to fundamentally expand the capacity of our support-delivery system.

## **Addressing supply-side constraints**

### **Background**

The promotion of SMMEs is a key element in the Government's strategy for employment creation and income generation. Due to obstacles of the past, the SMME sector is severely underdeveloped. A major effort is being made to operationalize and implement the policies outlined in the White Paper on small-business promotion. The White Paper provided for the establishment of an institutional support framework for SMME development. The institutions are described as are the key support programmes in terms of procurement.

Other initiatives such as the Department of Public Work's Emerging Contractor Development Programme and assistance with quality and standards by the SABS are also described. The relevant legislation is under consideration and various programmes and institutions have been established to give effect to the strategy, including;

Centre for Small Business Promotion at the Department of Trade and Industry;  
Ntsika Enterprise Promotion Agency to provide non-financial assistance;  
Khula Enterprise Finance Limited for the provision of financial support to SMMEs.

In addition, the Department of Trade and Industry has established a number of other supply-side incentives. Many of these are geared towards promoting SMME's. Examples of some are the Small and Medium Manufacturing Development Programme (SMMDP), the Short Term Export Finance Guarantee Facility, the Export Marketing and Investment Assistance Scheme (EMIA) and the Competitiveness Fund.

A number of recent national initiatives have taken place in an effort to promote SMME's. Some of these, as they relate to procurement support are described below. These initiatives relate mainly to supply-side measures and therefore procurement procedure reforms, which have been implemented by the Office of the State Tender Board, are not described in this section.

#### **Centre for Small-Business Promotion (CSBP)**

The Centre for Small Business Promotion (CSBP) was established following the President's Conference on Small Business which was held in March 1995. The Mission of the CSBP is to champion, implement, monitor and evaluate the National Small Business strategy; the aim of the strategy being to contribute to job creation, income generation, the redistribution of wealth and overall economic growth.

The objectives of the CSBP are achieved through the creation of an enabling legal environment and sustainable institutional framework that facilitates increased access to services that SMMEs require in the area of finance, training, markets, technology, infrastructure and information.

In terms of market access services, the CSBP provides funding for the Tender Advice Centre programme, which is run by Ntsika

#### **NATIONAL SMALL BUSINESS ACT (1996)**

The National Small Business Bill establishes a National Small Business Council whose functions are to :

*represent and promote the interests of small business.*

*advise the national, provincial and local spheres of government on social and economic policy that promotes the development of small business.*

The Bill also establishes the Ntsika Enterprise Promotion Agency whose main functions are to :  
*expand, co-ordinate and monitor the provision of training, advice counseling and any other non-financial services to small business.*

*provide financial support to service providers that provide the aforementioned services.*

*consult with any organ of government, the National Small Business Council or any service provider in order to :*

*facilitate the provision of business advice and counseling services to small businesses.*

*facilitate access by small business to raw material and other products.*

*facilitate international and national market access for products and services of small businesses.*

*generally strengthen the capacity of service providers to support small business; and small business to compete successfully in the economy, and*

*formulate and co-ordinate a national programme of policy research, collection and dissemination of information concerning small business.*

Other functions of the Ntsika Enterprise Promotion Agency are to :

*investigate, at the request of the Director-General, the affect of existing and proposed legislation on small business, and to report to the Director-General thereon;*

*provide information and analysis on the implementation of the National Small Business Support Strategy to organs of government;*

*make recommendations to organs of government on existing and proposed policy affecting small business; and*

*improve the general understanding of the public regarding small business contribution to the South African economic growth job creation and welfare.*

#### **Tender Advice Centres**

Following the recommendation in the Procurement Reform Task Team's 10 Point Plan, Tender Advice Centres were established in a number of regions. The objective being to mobilize, formalize and capacitate viable, small, medium and microbusinesses and facilitate their increased access to government procurement opportunities.

This was to be achieved through:

Installation of NISS computer software developed by the Centre for Scientific and Industrial Research (CSIR) for the purpose of information storage and dissemination;

Installation of tender distribution networks to facilitate timely availability of tenders at specific centres.

Engaging in a process of demystifying tendering regulation and procedure through awareness campaigns, as well as the provision of actual counseling support to SMMEs in government tendering.

Twelve organizations were selected, based on the defined selection criteria, to participate in the pilot project for the duration of 9 months commencing March 1997.

An evaluation of the programme was performed during January 1998. The evaluation pinpointed a number of problem areas. Ntsika is currently sourcing service providers who can provide support to Ntsika in all of the following:

- Information and referral services;
- Tender counseling (pre-contract / post-contract);
- Assist SMEs to complete tender documentation;
- Assess SMEs training needs and coordinate training programmes;
- Evaluate the capacity of SMEs to deliver on contracts.

Selected service providers will be commissioned to establish Tender Advice Centres in various locations in South Africa. The above relates to non-financial support services. Access to finance is considered a major constraint to SMME's.

### **Khula Credit Guarantee Scheme**

This scheme is not specifically developed as a contract-financing scheme and therefore does not relate to procurement. It does, however, provide a guarantee of most of the collateral that banks require when issuing loans. In recognition that collateral constitutes a serious constraint for SMME's, particularly for previously disadvantaged entrepreneurs, Khula established Credit Guarantee Schemes.

The original scheme was transferred to Khula from the Small Business Development Corporation (SBDC). Khula substantially revised the scheme, with the result that the percentage of guarantees issued to previously disadvantaged entrepreneurs has risen from 20 to 50%; 633 guarantees were issued within the first year of operation (as opposed to about 1,470 under the SBDS over a 4-year period). Nevertheless, the level of utilization remains far below expectations.

Three reasons have been given for the low level of utilization. First, the guarantee schemes were operating through the small-business units at the banks rather than through the branch structures. Secondly, high bank transactions costs were not significantly reduced by Ntsika's non-financial support services. Thirdly, Ntsika's programme did not adequately address the risks of business failure. In response, Khula has decided to significantly revise the Credit Guarantee Schemes. From 1 March 1998, Khula increased the maximum loan amount to R 1 million and the maximum guarantee to 80%. Collateral requirements for the unguaranteed portion were revised to include a personal guarantee based on a certified statement of net worth, which has reduced the cost of registration collateral.

A more fundamental restructuring of the Guarantee Scheme is envisaged. Business Development officers will be employed at a local level to receive, review and appraise business

plans from entrepreneurs. Once the officer is satisfied with the viability of the proposal, these proposals will be forwarded to Khula. Should Khula be satisfied with the proposals, a guarantee will be awarded. The business development officer will then offer the proposal to local bank branches for approval. Every successful applicant will be assigned a mentor, who can be called upon either by the bank directly in the case of arrears, or by the client for business support. Two categories of mentor will be established: those with general business skills, and those with specialist knowledge.

Khula envisages that this scheme may be financially more viable than the existing scheme, as some banks have expressed a willingness to pay an administration fee for the acceptance of pre-guaranteed proposals. Two issues are critical to the success of the scheme: first, banks have to support the revised scheme; and secondly, while the scheme may be self-sustaining in the long run, it will require significant initial capitalization. The revised Credit Guarantee Scheme is expected to go a long way to increasing access to finance from banks for SMME's. However, there remain questions over whether the Government should be responsible for subsidizing private-sector investment, on the "supply side", for an extended period of time.

### **Group purchasing scheme for materials**

Ntsika is currently investigating the possibility of setting up a group purchasing scheme for SMMEs in terms of which SMMEs will obtain discounted prices with suppliers on identified raw materials. The Gauteng Department of Housing is investigating a material supply initiative whereby selected material suppliers will agree to supply emerging contractors operating on housing projects of a specific size at competitive rates.

### **Emerging Contractor Development Programme**

The Emerging Contractor Development Programme (ECDP) is focused on those contractors who have the required technical skills, but have been unable to source work opportunities from the public sector due to a lack of expertise in submitting quotations and tenders. The essence of the ECDP is the creation of an enabling infrastructure in each of the Department's regional offices to provide emerging contractors with access to specific categories of work opportunities, and to training and support programmes. Central to this enabling infrastructure is the help desk within each regional office, which will be the primary focal point of the interface with the contractors

### **Green Paper on Creating and Enabling Environment for Reconstruction, Growth and Development in the Construction Industry**

This Green Paper, which is coordinated by the Department of Public Works and in which the Departments of Transport, Water Affairs and Forestry, Housing, Labour, Education, Trade and Industry and State Expenditure participate, has the promotion of new industry capacity and the emerging sector as one of its focus areas. This paper presents the following vision in this regard :

In creating, required new industry capacity, construction industry policy must promote the participation of growth of small and micro enterprises (SMEs) through affirmative action in support of historically disadvantaged sectors of South African society.

This paper identifies the following constraints :

Lack of access to work opportunities;  
Lack of management expertise;  
Inability to access training;  
Business failure and growth patterns in developing new contractors;  
Contradictions of community demands and SME growth;  
Difficulty in organizing and regulating the sector.

The paper tables proposals in respect of:

Review of documentation;  
Review of performance standards and contractor accreditation;  
Simplification of documentation;  
Enabling a continuous flow of work;  
Information;  
Access to finance;  
Payment and surety arrangements;  
Dispute resolution procedures;  
Skills formation and access to training;  
Monitoring performance;  
Institutional responses.

### **SABS "Missing Link" programme**

The SABS has implemented the "Missing Link" programme to assist SMME's in solving problems experienced, as far as specifications and standards are concerned.

Small businesses are offered courses on standards to ensure that the missing component of standards and specifications requirements is fulfilled (missing in the sense that despite a large number of business courses that are on offer, no courses on standards were previously available). According to the SABS standards are important because they provide for the coordination and harmonization of products to acceptable levels, enable SMME's to compete in international markets if products conform to agreed standards, assist SMME's with obtaining products that offer value for money, and facilitate manufacturing through the interchangeability of parts and components.

The "link" component of the programme offers training programmes in various technical fields that are tailor made to improve SMME's and equip them with the knowledge to manufacture high-quality products that conform to acceptable manufacturing practices.

Currently training for the clothing, industrial chemicals, welding, paints and sealants and civil engineering (building and construction) subsectors are offered.

### **Manufacturing Advisory Centres (MACS)**

The manufacturing sector has been targeted for economic development in terms of recent industrial policy proposals. The key arguments are that manufacturing industry has been a critical element of growth in developing countries in three main ways.

First, through economies of scale which increase productivity and therefore wealth, secondly, through the positive external effects of manufacturing plants on each other and on the rest of the economy, and through forward and backward linkages in the economy; and, thirdly, through the positive direct and indirect effects of the development of manufacturing on employment creation.

For the SMME sector of any country to become competitive, however, small and medium-sized manufacturing firms must improve their performance. It was for this reason that the national Manufacturing Advisory Centre (MAC) programme was created.

MACs are regional centres established to assist SMMEs in improving their productivity and competitiveness in the local and international market places. The MAC programme is a coordinated outreach programme and its objective is to provide advisory and extension services to improve the performance of existing small and medium-sized manufacturers with under 200 employees.

The programme draws on resource and expertise from relevant service providers. There is also a focus on upgrading the capabilities of previously disadvantaged manufacturers. For this reason, there is a close relationship between MACs and the Local Business Service Centres (LBSCs). These links are crucial, as MACs focus on leveling the playing fields between established and emerging firms.

At a National level there is a partnership between Ntsika, the Council for Scientific and Industrial Research (CSIR) and the National Productivity Institute (NPI).

### **Business Referral and Information Network (BRAIN)**

The Centre for Small Business Promotion (CSBP) has identified the need for easy access to information for the SMME sector. Fortunately, the availability of technologies such as Internet and Call systems now makes it possible to provide information on a mass basis within the constraints of budget availability. Information alone, however, does not solve the

problems inherent in any SMMEs. A broad-based support network is needed to form the core of an enabling environment in which SMMEs can flourish and thereby play a critical role in the mainstream economy of South Africa.

Easy access to information on market opportunities such as tenders and export enquiries, should lead to greater participation by SMMEs in larger contracts and to greater efficiency in the trading process.

The CSBP has recognized the need for a supporting system, and is in the process of developing a Business Referral and Information Network (BRAIN). In this initiative, information technology enables the collective memories of all those accessible through the referral system, plus information stored in books, videos and other media linked to the system, to collectively form a knowledge base for industry.

BRAIN will enable the relevant source of information / know-how required to be pinpointed and information to be effectively and efficiently delivered to SMMEs. This initiative is based on the premise that *trading information offers more and better opportunities to buy better and sell more. Know-hows transferred to SMMEs enable them to work smarter. Smarter translates into greater prospects of succeeding in business. SMMEs need to know what to do to succeed, how to do it smarter and where to acquire the necessary skills, resources and services.*

SMMEs will be able to access BRAIN through face-to-face consultation, the telephone, a fax machine, the postal service or the Internet. Appropriate information will be supplied to SMMEs from hawkers to exporters across the various industrial sectors. Three types of delivery services will be provided, viz.:

Internet access to search and fetch own information;

Business Information Hotlines for instant information;

Business Information Centres for face-to-face consultations.

The CSBP are developing BRAIN to serve approximately 50 medium-sized centres located at the metro level of local government. These centres will ensure that counseling and comprehensive training is available with  $\pm$  150 km radius of 90% of SMMEs within South Africa. A model for local government to fund a centre has been put forward.

The ultimate goal of the BRAIN programme is to increase the competitiveness and viability of existing and new businesses in order to generate wealth, employment and re-distribution by providing small businesses with easy access to relevant know-how, business opportunities, trading opportunities and operational support services.

## **THE BRAIN INITIATIVE**

The Centre for Small Business Promotion view the BRAIN initiative as a win-win scenario viz.:

Local government wins in respect of economic growth, reduction of unemployment increased taxes for other programmes.

SMMEs win by gaining easy access to more and improved services.

Service providers gain free promotion of their services, a presence on the Internet and SMME visibility amongst corporate procurement offices.

Domain experts gain recognition and are able to direct hyper linkages to websites.

Existing business centres win in that the BRAIN complifies their ability to offer improved services and extends their ownership base.

SMME development programmes win in that the stakeholder network increases the high speed of delivery of new products and services; programmes are delivered to a single point and a base is provided in which ideas can be tested, frustrations shared and partnerships formed.

BRAIN offers a gateway to know-how about :

Business start-up

Managing a business

Managing the business functions

Developing the business

Dealing with the business environment; and

Government incentive schemes to support the above.

It is envisaged that "Infant" BRAIN will be "mature" by the year 2000.

## **Public procurement as an instrument of policy**

### **Background**

The use of public-sector procurement as an instrument of government policy to achieve certain socioeconomic objectives can have significant outcomes in a variety of areas, ranging from the protection and development of national industry to social policy goals such as the promotion of equal opportunity. Likewise, the use of procurement as a regulatory tool to enforce existing legal obligations, or to encourage standards of behaviour beyond those required by the law, has the potential to make a substantial impact.

A recent study undertaken for the European Community cites five principle domestic (as distinguished from foreign policy) socio-economic or political functions which public sector procurement may be used to achieve, in addition to obtaining the required goods and services. These are to:

Stimulate economic activity;

Protect national industry against foreign competition;

Improve the competitiveness of certain industrial sectors;

Remedy regional disparities;

Achieve certain more directly social policy functions such as to foster the creation of jobs, to promote fair labour conditions, to promote the use of local labour, to prohibit discrimination against minority groups, to improve environmental quality, to encourage equality of opportunity between men and women, or to promote the increased utilization of the disabled in employment.

It can be seen from the above that public-sector procurement has been used in developed countries to achieve certain social policy objectives, such as the creation of jobs, the promotion of fair labour conditions, the use of local labour, the prevention of discrimination against minority groups, the improvement of environmental quality, the encouragement of equality of opportunity between men and women and the increased utilization of the disabled.

What is needed is a cost-effective procurement system which provides, encourages and promotes a government's socioeconomic objectives in a definable, quantifiable, measurable, verifiable manner, and in a form that can be audited, within a fair, equitable, competitive, cost-effective and transparent environment, without:

- Overtaxing the administrative capacity of government;
- Creating unfair competition within sectors of the economy;
- Abusing or lowering labour standards;
- Exposing Government to unacceptable risks;
- Compromising value for money; or
- Compromising the efficiency and effectiveness of the private sector in their ability to deliver.

No international models for such a form of procurement exists. Recently, however, a system of procurement which meets the aforementioned requirements has been developed in South Africa by the Procurement Task Team. This system, which is known as Targeted Procurement, enables procurement of goods, services and works to be readily used as an instrument of social policy by public bodies both on a large scale and in a focused manner. Aspects of Targeted Procurement can also be used to measure, quantify, verify and audit any socioeconomic targets that are to be met. This is important where governments use procurement as an instrument of social policy and grant concessions, linked to socioeconomic objectives, to the private sector.

## **Procurement reform in South Africa**

### *Overview*

The Ministries of Finance and Public Works embarked upon an initiative to reform public-sector procurement in South Africa. A Procurement Task Team consisting of

government officials and private-sector consultants was appointed to research and draft new policy proposals.

At the outset to the process, it was recognized that legislation following a white paper on procurement would be required in order to operationalize all reform policy proposals. As a result, the Task Team was required to develop interim policy proposals which could be implemented within the ambit of existing legislation and as such serve as the interim policy until such time as the reform process had run its course.

The Task Team accordingly prepared an interim strategies document which is commonly referred to as the 10 Point Plan, the objective being to provide opportunities and make it accessible for small businesses to participate in public-sector procurement.

This 10 Point Plan (Interim Strategies) was adopted by the then National Cabinet of Unity in November 1995 as its interim procurement policy. The 10 Point Plan remains Government's procurement policy while the new policy is being finalized and legislated.

**10 POINT PLAN : Government's current procurement policy**

The 10 points of this plan encompass the following strategies:

1. Improving access to tendering information.
2. The development of tender advice centres.
3. Broadening the participation base for contracts less than R 7,500.
4. The waiving of security /sureties on construction contracts having a value of less than R 100,000.
5. The unbundling of large projects into smaller contracts.
6. The promotion of early payment cycles by government.
7. The development of a preferencing system for small and medium enterprises owned by historically disadvantaged individuals.
8. The simplification of tender submission requirements.
9. The appointment of a procurement ombudsman.
10. The classification of building and engineering contracts.

A Green Paper on Public Sector Procurement in South Africa was released with the full endorsement of the national cabinet in April 1997. All the principles contained in the 10 Point Plan have been incorporated into the Green Paper. The Department of State Expenditure has been given the task to prepare a white paper and the subsequent new legislation on public-sector procurement.

## **Constitutional provisions pertaining to procurement**

Section 217 of the Constitution of the Republic of South Africa, 1996 (Act no. 108 of 1996) reads as follows :

- 217      (1)      *When an organ of state in the national, provincial or local sphere of government, or any other institution identified in national legislation, contracts for goods or services, it must do so in accordance with a system which is fair, equitable, transparent, competitive and cost effective.*
- (2)      *Subsection (1) does not prevent the organs of state or institutions referred to in that subsection from implementing a procurement policy providing for :-*
- (a)      *categories of preference in the allocation of contracts; and*
- (b)      *the protection or advancement of persons, or categories of persons, disadvantaged by unfair discrimination.*
- (3)      *National legislation must prescribe a framework within which the policy referred to in subsection (2) may be implemented.*

### ***Green Paper on Public-Sector Procurement Reform in South Africa***

The Green Paper recognizes that public-sector procurement can be used as a tool by Government to achieve economic ideals, including certain socioeconomic objectives. This view forms the foundation of the procurement reform process and the development of policies and procedures. At the same time, the Paper recognizes that an effective and efficient procurement system will permit organs of State to deliver the quality and quantity of services demanded by its new constituency in accordance with its policies which are articulated in the Reconstruction and Development Programme and the Growth, Employment and Redistribution Strategy.

The Green Paper has two basic themes, viz.:

- Achieving good governance in procurement
- Achieving socioeconomic objectives through procurement

**GREEN PAPER PROPOSALS : Pillars of procurement reform in respect of socio-economic issues**

- *Public sector procurement should be structured in a manner that promotes economic reconciliation and competitiveness.*
- *The structuring of contracts should be such that small, medium and micro enterprise participation is maximised without compromising time, cost and quality.*
- *Value for money should not be based on least cost alone; it can include well defined socio-economic criteria which can be evaluated in a transparent and measurable manner.*
- *Targets should be set and delivery systems designed to facilitate one or more of the following :*
  - *the development of small, medium and micro enterprises particularly those owned and operated by previously disadvantaged persons;*
  - *increasing of the volume of work available to the poor and the income generation of marginalised sectors of society; and*
  - *affirmative action to address the deliberate marginalisation from economic, political and social power of black people, women and rural communities and to empower communities and individuals from previously disadvantaged sectors of society.*
  - *subject to such targets being readily definable, quantifiable, measurable, auditable and verifiable.*
- *The procurement process should be made accessible to the target groups and structured in a simplified and user friendly manner.*
- *The third tier of government should identify area bound targets and select associated delivery mechanisms.*
- *Organs of State should take cognisance of regional and local dynamics when implementing procurement policy and associated practices.*

The Green Paper, *inter alia* , addresses and provides principles and proposals in respect of:

- Access to tendering information and simplification of tender documents;
- Breakout procurement (unbundling);
- Awarding of tenders in terms of a development objective/price mechanism;
- An affirmative small, medium and microenterprise participation programme;
- Promoting employment-intensive practices;
- Affirming marginalized sectors of society in construction projects;
- Development of an affirmative procurement policy.

The Green Paper, in the chapter on promoting employment-intensive practices, proposes that procurement can facilitate the generation of jobs in South Africa by:

- Ensuring that the foreign content in contracts involving goods, services and works is minimized;
- Encouraging the substitution of labour for capital;
- Supporting the use of “labour friendly” technologies which utilize a higher degree of labour input

than is the case for conventional technologies, or are well suited to implementation by small-scale enterprises; and

Encouraging and developing small-scale enterprises to implement employment-intensive practices and “labour friendly” technologies.

The paper also sets out an affirmative small, medium and microenterprise programme which is aimed at:

Reducing disparities in business ownership;

Directing some of the flow of commerce to and through those population segments which have historically been underutilized and excluded from participation;

Engaging small, medium and microenterprises in public-sector procurement activities through prime (main) contractors on medium to large public-sector contracts;

Providing accessible markets; and

Forging linkages with large-scale enterprises.

*The paper stresses that an affirmative small, medium and microenterprises participation programme should be integrated with development initiatives aimed at enhancing the business capacity and skills of established small, medium and microenterprises and should provide work opportunities for those enterprises which graduate from initiatives aimed at developing new small, medium and microenterprise capacity.*

The Green Paper also outlined, an Affirmative Procurement Policy which is required to enact the vision for the Procurement Reform Process and to facilitate the engagement of previously disadvantaged enterprises and communities. The paper envisaged that such a policy would promote programmes aimed at the engagement of small, medium and microenterprises owned by previously disadvantaged persons and an increase in the volume of work available to the poor, and income generation for marginalized sectors of society.

## Current South African procurement practices

### Overview

National, provincial and local Government departments in South Africa have an enormous collective buying power. According to various analysts, the *Total Consolidated General Government Procurement* is estimated to amount to R 60 billion for the 1997/98 financial year. This amount constitutes approximately 13% of *Gross Domestic Product* and represents some 30% of all government expenditure.

The estimated *Consolidated General Government Procurement* spending may be categorized as follows:

Central government	R 24 billion	(40%)
Provincial government	R 27 billion	(45%); and
Local authorities	R 9 billion	(15%)

Extrabudgetary institutions increase these amounts by a further estimated R 8 billion.

Public sector procurement has a major impact on the South African macroeconomy, both in terms of consumption and investment spending. As such, public-sector procurement can be used as a tool by Government to achieve economic ideals, including certain socioeconomic objectives. At the same time, an effective and efficient procurement system will permit Government to deliver the quality and quantity of services demanded by its new constituency in accordance with Reconstruction and Development Programme principles and other policy objectives.

A fundamental requirement for any new procurement policy is that it should be in line with the national economic growth strategy with the acceptance that the country is now operating in a changed environment both locally and internationally.

#### ***Role of Tender Boards***

The present procurement system is maintained through a formal tendering system. Contracts are awarded by tender boards comprising government officials and non-government persons who are presently established in terms of National and Provincial Acts. The State Tender Board, for example, enjoys certain powers in terms of the State Tender Board Act, including the power to conclude agreements, invite offers, determine the manner in which, and the conditions under which offers must be made, to inspect and test supplies and services offered and to amend or cancel the concluded agreements. The responsibility to appoint members to the State Tender Board rests with the Minister of Finance. There are at present 1 National State Tender Board, 9 Provincial Tender Boards and in excess of 500 Tender Boards/Committees at local authority level.

The establishment and purpose of Tender Boards is traditionally seen as an effort to ensure sound decision-making in a fair and evenhanded manner and as a means to ensure that fraudulent practices are minimized. Tender Boards are, as such, concerned with the handling of tenders, whereas consumer departments are concerned with the administration of contracts that have been awarded.

As the law stands at present, the State Tender Board Act does not supersede the Provincial Tender Board Acts. Provincial Tender Boards have the authority to determine their own conditions under which offers are to be made. It is therefore inevitable that this results in different tendering cultures occurring throughout the country and different interpretations of what constitutes procurement reform, affirmative action, stimulation of local economies and the like. Coordination is difficult in these circumstances, particularly insofar as uniformity in approach and avoidance of duplication of effort is concerned.

It is impractical for Tender Boards to deal with all procurement matters pertaining to goods, services and works falling under their jurisdiction. Accordingly, Tender Boards frequently delegate authority to consumer departments or local authorities should these entities have systems in place to effectively manage and control procurement activities. Delegation eases the workload on Tender Boards and in effect streamlines the procurement process.

As a result, procurement reform in South Africa has been slow and in many instances ineffective. Although the 10 Point Plan was adopted as national policy by Government in 1995, it was only adopted by the State Tender Board during the latter part of 1996. Some of the Provincial Tender Boards have adopted it, whilst others have not and have developed their own policies. Some in turn have adopted only selected portions of the 10 Point Plan.

#### *Adjudication of tenders on a points system*

The 10 Point Plan made provision for the awarding of tenders in terms of a points scoring system, i.e., a development objective/price mechanism (see, Green Paper on Public Sector Procurement Reform in South Africa).

A development objective/price mechanism is a point scoring system in terms of which tenders are awarded in the first instance, points for their financial offer, and in the second instance, for their offer to exceed socioeconomic objectives, or their current enterprises status.

Development objective points are awarded for exceeding targets set in respect of :

Use of local resources;

Use of targeted labour;

Use of small, medium and microenterprises;

Employment generated;

or the degree to which the tendering enterprises has embraced :

Equity shareholding;  
Affirmative action principles;

Alternatively, points could be awarded for an enterprise's status, or for environmentally friendly practices.

The successful tender is the one which is awarded the most points, subject always to technical factors, previous contractual performance/recommendations, financial references, unit rates and prices, alternative offers, qualifications, etc., being acceptable. This system of tender adjudication replaces the practice of awarding the tender to the lowest priced offer, as it permits human resource/socioeconomic objective offers to be considered together with the financial offer.

In terms of these proposals, points are awarded for price and meeting certain socioeconomic criteria, the maximum number of points which a tenderer could score being 100.

Furthermore, penalties are to be applied to ensure that any cost premium paid in respect of development objective, which are not realized during the execution of the contract or obtained on a fraudulent basis, are recovered.

#### ***Awarding of tenders in terms of the Affirmative Procurement Policy***

*Minor contracts.* It is proposed that a system of direct preferences be implemented for Affirmable Business Enterprise (ABE) status together with Woman Equity Ownership. This policy will be based on a percentage price preference and shall apply to all contracts which are usually less than R 2 million (US\$ 350,000).

Thus, in effect certain tenderers who do not meet certain requirements are penalised accordingly, but are not prevented from tendering. On the other hand, those who fall within the targeted group and meet all the relevant requirements cannot hold a contract to ransom in terms of price as the reward for compliance will be outweighed by the loss of points incurred through uncompetitive tender prices.

Penalties will be applied to ensure that any cost premium paid will be recovered with a surcharge in respect of a false or inaccurate preference disclosure being realized during the execution of the contract. In addition, the tenderer will be liable to prosecution and disqualification from future tenders.

The preference system will be operated via tender adjudication criteria. The following is proposed :

Tendered price  
points

90

Affirmable Business Enterprise	7½points (fixed)
Women Equity Ownership	2½points (variable)
(A maximum of 2,5 adjudication points may be awarded to enterprises where the Women Equity Ownership (WEO) exceeds 25% in accordance with the following formula, provided that a certificate by an Auditor confirming such ownership is submitted with the tender)	
$No = 0,0333 \times (WEO - 25)$	
<u>Total:</u>	<u>100 points</u>

*Major contracts.* For contracts exceeding R 2 million (US\$ 350,000), tenders are adjudicated on the basis of resource specifications which provides for the following:

Price	90 points
Tendered Participation Goal	10 points (variable)
<u>Total:</u>	<u>100 points</u>

For example, the TP1 (APP1) specification is used to target Affirmable Business Enterprises (ABEs). This specification facilitates the engagement of SMME’s that are owned and controlled by previously disadvantaged persons (ABEs) in procurement activities alongside established contractors/service providers.

The specification permits the setting of goals for ABE participation in contracts which can be met by contractors who include for ABE participation in one or more of the prescribed ways in the performance of their contracts.

The APP1 Specification, in a practical and pragmatic manner, requires the contractor to “unpack” his contract into smaller contracts, to procure the services of targeted SMMEs to perform such contracts and to administer such contracts. Accordingly, the APP1 specifications may be regarded as being an instrument for breakout procurement as it facilitates an increase in SMME participation by targeted businesses in public-sector procurement activities. The APP1 Specification is recommended for use on major contracts provided that:

The nature of the goods and services that are required are such that there is a likelihood that a number of ABEs would be available to participate in the relevant activities;

The contract duration is sufficiently long to permit monitoring and contract compliance procedures to be established and implemented. Generally, the minimum Contract Participation Goal should be set

between zero and 10%. Maximum points should be awarded for the attainment of Contract Participation Goal of 40% or more.

**Awarding of tenders in terms of the TP1(APP1) specification**

Points awarded in respect of the financial offer are calculated as follows :

$$N_p = \frac{Z (1 - (P - P_m))}{P_m}$$

- where
- $N_p$  = the number of tender adjudication points awarded on the basis of price
  - $P_m$  = the price of the lowest responsive tender adjusted to a common base / on a comparative basis, as relevant.
  - $P$  = the price of the responsive tender under consideration adjusted to a common base / on a comparative basis, as relevant.
  - $Z$  = a number, usually 90, reflecting the importance of price.

Points in respect of attaining socio-economic objectives are calculated as follows :

$$N_c = \frac{X (D - D_s)}{Y - D_s}$$

- Where
- $N_c$  = number of tender adjudication points awarded
  - $D$  = the tendered Contract Participation Goal percentage in the tender under consideration.
  - $D_s$  = the specified minimum contract participation goal percentage, usually 5 - 10%.
  - $X$  = maximum number of adjudication points assigned for the socio-economic aspect of the tender (usually 10 points).
  - $Y$  = Contract Participation Goal percentage above which no further tender adjudication points are awarded, usually 40%.

**NOTE :** In design and build works contracts the 90/10 formulation can be changed to permit technical criteria to be scored.

*Definitions* In order to ensure that the target groups are unambiguously defined, the following words and expressions have the following meaning :

**Affirmable Business**

**Enterprise (ABE) :** A business which adheres to statutory labour practices, is a legal entity registered with the Department of Inland Revenue and an independent and continuing enterprise for profit, providing a Commercially Useful Function and:

which is at least two thirds Owned by one or more Previously Disadvantaged individuals or in the case of a company, at least two thirds of the shares are owned by one or more Previously Disadvantaged Individual ;

and

whose management and daily business operations are in the control of one or more of the Previously Disadvantaged individuals who effectively own it; provided, however, that the annual average turnover excluding Value Added Tax (VAT) of the business during the lesser of the period for which the business has been operating and the previous three financial years does not the exceed prescribed annual turnover limits.

**Control :** The possession and exercise of legal authority and power to manage the assets, goodwill and daily operations of a business and the active and continuous exercise of appropriate managerial authority and power in determining the policies and directing the operations of the business.

**Commercially Useful**

**Function :** The performance or real and actual work, or the provision of services, in the discharge of any contractual obligation, which shall include but not be limited to the performance of a distinct element of work which the business has the skill and expertise to undertake, and the responsibility for management and supervision of such work.

**Executive Director:** A full-time partner in a partnership, a director of a company established in terms of the Companies Act, 1973 (Act 61 of 1973) or a member of a close corporation registered in terms of the Close Corporation Act, who, jointly and severally with his/her other partners, co-directors or co-members, as the case may be, bears the risk of business and takes responsibility for the management and liabilities of the partnership, company or close corporation on a day to day basis.  
NOTE: Non-executive directors of public companies are specifically excluded. A sole proprietor may be regarded as being an Executive Director.

**Owned :** Having all the customary incidents of ownership, including the right of disposition, and sharing all the risks and profits commensurate with the degree of ownership interest's as demonstrated by an examination of the substance, rather than the form of ownership arrangements.

**Previously Disadvantaged**

**Individuals (PDI) :** Individuals who, being South African citizens, are socially and economically disadvantaged by the legacy of the South African political dispensation prior to April 28, 1994. For the purpose of the Contract, the refutable presumption shall be made that individuals who fall into population groups that had no franchise in national elections prior to the introduction of the 1984 constitution and the tricameral parliamentary system, are Previously Disadvantaged Individuals. It is incumbent on individuals to demonstrate their claims to fall into such population groups on the basis of identification and association with and recognition by the members of such group.

**Woman :** A female person who is a South African citizen and a female at birth.

**Women Equity**

**Ownership (WEO) :** The collective Ownership percentage of Executive Directors within an enterprise who are Women.

## International trade

*Competition.* Most of South Africa's industries are not yet in a position to compete on a par with their international counterparts. There are a number of reasons for this state of affairs, particularly the fact that South African industries have not gone through the full development cycle experienced by other developed economies. Accordingly, many South African industries would find it very difficult to compete both locally and abroad if all forms of preference and support for locally manufactured products were to be abolished.

Whilst State regulatory policy should aim to achieve its goals in an international context, it has to take into consideration the support and development of local industry, and the creation of job opportunities. The policy therefore must respond to key issues of national priority such as the upliftment of previously disadvantaged sections of the community, whilst also reflecting on issues pertinent to international trading, and how these issues will be managed. Industry must become competitive both on the local and international markets.

### INTERNATIONAL COMPETITION (FOREIGN TENDERS)

(Extracts from the Green Paper on Public Sector Procurement Reform in South Africa)

Local industry can be protected in a number of ways including :

- The imposition of restrictive tariffs on all goods of foreign origin;
- The institution of non-tariff based controls on importation (i.e. Import Control);
- The provision of preferences for local supply based on local content;
- The application of affirmative (targeted) procurement practices.

### PROPOSALS

The current preference systems for local content should be continued and be extended to professional services contracts;

Specific attention should be paid to the selection of contract strategies, the packaging of contracts and the setting of human resource goals in order to maximise local content;

The continuation of the preference system should not rule out the adoption of broader policies in the future which may be easier to manage and which can yield increased benefits. One of these policies could be an offset policy. An offset policy can be comprehensive, covering many issues, yet be easy to manage, since the responsibility for satisfying the offset agreement requirements rests with the seller (foreign tenderer). An offset policy has an inherent bias towards export promotion, which is an indirect, but more effective way of supporting local industry;

In order to simplify tender documentation, streamline administrative procedures and focus protective measures, preference systems should be linked to the categorisation of contracts and applied only to specific sub-categories of contracts.

*World Trade Organization Agreements (WTO).* South Africa, a Founder Member of GATT, is classified in the WTO as a *developed* country and there is some debate as to whether

South Africa should seek to be reclassified as a *developing* country. Although it has never formally sought reclassification, it negotiated favourable conditions and extended implementation periods in several of its sensitive economic sectors during the Uruguay Round of the GATT. Thus, while WTO rules regulate international trade practices and procedures, there is significant scope to negotiate specific terms and conditions that cater for national interest and priorities.

Unlike most of the WTO agreements to which South Africa is committed as part of the WTO's single undertaking principle, the Agreement on Government Procurement is plurilateral and extends obligations only to members that are signatory to its provisions. South Africa has, to date, not signed the Agreement and it appears that the Government will come under increasing pressure from its main trade partners to do so.

*Industrial Participation Programme.* South Africa has developed an Industrial Participation Programme which became obligatory on 1 September 1996. In effect, this means that all Government and parastatal purchases (goods, equipment or services) with an imported content equal to or exceeding US\$ 10 million are subject to an Industrial Participation Obligation. The seller/supplier who incurs an Industrial Participation Obligation will be required to participate in the South African economy as suggested by specified guidelines and evaluation criteria based on the principle of mutual benefit and business sense.

The role of this Programme is to fast-track investment, exports and technology development by utilizing the instrument of government procurement to leverage such initiatives. The Programme is a component of industrial strategy that seeks to work in partnership with the private sector.

In this regard, the Government has worked in a steady and determined manner to make South Africa an investment-friendly economy. The Industrial Participation Programme is designed to create a win-win situation by encouraging foreign suppliers of major government contracts to seriously evaluate the South African market a possible investment or business location.

## INDUSTRIAL POLICIES AND PROGRAMMES

(Extract from DTI's discussion document entitled "Industrial Policy and Programmes in South Africa").

*While a number of key policies such as exchange rate, monetary and labour market policy are outside of the DTI's direct policy making framework, the Department strives to impact on these policies through a variety of mechanisms. These include information sharing agreements with those government institutions responsible for administering these policies as well as DTI involvement in an array of fora where these issues are raised.*

*This is a critically important aspect of the Department's business as a lack of policy co-ordination between policymaking institutions can easily lead to the effect of one policy being undermined by the implementation of another. Notwithstanding the above, the DTI is responsible for administering five key pillars of policy intervention designed to accelerate manufacturing development. These include :*

*Investment support;  
trade facilitation;  
technology promotion and innovation support;  
strategic and informational leadership; and  
contributing to human resources development.*

*Current investment policies include :*

*Tax holding schemes  
Spacial Development Initiatives  
Industrial Development Zones  
World Player Schemes  
Small Business Investment Programmes*

### *Targeted procurement*

#### *Overview*

Targeted Procurement, or as sometimes referred to as Affirmative Procurement, is an innovative form of procurement which has recently been developed in South Africa by the Procurement Task Team to provide employment and business opportunities for marginalized individuals and communities. It enables social objectives to be linked to procurement in a **fair, transparent, equitable, competitive and cost effective manner**. Targeted Procurement also permits these social objectives to be **quantified, measured, verified and audited**.

Targeted Procurement, through a variety of techniques, provides opportunities for participation by targeted enterprises, even to those who may not have all the necessary resources, capacity or expertise to perform contracts in their own right. This is done in a manner which does not guarantee contracts to such enterprises. On small contracts having a value below a predetermined financial threshold, direct preferences are accorded to targeted enterprises to tip the scales in their favour. On contracts above a financial threshold, tenderers are required to compete on the basis of both the **product** and the **process**. Technical specifications are used to define the product and to set out the acceptance criteria relating thereto. Standardized resource specifications are used to define social objectives and the acceptance criteria relating thereto. These specifications accordingly define the social deliverables which are to be realised though the process of delivery, and set out the manner in which they can be achieved, measured and monitored. Contracts are usually awarded to the most advantageous offer, based on a balance between the tendered price and the tendered deliverables in respect of targeted groups. Targeted enterprises, depending upon the contracting

strategy which is adopted, may participate in contracts as prime contractors, joint venture partners, subcontractors, service providers, manufacturers or suppliers.

**TARGETED PROCUREMENT : The attainment of socio-economic deliverables**

Socio-economic deliverables are achieved through a combination of :

- the classification of contracts which enables them to be :
  - packaged (unbundled) in a manner which facilitates the engagement of a range of targeted groups; or
  - structured in a manner which permits targeted groups to participate.
- the use of resource specifications, i.e., performance specifications which define the socio-economic deliverables, set out the method by which deliverables can be attained, audited and verified and the means by which progress towards the attainment of the deliverables can be quantified at discrete intervals.
- the use of development objective / price mechanisms, e.g., a point scoring system in terms of which tenderers are awarded, in the first instance, points for their financial offers, and in the second instance, points for their offers to exceed specified, minimum socio-economic objectives, or, in the case of very low value contracts, for their current enterprise statuses.

### **Target groups**

Small and medium-sized enterprises can be targeted on a generic or area bound (localized) basis. Generic targeting in turn, can target either all small and medium enterprises within a country, or block of countries, or small and medium enterprises within demarcated political boundaries which are owned and controlled by marginalized individuals (Affirmable Business Enterprises). Marginalized individuals can be defined on the basis of race, gender, ethnicity, disability, etc.

Marginalized individuals can be targeted for employment on works and services contracts on the basis of gender, race, ethnicity, locality, age, disability, period of unemployment, etc.

**TARGETED PROCUREMENT : Standardised Resource specifications**

The following standardised resource specifications have been developed :

TP1 (APP1) : Targeting of Affirmable Business Enterprises

TP2 (APP2) : Structured Joint Ventures (Affirmable Partners)

TP3 (APP3) : Structured Joint Venture (Targeted Partners)

TP4 (APP4) : Targeting of Local Resources

TP5 (APP5) : Engagement of Targeted Labour

TP6 (APP6) : Targeting of Affirmable Professional Service Providers

Each of the Targeted Procurement resource specifications has a measurable component which enables the amount of participation by the target group to be quantified and monitored. In each case, the value of the contribution is computed, in terms of a prescribed formula, as a monetary value (goal credits) and is expressed as a percentage of the total value of the goods and services provided, or works performed, in terms of the contract.

The goals associated with each specification can be readily audited and verified during the performance of a contract. They are as such indicators of economic empowerment in terms of employment and/or business opportunities. This permits reporting on key indicators to take place.

### Unbundling strategies (breakout procurement)

Small, medium and microenterprises (SMMEs) can participate in public-sector procurement in one of two ways. They can either contract directly with a public body, or participate as a subcontractor, supplier, manufacturer or service provider to a prime contractor or in some point in the delivery chain.

The breaking down of tenders into smaller components is not always justifiable owing to the division of responsibilities, interdependence of activities, programming, duplication of establishment charges and underutilization of resources. Furthermore, the administration of such contracts by public bodies and their agents is more complex and costly than of fewer larger ones.

The use of Targeted Procurement enables contracts to be unbundled in a number of ways, by the following:

- Procuring works in the smallest practicable quantities;
- Obligating prime contractors to engage SMMEs in the performance of their contracts in terms of resource specifications;
- Requiring joint venture formation between large businesses and SMMEs (Structured Joint Venture);
- Providing third party management support to enterprises which are not capable of operating as prime contractors (Development Contracts).

The unbundling strategies afford the full spectrum of SMMEs, from those operating as labour only contractors to those operating as prime contractors, opportunities of participation.

## **National Department of Public Work's initiative for the delivery of targeted procurement**

The National Department of Public Works has embarked upon an initiative entitled "The Delivery of Targeted Procurement". This initiative is aimed primarily at promoting Affirmable Business Enterprises (ABEs) via public-sector procurement.

An Affirmable Business Enterprise (ABE) is defined as a business which, *inter alia*, has a limited annual turnover as specified and is at least two thirds owned and controlled by one or more previously disadvantaged individuals (i.e. those persons who did not have the vote prior to the April 1994 elections).

Direct preferences are accorded to ABEs in respect of low-value contracts. In contracts which generally have a value in excess of R 2 million, participation goals are set. (A participation goal is a percentage of the monetary value of the contract which is used to represent ABE participation). Tenders are awarded in terms of a development objective / price mechanism, where 90 points are awarded for price and 10 points are awarded for the degree to which tenderers exceed minimum socioeconomic goals.

ABE participation in these contracts can take place in one or more of the following ways :

- Subcontracting parts of the contracts to ABEs;
- Subcontracting parts of the contract to joint ventures with ABE partners;
- Obtaining supplies and materials from ABE suppliers;
- Obtaining manufactured articles from ABE manufacturers;
- Engaging ABE professional, technical or managerial service providers;
- Entering into joint venture arrangements with one or more ABEs.

**CASE STUDY : The experience of the National Department of Public Works**

In August 1996, the State Tender Board approved that the National Department of Public Works could pilot the implementation of the Affirmative Procurement Policy on all its construction projects. For the period August 1996 to October 1997, 3423 building and civil contracts totalling R914,5 million were awarded, utilising the Affirmative Procurement Policy specifications, a breakdown of which is tabulated below. (Quotations refer to low value contracts which were concluded without following the formal tendering procedures which are applicable to contracts having a monetary value above a certain threshold). Affirmable Businesses Enterprises (ABEs) (black owned SMMEs) were targeted. Affirmable Business Enterprises were defined in terms of racial ownership and control and average annual turnover within prescribed limits. Businesses which qualify for ABE status have to have at least two thirds ownerships by Previously Disadvantaged Individuals.

An independent review of the department's records concerning the award of these 3423 contracts was undertaken. A random sample of 898 records were electronically captured and analysed. Although this sample in number covered only 26% of the total departmental record, it represented 79% of the monetary value of the record and captured just over two thirds of the contracts which fell outside the quotation category and 80 percent of the contracts having a contract value in excess of R2,0 million. The statistics generated by this review are tabulated below.

Various construction companies were approached in order to establish how much work was outsourced to ABEs (ABE participation) prior to the introduction of the Affirmative Procurement Policy. The general consensus was that ABE participation levels in the building industry prior to the introduction of the Affirmative Procurement Policy was around 3%. This being the case, the introduction of the Affirmative Procurement Policy on contracts having a value in excess of R2,0 million has resulted in a 10 fold increase in ABE participation on departmental contracts at a cost premium of less than 0,7%. (Commentators at the time when the Affirmative Procurement Policy was launched had predicted a cost premium of between 10 and 15%).

**Statistics pertaining to all tenders awarded (during the period August 1996 to October 1997)**

CONTRACT VALUE	No. of contracts awarded	Tender Value	
		(Rand x 1 000 000)	(%)
R0 - R45 000	272,9	R25,9	2,8
R45 000 - R100 000	256	R18,7	2,0
R100 000 - R0,5 million	308	R59,4	6,5
R0,5 million - R2,0 million	75	R73,4	8,0
> R2,0 million	55	R737,1	80,7
<b>TOTAL</b>	<b>3423</b>	<b>R914,5</b>	<b>1000</b>

**ABE participation (August 1996 to October 1997)**

CONTRACT VALUE	COST PREMIUM (%)	PERCENTAGE OF CONTRACTS AWARDED TO ABEs	PERCENTAGE OF TOTAL TENDER VALUE AWARDED TO ABEs

R0 - R45 000	0,2	34	20
R45 000 - R100 000	0,9	8	8
R100 000 - R0,5 million	1,5	12	11
R0,5 million - R2,0 million	1,3	12	11
> R2,0 million	0,7	-	30
<b>TOTAL</b>	<b>8</b>	<b>-</b>	<b>28</b>

A National Working Group comprising representatives of national departments, provincial public works departments and selected local authorities has been constituted to facilitate the flow of information and to provide inputs and direction in the process of delivery. A website ([www.pwdprocure.co.za](http://www.pwdprocure.co.za)) has been established to disseminate information and to serve as a library. Furthermore, a Geographical Targeted Procurement Management System (GTPMS) is being developed to monitor all aspects of Targeted Procurement on a geographic basis.

In addition the Department of Public Works has developed a sub-initiative within the broader Delivery of Targeted Procurement initiative, called the Strategic Projects Initiative. The Strategic Projects Initiative is aimed at the development and promotion of the sustainable growth of black construction capacity at prime contractor level.

The Department believes that appropriate mentoring on financial gearing, project resourcing, risk management, etc. is critical to the ongoing success of a new construction enterprise and is of the opinion that a carefully structured mentoring program will contribute significantly in addressing these issues. The Department intends mobilizing initial seed funding for this exercise.

In the medium term, it is envisaged that this will be funded by appropriate Business Associations and the current beneficiaries of this programme.

Several options are being explored to provide easier access to finance, plant and materials, with the Department facilitating interactions between local and overseas interested parties.

### **Role of local government**

Local government collects substantial amounts in rates, levies, services charges, fees, etc. They employ vast numbers of people, purchase goods and service, invest in capital projects and set by-laws and regulations to govern local businesses. Accordingly, they can play a significant role in providing social and economic development.

Research also highlights substantial differences in entrepreneurial activity between various localities. For instance, there are comparatively double the number of self-employed in metropolitan areas as compared with rural areas. Similarly, the percentage of entrepreneurs and self-employed in provinces with a high level of economic activity is more than doubled that of provinces with a low level.

Accordingly, local government can influence the direction and structure of the local economy through its expenditure on assets and the provision of services particularly insofar as employment and business opportunities are concerned. It is interesting to note that several Metropolitan Councils in South Africa have adopted the Targeted Procurement Policy on all their contracts (goods, services and works) and are implementing it in terms of the National Department of Public Works' Initiative for the Delivery of Targeted Procurement.

#### **PROPOSALS FOR THE STIMULATION OF LOCAL ECONOMIES**

(Extract from the Green Paper on Public Sector Procurement Reform in South Africa).

Contract strategies, the packaging of contracts and affirmative procurement practices should be used to stimulate local industries;

Preferences outside a National Procurement Framework for local suppliers, service providers and contractors or local content, designed to advantage those located in specific geographical areas over neighbouring regions within the boundaries of South Africa, should not be permitted;

Local authorities should implement contractor / manufacturer development programmes in their areas of jurisdiction in order to develop target group enterprises who are capable of participating in participation programmes;

Local authorities should interface with national and provincial organs of State in respect of engineering and construction contracts, in order to secure the contract strategy, and delivery and targeting options which best serve the local economy on contracts put out by such bodies;

Local and regional authorities should establish data bases of local suppliers, service providers and contractors in order to award contract having a low financial value to such enterprises where a less formal tendering system is permitted.

### **Facilitating SMME access to markets**

#### **Finance**

One of the major challenges facing many SMME and emerging companies is their ability to attract sufficient debt and equity capital to fund the growth requirements of the enterprise. As enterprises become more successful in obtaining larger contracts their ability to internally finance themselves diminishes. Many of these firms, while still growing, have not reached the creditworthy stage usually required by traditional financing sources. Others having utilized their existing credit lines, find that their bank is unwilling to extend them further, even for performance on a contract.

Efforts to raise capital from existing shareholders are often unsuccessful. As a result, there is a need for institutions, somewhere between investment companies and commercial

banks to provide assistance in contract financing and for the client bodies, in the interest of developing this sector, to make some provision in the procurement system to address this issue.

Another important factor in the life of the smaller emerging enterprise is cash flow, or more particularly, fair remuneration for an activity which is completed to specification and then paid for when due. This is because the smaller enterprise is usually unable to :

- Survive even short periods without work;
- Obtain sufficient credit or surety to be able to finance his part of the employers' project for more than a few weeks;
- Devote time to debt collection beyond the usual submission of an invoice; and
- Pursue late or non-payment in formal proceedings irrespective of the degree to which it is rightfully due.

The Green Paper on procurement proposes that:

- *Payment systems should be streamlined and rationalised*
- *Electronic payment systems should be introduced*
- *The audit procedures of interim payments in engineering and construction works contracts should be revised*
- *Interest at rates above the bank overdraft rates should be paid to suppliers / service providers / contractors in respect of overdue payments.*

Proposals from various quarters have been made for the establishment of an equity fund to provide capital so as to allow emerging contractors to operate at scale. These proposals have suggested that funds for this purpose should be secured from the State and capital should be provided in terms of a share of the profits.

The Department of Trade and Industries is developing a comprehensive strategy to provide financial access for SMMEs. It has identified four objectives associated with access to affordable finance for SMMEs, viz.:

- To significantly increase the levels of commercial and non-governmental organization (NGO) lending (and financial services) to SMMEs at interest rates (and fees) not inflated by unreasonable risk perceptions;
- To improve the outreach and efficiency of both conventional and alternative financial institutions, especially in unserved rural areas;
- To stimulate the provision of start-up and small-scale equity products for SMMEs;
- To expand the number of SMEs listed on the Johannesburg Stock Exchange.

A comprehensive and integrated policy framework and implementation approach is required to address these objectives.

### **Performance bonds**

Client bodies are exposed to a certain amount of risk particularly in respect of engineering and construction works contracts, to the extent that contractors may fail to perform or provide a defective product. This can have direct financial implication insofar as rectification and completion of the works is concerned, and consequential financial implications resulting from the delayed occupation or possession of the assets that are created. Delayed completion also inevitably results in increased construction costs. As a result, client bodies require contractors to lodge security guarantees and retain an amount from interim certificates in order to cover some of this risk. Prime contractors in turn, in order to minimize their risk, often require subcontractors to provide similar guarantees.

Contract failures, resulting in performance bonds being called in, inevitably result from poor management viz., overextension; inadequate experience; inefficient operations; lack of proper job cost and accounting records and procedures; failure to arrange for proper financing; entering into hazardous ventures; lack of business acumen; and erroneous tender submissions (mistakes in estimating both of an arithmetical and judgemental nature, failure to allow for the contingencies; unforeseen external factors resulting on non-recoverable cost increases).

Insofar as small, medium and microenterprises/emerging construction businesses are concerned, this presents a significant financial hurdle to overcome in the pursuit of being awarded contracts. Furthermore, such enterprises, because of their greater risk factor presented to sureties, usually have to obtain their performance bonds at significantly higher rates than the large well established firms. Accordingly, they not only struggle to secure bonds, but have to do so at a cost premium.

Specific strategies and innovations are required to enable emerging SMMEs to be able to obtain the necessary performance bonds as these organisations usually have a weak financial base, which is not conducive to obtaining guarantees from financial institutions.

Strategies that can be adopted to minimize the risk exposure of public bodies include:

- Minimizing risk through the grading of contractors;
- Provision of sureties / security as opposed to performance
- Bonds;
- Establishment of a National Guarantee Fund;
- Increased retention fund payments;
- Separate materials and labour guarantees;
- Reducing of levels of performance bonds by means of contract;
- classification on the basis of risk exposure;
- Guarantees under written by development agencies;

- contractor associations and the like.

### **SMME registration**

Registration of contractors/service vendors is encountered in many countries. In some developed countries, contractor registration is used as a means of procuring goods, services and works by means of a qualification system. This system requires firms to qualify to be included on an approved list of tenderers. Public client bodies are able to access the list, draw up a schedule of firms which are suitable for a project (prequalify), and seek tenders from firms of equivalent size, capability and experience rather than to call for public tenders.

Registrations of contractors and service vendors on databases can either be undertaken by the public body itself or by a commercial organization. In some countries suppliers and service providers pay an annual registration fee to a commercial organization to be placed on their database which in turn is sold to public-sector bodies. In South Africa, however, this latter practice would be unlikely to satisfy the constitutional provisions. As such public bodies would have to establish and maintain their own databases. In any event, the procurement regime in South Africa is such that only quotations (very low value contracts and professional services) could be obtained on this basis.

Many developing countries in Africa have contractor grading systems for works contracts. Typically, contractors are classified in terms of their resources e.g. financial, equipment, supervisory staff, and previous experience. Monitors are appointed to verify contractor classifications and to reassess classifications from time to time. Contracts are packaged to suit contractors of a particular classification, usually in terms of complexity, monetary value and nature of the work. Typically, contractors may not tender for work above their contract status but may tender for work below their status, i.e., a B class contractor may tender for class B, C or D contracts, but not for class A contracts.

This system has proved to be useful in developing a local industry and to minimise work performed by foreign companies, as the system ensures that work which the local industry is capable of undertaking, is packaged appropriately. It also reduces the risk exposure of donor bodies / government departments as the categorization in essence is aimed at minimizing failure to perform.

The question of registration can be approached in a number of ways and is required for a number of reasons, one of which is to identify the SMME's field of operation (activity) in order to effectively target and promote certain types of businesses (see table 2).

Registration may be needed for accreditation purposes or as a means of :

- Compiling a database and packaging contracts;
- Regulating the industry;
- Ensuring equitable work loads to pre-qualified service providers;
- Certifying the bona fides of target groups.

## GREEN PAPER PROPOSALS ON REGISTRATION

### PUBLIC SECTOR PROCUREMENT REFORM IN SOUTH AFRICA

This paper suggests that registration must be instituted as a means of :  
compiling a data base for the packaging of contracts and identifying target groups;  
regulating participation in public sector procurement;  
promoting good business practices and adhering to statutory regulations and requirements; and  
censuring those who transgress codes of conduct, fail to meet their tax, levy or service charge obligations, or obtain work in a fraudulent manner.

In terms of the proposals, non-registered suppliers, service providers and contractors should not be permitted to participate in public sector procurement activities.

The paper proposes that registration must be subject to the observance of a code of conduct which should, *inter alia*, require that signatories undertake to :

tender only on projects which they are capable of executing with the resources they are able to marshal in accordance with the terms and conditions of contract;  
remunerate staff in accordance with relevant labour legislation;  
pay UIF, Workman's Compensation, service charges, VAT, income tax and other taxes as appropriate;  
adhere to safety and health regulations insofar as their worker's are concerned;  
engage subcontractors at reasonable prices so that they have the potential to adhere to labour standards;  
not engage in Dutch auctioning in the engagement of subcontractors (i.e. the practice of hawking prices around in order to drive prices down); and  
adhere to environmental standards.

### CREATING AN ENABLING ENVIRONMENT FOR RECONSTRUCTION, GROWTH AND DEVELOPMENT IN THE CONSTRUCTION INDUSTRY

This paper suggests that the registration and categorisation of contractors and enterprises will enable the following :

the operation of a preference scheme or approved public sector tender list which would reduce industry and public sector costs associated with the tender process.  
performance monitoring to enable the promotion of improved contractors and to ensure compliance where standards are violated.

The targeting of resources to emerging enterprises which are demonstrating progress and the withdrawal of support from those who have graduated or have failed to progress.

**TABLE 2 : CLASSIFIED LIST OF ACTIVITIES FOR INCLUSION IN THE ABE DIRECTORY AND IN THE DATA CAPTURE PROGRAMME**

1. CONSTRUCTION	2. SERVICES	3. WHOLESALERS/DISTRIBUTION
<input type="checkbox"/> C1 Airconditioning Systems	<input type="checkbox"/> S1 Accommodation	<input type="checkbox"/> W1 Automotive Parts
<input type="checkbox"/> C2 Alarm Systems / Security Systems / Access Control	<input type="checkbox"/> S2 Advertising / Public Relations	<input type="checkbox"/> W2 Building Materials / Hardware
<input type="checkbox"/> C3 Autoclaves	<input type="checkbox"/> S3 Auto Repairs & Services	<input type="checkbox"/> W3 Cleaning Supplies / Chemicals/ Pesticides
<input type="checkbox"/> C4 Automatic Hanger Doors	<input type="checkbox"/> S4 Bookkeepers	<input type="checkbox"/> W4 Clothing
<input type="checkbox"/> C5 Automatic Sliding Doors	<input type="checkbox"/> S5 Carpet Cleaning	<input type="checkbox"/> W5 Computer Equipment / Software
<input type="checkbox"/> C6 Automatic Sprinkle Fire Protection	<input type="checkbox"/> S6 Catering / Vending / Food Supply	<input type="checkbox"/> W6 Curtains
<input type="checkbox"/> C7 Brickwork / Masonry	<input type="checkbox"/> S7 Cleaning Services	<input type="checkbox"/> W7 Domestic Appliances
<input type="checkbox"/> C8 Cabinet / Furniture Making	<input type="checkbox"/> S8 Computer Supplies / Services	<input type="checkbox"/> W8 Medicines
<input type="checkbox"/> C9 Carpeting / Tiling / Floor Covering	<input type="checkbox"/> S9 Diesel & Petrol Engines	<input type="checkbox"/> W9 Electrical Supplies & Equipment
<input type="checkbox"/> C10 Ceilings, Partitioning and Shopfitting	<input type="checkbox"/> S10 Debt Collection	<input type="checkbox"/> W10 Fire Extinguishing
<input type="checkbox"/> C11 Cladding Contracts	<input type="checkbox"/> S11 Educational Services	<input type="checkbox"/> W11 Fire Protection & Detection
<input type="checkbox"/> C12 Cooking & Related Systems	<input type="checkbox"/> S12 Florists / Garden Services	<input type="checkbox"/> W12 Floor Coverings
<input type="checkbox"/> C13 Compressed Air Installations	<input type="checkbox"/> S13 Food & Beverage / Entertainment	<input type="checkbox"/> W13 Food Supplies
<input type="checkbox"/> C14 Concrete works	<input type="checkbox"/> S14 Funeral Services	<input type="checkbox"/> W14 Fuel Supplies
<input type="checkbox"/> C15 Demolition	<input type="checkbox"/> S15 Handyman	<input type="checkbox"/> W15 Furniture
<input type="checkbox"/> C16 Electrical Contracts	<input type="checkbox"/> S16 Horticultural Services	<input type="checkbox"/> W16 Generating Sets
<input type="checkbox"/> C17 Evacuation Systems	<input type="checkbox"/> S17 HV Fault Finding, Jointing & Terminations	<input type="checkbox"/> W17 Industrial Catering Equipment
<input type="checkbox"/> C18 Fencing	<input type="checkbox"/> S18 Insurance / Employee Benefits	<input type="checkbox"/> W18 Laundry Equipment
<input type="checkbox"/> C19 General Building Work	<input type="checkbox"/> S19 Interior Decoration	<input type="checkbox"/> W19 Medical Supplies & Equipment
<input type="checkbox"/> C20 General Electrical Work	<input type="checkbox"/> S20 Interior / Industrial Design	<input type="checkbox"/> W20 Office Supplies + Stationery
<input type="checkbox"/> C21 Glazing	<input type="checkbox"/> S21 Laundry Services / Dry Cleaning	<input type="checkbox"/> W21 Office Equipment
<input type="checkbox"/> C22 Hauling / Heavy Equipment / Transport	<input type="checkbox"/> S22 Locksmith Services	<input type="checkbox"/> W22 Paint Supplies
<input type="checkbox"/> C23 Hot Water Installations	<input type="checkbox"/> S23 Mailing / Courier Services	<input type="checkbox"/> W23 Recreational Supplies
<input type="checkbox"/> C24 Incinerators	<input type="checkbox"/> S24 Medical / Ambulance / Health Care	<input type="checkbox"/> W24 Refrigeration & Air Conditioning
<input type="checkbox"/> C25 Landscaping / Earthworks	<input type="checkbox"/> S25 Municipal Services	<input type="checkbox"/> W25 Vehicles
<input type="checkbox"/> C26 Lift & Escalator Equipment	<input type="checkbox"/> S26 Personnel Services	<input type="checkbox"/> W26 Workshop Equipment
<input type="checkbox"/> C27 Mechanical Contracts	<input type="checkbox"/> S27 Pest Removal Services	<input type="checkbox"/> W99 Other
<input type="checkbox"/> C28 Metalwork and burglar guards	<input type="checkbox"/> S28 Printing / Photography / Graphic Design	
<input type="checkbox"/> C29 Painting	<input type="checkbox"/> S29 Real Estate	
<input type="checkbox"/> C30 Paving	<input type="checkbox"/> S30 Safety & Security Services	
<input type="checkbox"/> C31 Plastering	<input type="checkbox"/> S31 Security & Access Control	
<input type="checkbox"/> C32 Plumbing	<input type="checkbox"/> S32 Servicing HV & LV Switchgear / Transformers	
<input type="checkbox"/> C33 Precast Concrete Manufacture	<input type="checkbox"/> S33 Site Cleaning	
<input type="checkbox"/> C34 Pumping Installations	<input type="checkbox"/> S34 Solid Waste Disposal	
<input type="checkbox"/> C35 Road Marking + Signage	<input type="checkbox"/> S35 Telecommunications	
<input type="checkbox"/> C36 Roadworks & Site Clearing	<input type="checkbox"/> S36 Travel Agencies	
<input type="checkbox"/> C37 Roofing & Waterproofing	<input type="checkbox"/> S99 Other	
<input type="checkbox"/> C38 Sewage Installations / reticulation		
<input type="checkbox"/> C39 Specialist Contracts		
<input type="checkbox"/> C40 Steam Installations & Ancillary Equipment		

		<b>4. PROFESSIONAL SERVICES</b> <input type="checkbox"/> P1 Accountants / Financial Advisory Services <input type="checkbox"/> P2 Architects <input type="checkbox"/> P3 Attorneys / Legal Services <input type="checkbox"/> P4 Consulting Engineers (Civil/Structural) <input type="checkbox"/> P5 Consulting Engineers (Electrical) <input type="checkbox"/> P6 Consulting Engineers (Mechanical) <input type="checkbox"/> P7 Consulting Engineers (Multidisciplinary) <input type="checkbox"/> P8 Land Surveyors <input type="checkbox"/> P9 Medical Practitioners <input type="checkbox"/> P10 Pharmacists <input type="checkbox"/> P11 Project Managers <input type="checkbox"/> P12 Quantity Surveyors <input type="checkbox"/> P13 Teachers <input type="checkbox"/> P14 Town Planners <input type="checkbox"/> P15 Training Providers <input type="checkbox"/> P99 Other
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### Subcontracting issues

In South Africa subcontractors have very little negotiating power with prime contractors due to the fact that there is always a next job syndrome, non-payment by the prime contractor and victimization in certain instances. Some of the problems expressed by subcontractors included the ‘hawking’ of prices submitted to prime contractors in order to obtain lower prices from others, the risk of non-payment and the use by prime contractors of subcontractor’s monies as an interest- free overdraft facility.

At present, public-sector employers only have a relationship with the prime contractor and they regard subcontracting issues to be the prime contractor’s problem, and of no concern to themselves. Subcontracting is an effective means of involving small, medium and microenterprises in public-sector procurement activities e.g. subcontractors account for more than 60% of the work on building sites. As such the plight of subcontractors cannot be ignored.

Resource specifications can be used to create subcontracting opportunities for targeted subcontractors. Subcontracting because of the terms and conditions under which it takes place, has in the past not been attractive to emerging contractors or those enterprises which have been historically disadvantaged. There are a number of reasons for this; the principle one being the unfavourable and harsh conditions of subcontract. Accordingly, targeted SMMEs have called for public bodies to fragment the larger contracts into smaller contracts so that they can be engaged as prime contractors under more acceptable terms.

The emerging subcontractor cannot, reasonably, be expected to depend on the integrity and sympathy of the main contractor in order to achieve a fair outcome to his subcontract. A well-established and experienced subcontractor is in a far better position both to assess the risk imposed on him by a conventional subcontract agreement and to manage those risks. Nevertheless, there is a good reason for trying to afford even experienced subcontractors some relief from unreasonable subcontract conditions. Any participative programme embarked upon by the Government must address the conditions of subcontract so as to make subcontracting attractive to targeted SMMEs.

The resource specifications published by the Procurement Forum which cover the engagement of targeted enterprises as subcontractors require the tendering entity to enter into written contracts with targeted enterprises which do not contain any of the following provisions:

- A right of set-off in favour of the employing contractor;
- Authoritarian rights given to the employing contractor or his agent, with no recourse to independent adjudication in the event of a dispute arising;
- Payment procedures based on a pay-when-paid system;
- A dispute resolution procedure which does not include inexpensive Alternative Dispute Resolution (ADR) procedures such as arbitration or mediation;
- Unreasonable retention percentages and periods of retention;
- A requirement for a surety to be provided in contracts of value less than R 100,000;.
- Conditions which are more onerous than those which exist in the main contract;

Prime contractors who engage targeted SMMs as subcontractors in terms of any of the above-mentioned conditions will have credits towards their contractual goals denied on the grounds of non-compliance with the specifications.

### **Procurement documentation**

It has been argued that current procurement policies and procedures tend to favour the larger and more established enterprises and that they are so complex that they do not provide small, medium and microenterprises with easy access into the mainstream procurement activities funded by the public sector.

The Green Paper calls for a commitment from procurement units to use standard contract documentation with minimal deviations from the accepted standard forms of contract and specifications. The practice of writing extensive special conditions of contract to change the risks, rights and obligations of the parties upon which standard conditions of contract are based, should cease. Bodies responsible for the development and publication of such documents must be called upon to publish amended versions of their documents as soon as the general weight of opinion requires such amendments.

It proposes that procurement documentation should be completely overhauled and rationalised to encourage participation by emerging businesses in public sector procurement activities. The whole tendering process should be made more accessible by ensuring that tender documentation is :

- Easy to comprehend and user-friendly;
- Free of unduly onerous requirements and conditions;
- More widely disseminated and distributed, in order to reach all potential tenderers; and
- Standardized.

### **Appropriate technologies**

South Africa's approach to the management of technology has changed dramatically in the last few years. Government recognizes the vital importance of having a technology promotion policy in place in order to support economic growth, specifically driven by the

export of high value-added manufacturing goods. A major thrust of government policy in this regard has been a recent move to establish a new National System of Innovation (NSI) aimed at coordinating the activities of the science, engineering and technology (SET) community and to promote technological innovation. In terms of coordinating SET activities, the NSI advisory panel will have oversight for the entire system, including : ensuring the integration of policies with respect to science and technology, linking the research activities of the scientific institutions (such as the science councils) and the universities to the needs of industry, and requiring that the research activities of the strategic industries are managed with reference to broader Science and Technology policy objectives. In terms of its innovation-promotion mandate, the NSI will also oversee specific programmes aimed at the supporting of both large, long-term research into industrial innovation, as well as direct grants for the development of product or process innovation in SMMEs. There are a number of programmes included in this framework, namely the National Research and Technology Foresight Programme, the Innovation Fund, the Support Programme for Industrial Innovation (SPII) and the Technology and Human Resources for Industry Programme (THRIP).

Government needs to identify and promote the use of technologies which have the potential to increase the number of employment opportunities generated per unit of expenditure; provided, however, that any cost premiums associated with such usage are modest. It will also have to review existing standards without compromising end-user requirements, including test methods and acceptance criteria, and modify them, as necessary, in order to facilitate the usage of such technologies by the SMME sector.

Upgrading of technology through a programme of international partnership instruments is required. Joint Ventures with international companies needs to be encouraged.

## **Quality**

ISO 8402 defines quality as *the total characteristics of an entity that bear on its ability to meet stated and implied needs*. Quality may be regarded as conformance to stated requirements (specification) rather than fitness for purpose. It is achieved by executing a contract to the stated requirements. Quality can be managed and given visibility by means of one or more of the following :

- Quality assurance, e.g. SABS ISO 9000 and other such certification schemes;
- Total Quality Management;
- Development of personnel; or
- Bench marking.

The South African Bureau of Standards (SABS) has a product certification scheme called the Mark Scheme. If a manufacturer is prepared to manufacture commodities in accordance with the requirements of a mark specification and to apply the required quality control measures to his factory, he may apply to the SABS to use the applicable certification mark on his commodity. Of the some 3,500 SABS specifications, about 700 have been declared mark specifications. There are currently, approximately 3,000 permit holders.

SABS ISO 9000 has strong support in some areas and forms the basis for most certification schemes. It has, however, been strongly criticized for being over-bureaucratic,

expensive, vulnerable to variable interpretation, inappropriate for small firms and existing as a goal rather than a means to an end. Nevertheless, it is an appropriate basis for effective management of quality notwithstanding its reliance on paperwork. Currently, approximately 1,500 firms have been certified.

Small firms have experienced some difficulties with the SABS ISO 9000 scheme. They have argued for a simplification of the standard and have complained about the cost of certification. There is no doubt that the cost of certification as a proportion of turnover for a small firm is significantly greater than for a large firm.

Small and emerging manufacturers have particular problems in achieving quality, depending, however, upon how quality is measured and defined. Current practice is to define quality in terms of certain accepted criteria and to measure such acceptance in terms of prescribed test methods and procedures. These are usually set out in SABS specifications or test methods which have, to a large extent, been formulated or drafted with the approval of industry and industry-related research and development organizations.

It may be argued that these standards have been drafted to suit well-established industry, and are framed around plant-based methods of manufacture and medium- to large-scale enterprises which have a reasonable degree of technical competency and testing resources. In addition, the test methods and procedures for quality assurance are generally written for a scale of operation where sufficient quantities for statistical purposes are manufactured, and the cost of testing by external authorities (or that associated with the establishment of in-house laboratories) can be written off against the volume of the article which is manufactured.

Failure by a small-scale manufacturer to comply with one of the requirements of these specifications, albeit a relatively minor lack of compliance, means that compliance with a SABS specification cannot be claimed. Thus, in effect, many of the current specifications present a barrier to entry to small-scale entrepreneurs and exclude their participation in particular markets.

The Green Paper on Public Sector Procurement Reform in South Africa suggests that the strategies to overcome difficulties relating to small-scale manufacture should include :

- Monitoring of the performance of manufacturers by the State in terms of sampling plans;
- Establishment of centralized testing centres;
- Formulation of specifications which describe product properties in terms of their physical properties rather than by reference to a series of standards;
- development and specification of simple site (point of manufacture) tests which confirm the acceptability of products for their intended purpose;
- review of testing and acceptance tests, criteria and norms;
- Setting of appropriate standards for different applications of a manufactured article; and
- Education and training of manufacturers.

## Training of procurement officials

The full potential of any SMME programme will not be realized without the training of officials. A structured training programme to import skills development and professionalism needs to be introduced for those with procurement responsibilities.

Procurement staff, apart from receiving training tailored to the specific needs of SMMEs, will require a mix of three sorts of training, depending upon the degree to which they are involved in procurement :

- Basic procurement training;
- Training in personal and general management skills;
- More advanced training in specialist procurement skills.

### **Training and mentorship to SMMEs**

The development of skills is the key to achieve successful outcomes in any SMME programme. Technical, managerial, commercial and administrative skills and competencies are required. These requirements need to be linked up with other government training programmes, and tied in with an appropriate qualifications system.

It is imperative that training be planned, resourced and budgeted for. A Structured Training Plan needs to be developed for each sector engaged in public-sector procurement. Such a plan needs to consider the training required to transfer the necessary and appropriate skills to participants and the levels of existing capacity associated with various SMME development programmes and as such should include :

- Activity lists of all training items;
- Schedules to show when the training of each activity should occur;
- Resources required in respect of each training activity and where such training will be carried out;
- Budgets for training;
- Management structure required to ensure its successful implementation;
- How the technology transfer is envisaged to take place.

Training does not just happen. It must be made to happen. It is important that persons be appointed to manage and coordinate training, and be held accountable for the achievement of training targets.

Training is the term used for the transferring of skills and competencies to individuals and groups by the use of classroom instruction, training materials, practical experience, etc., in a controlled manner to achieve predetermined outputs, in line with the requirements of the client or accrediting organization.

A mentor, or mentoring organization, attends to the more specific needs of contractors, suppliers and service providers as they go about their day to day business

activities. It is extremely unlikely that the needs of one contractor/service provider/supplier will be the same as the next. Therefore whereas a trainer can be trained to impart skills and competencies in line with given material, the mentor will be required to possess the actual experience and knowledge of the line of business. SMMEs require both mentoring and training.

### **Electronic access to business opportunities**

There are a number of electronic systems which are currently available which provide a means of matching opportunities to appropriate suppliers and suppliers to opportunities viz.:

- Push system: Organizations, for a fee, automatically receive all relevant opportunity information on a regular basis;
- Pull system: Organizations are able to find relevant opportunities from the Internet, from a Call-system and from a business centre (or from other public information points).
- Third party matchmaking: Any person (or at least staff at business centres) with access to the Internet is able to matchmake (or link) opportunities to suppliers. A single search to specific criteria provides either a list of opportunities with matchmaking list of suppliers or alternatively a list of suppliers with matching lists of relevant opportunities.

The majority of SMMEs cannot access opportunities presented through electronic media and even if they could do so, they probably would not have the resources to devote the requisite time and energy to access the opportunities presented in the various systems. Clearly there is a need for a single point of entry.

A single point of entry system also provides substantial benefits to public sector and corporate procurement officers. These offices could enter their tender and other opportunities from their desktop computers and be assured that these opportunities are automatically distributed to all SMMEs. Such an ability to match opportunities to suppliers electronically will give South Africa an international competitive advantage in the efficiency of making marketing linkages, which could contribute substantially to growth in electronic commerce, enabling more SMMEs to benefit from the advantages offered by e-commerce.

#### CURRENT ELECTRONIC MEDIA INITIATIVES

##### DTI : BRAIN Programme

BRAIN website (as single entry point for all business information)

Access to government databases such as : Registrar of companies, Exporters, etc.

Means of interacting with SMMEs (Business Centres, call-system, website, Business Buzz)

##### TIS (incorporating Sourcelink)

A self-sustaining business system to access, sort and distribute tender opportunities

Established systems and technology to access opportunities electronically and manually, to distribute electronically or by fax or in hard copy. Also, for suppliers to submit offers (quotes/tenders) and procurement officers to place orders.

R10 billion worth of annual opportunities

##### Braby's

A self-sustaining business system to access information on suppliers, sort and publish such information on the web and in directories.

Established systems and technology to do the above.

600 000 SADC suppliers on their database, which is accessible via the Internet.

A process where approximately five thousand organisations are contacted daily, to update their information.

##### CSIR

A database (multi-media) system called "in-Touch" developed to publish SMME information suitable for procurement from government and corporates.

##### Pretoria Metro

A Tradepoint software programme, close to launch

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### **Assisting Small Businesses through Government Purchases An Overview of United States Policies and Practices**

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**Assisting Small Businesses through Government Purchases  
An Overview of United States Policies and Practices**

## Introduction

Long before the SBA was created, the Congress recognized the need to help small businesses receive Federal contracts. During the Second World War, to ensure the participation of small businesses in the war production effort, the Congress passed a law creating the **Certificate of Competency (COC) Program**. The COC Program is an appeal process available to small businesses that are the low bidders on government contracts, but are proposed for contract denial because of decisions by contracting officers that mention inability to perform.

Today the COC Program is but one of several programs that are important to the small business community. Other programs include (1) **Procurement Policy and Liaison**, through which SBA plays a key role in the development of federal acquisition legislation, policy and regulation to protect the interest of small business; (2) **Prime Contracts**, which ensures that small business receives an equitable share of federal prime contracts; (3) **Procurement Breakout**, which advocates the breakout of procurement items for full and open competition to achieve significant savings to the Federal Government; (4) **Subcontracting Assistance**, which ensures that small business receives its fair share of federal subcontracts; (5) **PRO-Net**, which is an Internet-based database of small business firms used by government contracting officers, large business prime contractors, and state and local governments; (6) **Size Determinations**, which ensures that only eligible small businesses are reaping the benefits of the government's small business programs; and (7) the **Natural Resources Sales Assistance Program**, which aids and assists small business in obtaining its fair share of federal property offered for sale or disposal by other means.

By achieving significant savings to the taxpayer, these programs pay for themselves many times over. For example, in 1997 alone, these programs achieved savings of US\$ 94 million. These savings are many times the cost of salaries, travel, and all other expenses for the personnel who carry out these programs throughout the United States. The Procurement Breakout Program alone has saved the American taxpayer more than US\$ 2.4 billion since 1985.

Most importantly, through these programs, SBA is able to overcome the natural tendency of contracting officers to obtain goods and services from familiar, large business sources. This is especially important today in SBA's efforts to ensure equitable opportunities for small disadvantaged small women-owned firms.

### **How does the Government Contract Program work?**

The Federal Government purchases goods and services at hundreds of installations, both military and civilian, throughout the United States called "buying activities." SBA stations Procurement Center Representatives (PCR) at these activities to initiate small business set-asides and to promote the use of small business. These PCRs also review the proposed subcontracting plans of large business prime contractors. We also station SBA Breakout PCRs (engineers) at major buying activities to analyze large sole source procurements and recommend competitive procurements as appropriate. While the primary mission is to promote full and open competition, the result of their effort is two-fold: (a) it achieves a significant cost savings to the taxpayer; and (b) it expands the participation of small business.

The Subcontracting Assistance Program employs Commercial Market Representatives, or CMRs, who perform compliance reviews of large business prime contractors to ensure they are providing maximum practicable opportunity for small businesses. The CMRs also counsel small

businesses about marketing their products and services to large prime contractors and provide small business sources to large businesses.

SBA Industrial Specialists conduct site visits and do plant surveys on companies applying for a COC. Besides issuing COCs, SBA offers counseling to small businesses whenever it cannot issue a COC.

The SBA PRO-Net database provides profiles of small firms to help government contracting officers, large business prime contractors and State and local governments to identify small business sources for the products and services that they need. PRO-Net is an Internet-based system, available to our users free of charge.

Through the Size Determination Program, SBA ensures that only legitimate small businesses are awarded federal contracts that are set aside for small businesses. We do this by conducting a formal assessment of a company's size if a protest is filed on a specific contract by a contracting officer, SBA, or another bidder.

**Fiscal year 1997 Federal Procurement Awards<sup>15</sup>**

**Prime Contract Awards:**

Small Business Prime Contract Awards (includes):	\$ 40.6B	24.9%
8(a) Awards	\$ 6.3B	3.9%
Small Disadvantaged Business Prime Contract Awards (non-8(a))	\$ 10.8B	6.6%
Small Women-owned Business Prime Contract Awards	\$ 3.5B	2.2%
<u>Total Prime Contract Awards</u>	<u>\$ 162.6B</u>	

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<sup>15</sup> Source: Federal Procurement Data Center, General Services Administration. The base is limited to dollars awarded to small and large business concerns.

## Subcontract Awards:

The final results for fiscal year 1996, the most recent year for which we have statistics, are as follows:

Small Business Subcontract Awards (includes):	\$ 27.0B	40.9%
Small Disadvantaged Business Subcontract Awards	\$ 4.3B	6.5%
Small Women-owned Business Subcontract Awards	\$ 2.4B	3.6%
Large Business Subcontract Awards	\$ 38.9B	59.1%
<u>Total Subcontract Awards</u>	<u>\$ 65.9B</u>	

## Prime Contracts Program

### Overview

The programs of the Office of Prime Contracts strengthen the economy of the nation by increasing opportunities for small business participation in the federal acquisition process and expanding full and open competition to effect savings to the Federal Government. Opportunities for small business are increased primarily through the efforts of our PCRs who champion the interests of small business and recommend small business set-asides at assigned federal contracting activities. Our Breakout PCRs are advocates for the breakout of items for full and open competition to save money for the government. Most PCRs are resident at major buying activities, though a few reside at SBA District and Area offices.

### Current issues

As a result of the **Federal Acquisition Streamlining Act of 1994**, many agencies decreased their contracting staff and, as a result, increased the practice of contract bundling by consolidating requirements that were formerly separate contracts. Our concern is that bundling consolidates requirements which individually were or could be performed by small business and prevents, in many instances, performance by small business. We are currently revising Part 125 of Title 13 of the Code of Federal Regulations to add the regulatory language on bundling addressed in the **Small Business Reauthorization Act of 1997**. The statutory amendments recognize that the consolidation of contract requirements may be necessary and justified, but require that each federal agency take steps to avoid unnecessary and unjustified bundling of contracts that precludes small business participation as prime contractors. To further assess the effect on our small business constituency, our PCRs collect data on bundling practices at the buying activities they cover and we have provided a mechanism for the contractor community to report instances of bundling to SBA via the Internet.

As federal agencies developed strategies to streamline, each agency sought ways to shorten procurement lead time, simplify the procurement process, save money and reduce procurement staff.

To achieve these goals, agencies relied more on the use of optional, multiple award General Services Administration (GSA) schedules and Government Wide Acquisition Contracts (GWACs) contracts to fill agency needs. In many cases, these requirements were formerly provided by small firms under individual contracts. We are working with the GSA and other agencies to devise innovative strategies to assure that small business firms retain their share of prime contracts. We have been successful in persuading several agencies to use innovative strategies that reserve contract awards for 8(a) firms and small businesses when specified conditions are met. CFR 13, Part 125, will be revised to provide guidance in using these strategies.

### **New initiatives**

In June, 1997, the Vice President announced *PRO-Net*, a new pilot initiative with 6,000 plus small firms in the database. The database is expanding weekly and currently contains profiles of over 177,000 firms. *PRO-Net* is an Internet-based electronic gateway to information for and about small businesses and is provided to users free of charge. *PRO-Net* provides profiles to federal and state agencies, federal prime contractors, and others who may be seeking small businesses sources as prime contractors and subcontractors. The system allows participating firms to continually update their profiles with current information. We are currently working with our resource partners, State and local governments, colleges and universities, local economic development centers, etc., to sponsor a dedicated *PRO-Net* access workstation at their facilities. Our goal is to establish a network of access stations throughout the United States.

One of our on-going initiatives is the Account Executive Program, through which we monitor the small business procurement programs at the Federal Government's largest departments and agencies. Our account executives negotiate procurement preference goals with their assigned agencies to assure that small, small disadvantaged and small women-owned businesses have the maximum opportunity to participate in federal contracts. The account executives serve as advocates to resolve problems between federal agencies and the SBA or federal agencies and the small business community.

Negotiation of the 1995 procurement preference goals resulted in agreements with several federal agencies to consider innovative ways to promote utilization of the SBA's 8(a) program. Our PCRs helped the local buying activities utilize firms in SBA's 8(a) portfolio that had not yet received a federal contract award. The 8(a) initiative resulted in 155 first time awards, valued over \$69.4 million in FY 1997.

Legislation generated two pilot programs managed by the Office of Prime Contracts in the last few years. The first is the Women-Owned Business Procurement Pilot introduced to help achieve the government-wide 5% goal for awards to women-owned small businesses. To assist agencies in achieving this goal, the SBA joined with 11 major federal agencies and other resource partners to establish a systematic approach to expand the pool of women-owned firms through outreach, training and marketing assistance. Each year a series of workshops are conducted at selected district offices in support of this pilot. In addition, we are taking steps to assure that women-owned firms receive a larger slice of the procurement pie by: requesting that each Cabinet member commit to specific strategies to increase the women's share of their agency's contracts; requiring agencies to consider women-owned firms when selecting a contractor in the streamlined procurement process; working to get more women-owned firms registered on the *PRO-Net* database; and appointing a program manager for the women's procurement issues.

The second pilot program resulted from a provision in the SBA's **1994 Reauthorization and Amendments Act**, which charged SBA with establishing and implementing a pilot program to improve access to federal contract opportunities for very small business (VSB) concerns. This program is an extension of the small business set-aside program. The regulations implementing the VSB pilot will be issued in FY 1999. PCRs will work with the district directors in the nine designated geographical areas to identify very small business concerns that are eligible to participate. (For purposes of this program, a very small business concern is one that has 15 or fewer employees and has average annual receipts that do not exceed \$1 million.)

### **Questions and answers**

**Q. Do PCRs actually make small business set-asides?**

A. PCRs recommend small business set-asides to agency contracting officers when the PCR identifies two or more responsible small business concerns expected to bid on a requirement and that award will be made at a fair market price. In FY 1997, PCR recommendations on new procurements resulted in almost \$1 billion in contract awards to our small business constituency.

**Q. Has the Breakout PCR program resulted in significant saving to the government?**

A. Since 1985, the program has produced savings in excess of \$2.4 billion for the Federal Government. In FY 1997, savings resulting from breakout recommendation were over \$69 million.

**Q. Does the Breakout program specifically benefit small business?**

A. Although the primary focus of the program is full and open competition, small business plays an increasingly important role in increasing competition. In FY 1997, Breakout PCR recommendations resulted in contract awards to small businesses totaling \$25.8 million.

### **Statistics**

There are currently 45 PCRs, plus seven field staff with collateral duties in the program. In FY 1997, PCRs reviewed approximately 42,000 acquisition packages. PCRs also counseled over 15,000 small business firms and supplied over 21,000 small business sources to contracting agencies. We have 14 Breakout PCRs stationed at major Department of Defense activities throughout the country. Over 2,600 recommendations, with a value in excess of \$384 million, were accepted for breakout in FY 1997. Breakout savings for the year totaled \$136.2 million.

## **Certificate of Competency Program**

### **Overview**

The purpose of the Certificate of Competency (COC) Program is to assure that small business concerns, especially those who are newly entering into the Government procurement arena, are given a fair opportunity to compete for and to receive a Government contract.

The COC Program is an appeal process available to a small business that is the apparent low offeror on a prime contract, but found nonresponsible by a government contracting officer. The process has a short turn-around time. The firm is advised that it must apply for a COC to continue to be eligible for contract award, and it is given only a few days to submit an application. The firm is not required to apply for a COC, of course, but it would no longer be eligible for the particular contract on which it had been found nonresponsible. Each COC is reviewed on its merits and is procurement specific. Once SBA issues a COC on behalf of a small business, the contracting officer is required to issue a contract to the firm.

### Current issues

A rewrite of the COC program's Standard Operating Procedure was completed and published on April 24, 1998.

The **Federal Acquisition Streamlining Act of 1994 (FASA)** and **Federal Acquisition Reform Act of 1995** (incorporated into the Defense Authorization Act of 1996) will have a profound effect on the ability of small businesses to enter the federal marketplace. These laws and their implementing regulations allow companies to be ruled out of contract competition without benefit of a referral to SBA for a COC because issues previously considered elements of responsibility are now being made evaluation factors and are not subject to a COC determination.

### New initiatives

Streamlined processing procedures for COC referrals below \$100,000 in value was implemented with the publication of the new COC standard operating procedure (SOP). This should make the overall COC process more customer-friendly, in addition to making the process easier for field staff to manage and maintain.

Explore ways of restoring some of the protection afforded small business prior to FASA and FARA.

### Questions and answers

**Q. How does the COC procedure operate?**

A. Procurement regulation requires the referral to SBA of a proposed rejection of a bid or offer of a small business concern where a determination of nonresponsibility has been made. SBA has 15 working days to determine if the small business firm has overcome those issues of responsibility to perform in accordance with the requirements of the procurement. The COC process is carried out by a specialized SBA field staff of individuals with technical, engineering, financial, and government contracting experience. In making its determination, SBA reviews all material submitted by the buying agency and the small business firm.

**Q. What other assistance does SBA offer through the COC Program?**

A. SBA's COC personnel are knowledgeable in many areas of government procurement administration as well as production and quality assurance matters. Small businesses are counseled on a regular basis by our COC field staff on these subjects.

**Q. Many Government procurement offices advocate eliminating the COC program or significantly changing its operation because they feel that SBA forces incompetent contractors upon them. Is this so?**

A. This is one of the myths that exists about the COC Program. Some people believe that SBA "rubber stamps" approval of COC applications.

Many small businesses feel the COC program has been effective, as it promotes competition, assures small businesses a fair chance to get the contracts they deserve, and saves the Government millions of dollars (approximately \$21 million in FY 1997).

SBA's COC reviews are comprehensive and are nearly always completed within 15 work days. Decisions are based on facts and analysis, not on opinion or personal leanings. Unless it can be established, in documentary form, that there is a reasonable assurance of completion of the proposed contract in accordance with all its terms, a COC will not be issued. In fact, only about 50% of all COC applications processed result in the issuance of a COC by SBA--hardly a rubber-stamp operation. COC certified contractors as a whole perform as well as or better than the general population of non-COC contractors. The on-time performance rate for COC certified small businesses was better than 95% in FY 97.

**Q. How has the COC Program aided in bringing new companies into the government procurement arena?**

A. One of the major benefits of the COC Program, as well as all SBA Government Contracting Programs, is the continual expansion of the competitive base of government offerors. The basic economic premise of market systems is that increased competition directly results in better prices and increased savings to the buyer.

One way newly entering small businesses are brought to our attention is through the COC program. If we cannot provide direct assistance in the form of a COC, the firm is referred to other SBA Programs, such as Financial Assistance, Management Assistance or Minority Business Programs. With the strong SBA field support system available, we have been extremely successful over the years in getting small firms to the point that they can obtain government contracts on a continuing basis on their own. In fact, a significant proportion of current small business government suppliers have a COC somewhere in their background.

## **Statistics**

There are currently 21 full-time and 6 part-time COC Specialists located in 12 offices throughout the U.S. In FY 97, we received and processed about 800 COC referrals, resulting in 400 COC applications, and we issued about 200 COCs. This resulted in a savings to the taxpayer of about \$21 million.

## **Subcontracting Assistance Program**

## Overview

The purpose of the Subcontracting Assistance Program is to ensure that small business receives maximum possible opportunity to participate in federal contracts as subcontractors and suppliers. The Program focuses on large businesses that are prime contractors to the Government and that have one or more federal contracts over \$500,000 (over \$1,000,000 in construction of a public facility). These dollar amounts are the thresholds for a subcontracting plan required by Section 8(d) of the Small Business Act. All subcontracting plans must have separate and distinct goals for small business, small disadvantaged business, and women-owned small business. Beginning in FY 1999, all subcontracting plans must also contain a goal for "qualified HUBZone small business concerns."

## Current issues

We currently have a dispute with a number of large businesses over the procedures for determining the size of their suppliers and subcontractors. Although SBA's regulations on this subject are clear, few large businesses are in compliance with the procedures for collecting self-certifications. The Aerospace Industries Association (AIA) believes that SBA's size regulations, which rely on Standard Industrial Classifications (sometimes called "SIC codes"), are cumbersome and impractical. We are in general agreement that the size regulations in the subcontracting program could be simplified, and we have established an industry working group to address the problem.

## New initiatives

We are working closely with the Office of Personnel Management (OPM) on a pilot program that requires the six largest health providers in the Federal Employees Health Benefits Program (FEHBP) to develop subcontracting plans with goals for the utilization of small business. The six providers in the pilot account for 75% of all federal employees. For the first nine months of the initiative, the participating carriers subcontracted \$357 million to small business - almost four times our projection.

In February 1998, we signed an agreement with General Motors, Ford, and Chrysler for a pilot program that will encourage subcontract awards to small disadvantaged firms, especially 8(a) firms. Vice President Gore announced the initiative at a signing ceremony at the White House. In May, 140 8(a) firms attended a conference in Detroit for 8(a) firms that are interested in doing business with the automakers. Representatives of General Motors, Ford and Chrysler explained how to do business with their companies.

The Office of Government Contracting is also working with the Office of Federal Procurement Policy (OFPP) to strengthen and clarify subcontracting regulations. At SBA's request, OFPP convened a working group last year to rewrite, simplify, and consolidate all prior policy letters on subcontracting, some of which date back as far as 1980. We expect the new policy letter to be published in the *Federal Register* as a proposed rule this summer.

In FY 1997, we undertook an ambitious program for marketing 8(a) firms to prime contractors in the private sector, with special emphasis on 8(a) firms that have not yet received their first 8(a) contract and on firms owned and controlled by women.

We have made the *Small Business Subcontracting Directory* accessible to the public on the Internet via *SBA ONLINE*. In addition, we are developing a *Subcontracting Opportunities Bulletin Board*, which should be operational this summer. The bulletin board will provide a vehicle for large

businesses to list sources sought announcements for future contracts and requests for proposals for current contracts. Small businesses will be able to access the bulletin board through the SBA Homepage on the Internet.

### **Questions and answers**

**Q: Can you tell us more specifically what SBA does to help small businesses obtain subcontracts?**

A: SBA does this in two ways. First, SBA's subcontracting specialists in the field, who are known as Commercial Market Representatives (CMRs), perform compliance reviews of prime contractors. Among other things, they examine the purchasing records of the large businesses to be sure that they are providing maximum practicable opportunity to small business in accordance with the law. Second, the CMRs counsel small businesses and refer them to specific prime contractors as may be appropriate. The CMRs also help the primes to identify small businesses with the products or services they need. In this way, SBA is not just monitoring the performance of the primes but actually taking a proactive role in matching them with small businesses.

**Q: How much authority do the CMRs have to make large businesses use small businesses?**

A: They have limited authority. The statute and regulations give SBA the authority to perform compliance reviews, but the regulations provide a number of restrictions. The most important restrictions are: (a) SBA cannot require a prime contractor to use a particular small business; and (b) SBA cannot prescribe the amount of subcontracting (if, for example, the prime contractor prefers to do the work with its own employees).

**Q: Given these limitations, what clout does SBA have in the subcontracting program?**

A: Since the statute does not give SBA much of a stick, we use the carrot approach. Since 1985, we have tried to motivate large businesses and other major prime contractors, including universities, to improve their small business programs by providing formal recognition to those that excel. We have two award programs for this purpose, the *Award of Distinction*, which is awarded to deserving companies throughout the year, and the *Dwight D. Eisenhower Award for Excellence*, our highest award, which is presented to no more than four companies at a special ceremony in Washington, D.C., during Small Business Week each May.

**Q: Do you have any evidence that these award programs have actually worked as intended?**

A: Beyond our expectations. Prime contractors such as the Boeing Company in Seattle have actually asked us to visit them and perform a compliance review so that they might be considered for an award.

**Q: Overall, how successful is the Subcontracting Assistance Program?**

A: Extremely so, if judged by the statistics. For example, subcontracts to small disadvantaged business remained at approximately 2% for several decades. Since the inception of our awards program in 1985, the percentage of subcontracts to small disadvantaged business has steadily

risen from 2.2% that year to 6.5% in fiscal year 1996 (the most recent year for which we have statistics).

## Statistics

In fiscal year 1997, SBA's CMRs conducted approximately 1,800 compliance reviews of large business prime contractors. They also performed nearly 500 needs assessments to identify opportunities for small business. The CMRs also furnished large businesses with more than 4,600 small business sources (specific referrals) and counseled over 9,000 small firms, including 2,944 small disadvantaged firms and 2,166 women-owned small firms.

The subcontracting achievements for fiscal year 1997 will not be available for several months. The subcontracting achievements for 1996 are as follows:

Total subcontracts	\$65.9 billion
Small business	27.0 billion (40.9%)
Small disadvantaged business	4.3 billion ( 6.5%)
Women-owned small business	2.4 billion ( 3.6%)

## **Nonmanufacturer Rule Waivers**

### **Overview**

The Small Business Act states that a recipient of a contract set-aside for small business or the SBA 8(a) program, other than the actual manufacturer or processor, must provide the product(s) of a small business. This requirement is commonly referred to as the Nonmanufacturer Rule. The Small Business Act also contains provisions which allow for the administrator (authority delegated to the Associate Administrator for Government Contracting) of the SBA to waive this requirement when there are no small business manufacturers or processors available to supply the product to the Federal Government.

There are two types of waivers of the Nonmanufacturer Rule and are referred to as "individual waivers" or "solicitation-specific" and "class waivers."

A class waiver waives a class of products as defined by the Office of Management and Budget's *Standard Industrial Classification Manual*, and the General Services Administration's *Product and Service Code Directory*. A request for a waiver of a class of products should refer to a specific subdivision, or statement of product, within a four-digit code in one of these manuals.

An individual waiver may be requested only by a contracting officer for the Federal Government based on a determination by the contracting officer, that no known small business manufacturer or processor exists for the required item.

## **Current issues**

We are working with the National Minority Medical Suppliers Association in an attempt to establish a criterion to which a set-aside can be created and a Nonmanufacturer Rule waiver granted for a medical/surgical Prime Vendor Program.<sup>16</sup>

## **Questions and answers**

**Q. Can a waiver of the Nonmanufacturer Rule be granted by SBA regional or district offices?**

A. No, waivers are processed at the SBA Central Office, Office of Government Contracting.

**Q. What is the duration of a class waiver, and can only a contracting officer request a class waiver?**

A. A class waiver is in effect until SBA is notified of a source for the product waived who has provided the product to the Federal Government. Any interested party may request a class waiver.

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<sup>16</sup>Based on several General Accounting Office (GAO) studies, it has been determined that the Federal Government needs to adopt a more economical inventory control method. An attempt at this is the Prime Vendor Program concept.

## Statistics

The number of waivers granted by fiscal year are the following:

FY 1997	73
FY 1996	172
FY 1995	178
FY 1994	192
FY 1993	115

### Natural resources sales assistance

#### Overview

The purpose of the Natural Resources Sales Assistance Program is to aid and assist small business in obtaining its fair share of federal property offered for sale or disposal by other means. Within this government-wide program our efforts have been concentrated on the sales of federal timber, royalty oil, coal leases, other mineral leases and federal surplus property. The Natural Resources Sales Assistance Program is a centralized function with Central Office staff management and industrial specialists located, Post-of-Duty, at key geographic locations throughout the United States (Atlanta, Georgia; Portland, Oregon; Seattle, Washington; and Denver, Colorado). Within the program, the primary demand has been on small business involvement in sales of government timber.

The Small Business Administration has interagency agreements with the Forest Service, Department of Agriculture; the Bureau of Land Management, Department of Interior; and the Department of Defense to jointly manage a timber sale program for small business. These agreements provide that if small business is not able to buy 90% of their fair share in any six-month period there will be timber sales designated by SBA for preferential bidding by small business in the following six-month period. Shares are established every five years on over 160 market areas throughout the United States using purchase and harvest history. Operation of the program depends on timber being offered for sale from federal government lands. This source of timber is disappearing as pressures have mounted on federal agencies from environmentalists to lock up more and more of the forest lands for wilderness, wildlife protection, scenic and wild river reserves, old growth, watersheds, and buffer areas for parks. As a result, timber sales have shrunk. Currently the major impact is in the Pacific Northwest, but the same thing is happening to differing degrees throughout the United States.

## Current issues

The President's Forest Plan: During his election campaign President Clinton promised a forest summit to address the timber supply crisis. That forest summit occurred April 1, 1993, in Portland, Oregon. At that summit the President promised to produce a forest plan which was published July 1, 1993. In the plan, the President promised a federal timber supply of 1.2 billion board feet to be sold annually in the Pacific Northwest States, northern California, Oregon and Washington. Additionally the plan relied heavily on economic revitalization for timber dependent communities through community and worker assistance programs.

Also in the plan the President directed his cabinet to identify and implement, in a priority manner, the best ways to strengthen small business and secondary manufacturing in the wood product industry. In addition, to implement the economic adjustment and community assistance initiatives of the President's plan, the Administrator signed a memorandum of understanding with ten other agencies which established a Multi-Agency Command (MAC), Regional Community Economic Revitalization Team (RCERT) and State Community Economic Revitalization Teams (SCERTS). SBA is represented on the MAC by Richard J. Sadowski, Assistant Administrator for the Office of Natural Resources Sales Assistance (ONRSA). Representatives from ONRSA are participating at the SCERT levels.

For most agencies, the first three years of their commitment were covered under the Interagency Memorandum of Understanding (MOU) for Economic Adjustment and Community Assistance. The final clause of the MOU provided an opportunity to extend that agreement for any additional period upon unanimous consent of the parties. A memorandum extending through 1998 was signed by former Administrator Lader and a request for another extension, along with a proposal to create the Southeast Alaska Community Economic Revitalization Team (SEA-CERT), is currently being reviewed by SBA.

In addition, the SBA continued its strong support for businesses in timber dependent Pacific Northwest communities through approving a number of loans in this area. The SBA also made available training seminars, economic development briefings and round table meetings with business leaders. Some areas of the Pacific Northwest have found the Community Economic Revitalization concept so helpful to their economic benefit that they plan continuing the process even after the CERT process itself might end.

5-Year Recalculation - The five year operational period is segmented into 10, six-month periods. If small business fails to buy 90% of its share in a six-month period the program is triggered. Set-asides or, designated timber sales, would be scheduled for the next six-month period. The amount of timber volume designated SBA is the small business share of timber to be offered in the next six-months plus, at least a portion of the deficit which was created. Special Rules accommodate the notion of some open sales in each six-month period available to bidders of any size designation. This year is particularly critical to the program because of the fact that this the year of the 5-Year Recalculation which establishes small business shares for the next five-year period.

## New initiatives

We are attempting to utilize more and more automation in an attempt to augment resources.

## Questions and answers

**Q. What effect would the elimination of the Small Business Timber Sale Program have upon the economy?**

A. Small business sawmills do not have the forest land and timber base to supply the raw materials necessary to manufacture the lumber products demanded by our nation. Large business does have an extensive land and timber base, but uses federal timber as a supplement. However, small business is an integral part of the forest industry and without the Timber Sale Program, small business would not be able to compete against large business.

### **Size Determination Program**

#### **Overview**

When the size status of a business is questioned, a formal size determination is performed by SBA Size Specialists in Government Contracting Area Offices. Any interested party may protest the size status of a business. An interested party could be an offeror on a set-aside contract, a contracting officer, SBA, etc. The protest can be in reference to the award of a specific small business set-aside contract or to the award of future set-aside contracts.

#### **Current issues**

The size regulations (13 CFR Part 121) were revised January 31, 1996 and the Size Specialists must adjust their determinations to the new regulations. For example, there are four additional exclusions from affiliation which include: members of approved small business pools, firms that lease employees from a firm whose primary business is leasing employees to other firms, mentor/protege firms, and certain investors in SBIC portfolio firms.

Also, there is no longer an absolute right to an appeal from a size determination. An appeal petition may be filed with the Office of Hearings and Appeals (OHA), but OHA has the right to accept or deny any petition.

Annual receipts have been simplified to incorporate figures already contained in the business' Federal Income Tax return. In addition, amounts collected for another by a conference management services provider or an advertising agent are excluded from a business' annual receipts.

#### **New initiatives**

As a result of the law requiring goals for women-owned businesses, a company's ownership may be challenged. We are in the process of determining how these protests will be handled.

We are working with the Office of Size Standards (OSS) to clarify the method used to determine average annual receipts. We are also working with OSS to simplify the method used by large prime contractors to identify the size status of their subcontractors.

#### **Questions and answers**

**Q. What is the benefit of a size determination?**

A. There are times when an other-than-small business tenders an offer on a small business set-aside procurement and is determined to be the low offeror. If that company's size status is protested and SBA determines it to be other-than-small, the contract can then be awarded to a legitimate small business.

**Q. Are the size regulations and policies useful to programs beyond the set-aside program?**

A. Yes. These regulations and policies are used by federal as well as some State and local governments as the basis to establish eligibility for small business preference programs. As an example, the Food and Drug Administration (FDA) has a small business exemption under the Prescription Drug User Fee Act. SBA performs size determinations for FDA. If the company is determined to be small, the FDA does not charge the company the user fee to test its proposed new drug.

### **Statistics**

There are currently four full-time and seven part-time Size Specialists. In FY97, they performed 416 size determinations. This was a decrease from FY96 in which 481 determinations were made.

## **Procurement policy and liaison**

### **Overview**

The Office of Procurement Policy and Liaison (OPPL) maintains contact with all federal departments and agencies to ensure that small business concerns receive fair and equitable treatment from each agency. The office also plays a key role in the development of federal acquisition policy, legislation, and regulations which may affect the interests of the small business community. OPPL closely monitors procurement legislation and makes suggestions for revisions which would accomplish the goals while retaining provisions that encourage the participation of small business concerns. This Office also participates in the development of the Federal Acquisition Regulation which governs federal procurement procedures.

## **Current issues**

### ***Contract bundling***

The Federal Acquisition Streamlining Act of 1994 (FASA) encourages contract consolidation to reduce the staff, costs and time needed to issue solicitations. Consolidation, or contract bundling, created barriers to small business participation in the federal marketplace due to the size of some consolidations. The SBA is revising part 125 of Title 13 of the Code of Federal Regulations (CFR) to add regulatory language addressing contract bundling, resulting from the changes set forth in the Small Business Reauthorization Act of 1997 (Public Law 105-135). In addition, this rule restates SBA's current authority to appeal to the head of a procuring agency other decisions made by the agency that SBA believes to adversely affect small businesses. The statutory amendments recognize that the consolidation of contract requirements may be necessary and justified, but require that each federal agency, to the maximum extent practicable, take steps to avoid unnecessary and unjustified bundling of contract requirements that precludes small business participation as prime contractors and to eliminate obstacles to small business participation as prime contractors.

### ***Multiple Award Contracts***

The Federal Acquisition Streamlining Act of 1994 (FASA) seeks to decrease procurement lead times, provide greater discretion to contracting officers, and minimize contract protests through the use of indefinite quantity indefinite delivery (IDIQ) contracts to more than one vendor providing the products/services required. Agencies then issue delivery/task orders to one or more schedule contractors. We are concerned that using the multiple award strategy provides an opportunity for agencies to use favorite contractors and exclude small business. Strategies to reverse this trend are being developed.

### ***Federal Supply Schedules***

Increased agency use of Federal Supply Schedules resulted in fewer contracts being set aside for small business. Small businesses are encouraged to compete for inclusion on schedules; however there is no assurance that they will receive orders. SBA is working with GSA and OFPP to devise strategies which would require greater consideration to small firms when purchasing from the schedule.

### ***23% Goal***

President Clinton has directed that 23% of all government contract awards be made to small businesses. This goal presents a variety of policy and procedural challenges to all federal agencies due to some of the challenges to small business resulting from procurement reform. We are working with all agencies to devise new approaches that will facilitate achievement of this goal.

## *OMB Circular A-76*

OMB Circular A-76 mandates standards by which federal agencies should evaluate the relative costs and benefits of performing a “commercial” activity in-house or contracting it out. As a practical matter, agencies have been less than aggressive in carrying out this mandate and some have ignored its provisions. Currently, legislation (Freedom from Government Competition Act, S-314 and HR-716) is pending which would mandate in law the regulatory requirements of A-76. While this development may create new opportunities for some small businesses, it may remove some existing prime contracts to other small businesses. SBA proposes to work with agency “public-private competition coordinators” to ensure that small firms receive a fair share of prime contracts and subcontracts.

## *Credit cards*

Due to the increased use of the purchase/credit card, we are developing strategies to assure that small business receives their fair share of these purchases. In addition, we are working with GSA and OFPP to establish a system that will provide agencies with the necessary data to record socioeconomic data for purchases via credit card.

## *Women Owned Business*

The Federal Acquisition Streamlining Act of 1994 establishes a goal to award 5% of all government contracts to women-owned businesses. Currently women receive approximately 2.2% of such awards. We are working with federal agencies to devise strategies to assist agencies to achieve this goal.

## *Micro-Purchase Threshold*

It has been proposed that the Micro-Purchase Threshold (MPT) be increased from \$2,500 to \$10,000 and therefore exempt from the mandatory set-aside provisions set forth in **The Federal Acquisition Streaming Act of 1994**. Currently, micro-purchases (under \$2,500) account for more than 60 % of the Federal Government's annual purchase transaction volume. The proposed increase in the MPT would significantly expand this unrestricted market to the detriment of small business participation. Further, micro-purchases do not require competition, only that the buyer determine the award price to be reasonable. This restriction on competition would encourage large business/brand-name purchasing and severely limit the ability of small business firms to successfully enter and compete in this segment of the market.

In summary, the raising of the MPT would result in: (1) a significant decrease in potential purchase order awards to small business; (2) an overall decrease in competition; and (3) a corresponding increase in the award of sole source purchase orders.

## New initiatives

Undertake a series of detailed, specialized studies to examine controversial or emerging issues in the government contracts arena. Potential issues include contract bundling, expanded use of the government credit card, increased use of multiple-award contracts, proposed increases in the micro-purchase and simplified acquisition thresholds, and special initiatives to increase contract awards to disadvantaged and women-owned businesses. This will strengthen SBA's ability to fulfill its mission in assuring that small firms receive their fair share of government contracts by providing in-depth policy research and analysis on federal government contracting policy issues likely to have a major impact on small firms

## Questions and answers

- Q. How does the small business community benefit from SBA's involvement in the legislative and regulatory procurement changes?**
- A. Often, in the effort to streamline procurement legislation and regulations, provisions which help to protect a fair share of federal contracts for small business are proposed for elimination. The SBA works closely with the lawmakers and the regulation writers and proposes alternate language which would accomplish the objectives of streamlining in a manner that would encourage and promote small business participation.

**Statistics** (none applicable).

## ANNEX E

# TRADE AND PUBLIC PROCUREMENT: THE PERSPECTIVE OF SMALL OPEN ECONOMIES

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## I. INTRODUCTION

Governmental discrimination in favor of domestic producers is often considered to be a non-tariff barrier to trade. In order to remedy this situation, the Government Procurement Agreement has been designed to subject government procurement to international competition. The agreement regulates the tendering process to guarantee the transparency of the procedures and to insure non-discrimination between domestic and foreign firms. The Agreement was negotiated in 3 rounds with a different version entering into force at the end of each round. The current version, which became effective in 1996, covers the majority of governmental entities and most government purchases (excluding defence purchases). It sets a general threshold of SDR 130,000 (approximately US\$ 187,000) below which it is not binding. Construction contracts are subject to a higher threshold of SDR 5,000,000 (approximately US\$ 7,188,000).<sup>17</sup> The GPA also includes a very advanced mechanism of enforcement called the Challenge Procedure which began 2 years ago. It is still too soon to assess the success of the current GPA. In the opinion of some analysts, the major point of dissatisfaction is the limited participation of developing countries (see Blank and Marceau, 1997). Out of 22 signatory countries only 2 (Israel and the Republic of Korea) are not included in the set of industrialized countries.

## II. THEORY

The effect of discriminatory public procurement depends significantly on the type of market structure on which it insists. If the market structure is perfectly competitive and the technology is subject to constant returns to scale, then only sufficiently "large" (in the sense specified below) discriminatory procurement is likely to affect domestic prices and output. Conversely, if the market structure is monopolistic, competitive and subject to increasing returns to scale, then even a small discriminatory procurement is likely to affect the size of domestic output. Because of this fundamental difference, the case of increasing returns and monopolistic competition (IRS-MC) and the case of constant returns and perfect competition (CRS-PC) are discussed in separate sections. There are 11 acronyms in this paper and a complete legenda is in the appendix. For convenience, the IRS-MC framework will be referred to also as the New Trade Theory while the CRS-PC framework will be referred to as the Heckscher-Ohlin paradigm.<sup>18</sup> Since this study takes the perspective of a small open economy, I assume that the country under investigation is small with respect to the rest of the world.<sup>19</sup>

Discrimination against foreign bidders may take various forms. One well known one is the *price preference margin*. According to this mechanism, purchasing entities must allow a price preference margin in favor of domestic supplier before they can purchase from a foreign source. The Buy American Act is a famous case of this type of discrimination. Another discrimination (perhaps more common than the price preference margin) takes the form of an *outright exclusion* of foreign bidders from the tendering process. This practice is one of the many forms of a non-tariff type of protectionism and it is more difficult to detect and remove. A third type of discrimination is the *domestic content requirement*. In this section, I analyse the consequences of these 3 discriminatory practices in 3 distinct settings: (1) in the pure Heckscher-Ohlin model (section II.1); (2) in the pure New Trade Theory model (section II.2); and (3) in a mixed model where the commodity purchased by the Government is subject to CRS-PC but is produced by means of intermediate inputs subject to IRS-MC (section II.3).

### II.1 DISCRIMINATORY PROCUREMENT IN THE HECKSCHER-OHLIN MODEL

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<sup>17</sup> There are some exceptions to the general threshold, (for details, see Hoekman and Mavroidis, 1997, table 1. The exchange rate in 1996 was US\$ 1.4376 SDR 1.

<sup>18</sup> This terminology is a bit reductive because not only the Heckscher-Ohlin model, but also the Ricardian model rests on a CRS-PC market structure. However, this definition is immaterial for the scope of this paper.

<sup>19</sup> A graphical analysis in a two country general equilibrium set up can be found in Trionfetti (1997b).

The Heckscher-Ohlin model hinges on the assumption of constant returns to scale and perfect competitive markets. The analysis in this paper uses the standard graphical tools used in any modern textbook of international economics.<sup>20</sup> A classical reference for the analysis of discriminatory government procurement in the context of the Heckscher-Ohlin model is Robert Baldwin (1970, 1984) from which this section draws.

### II.1.1 Outright exclusion of foreign bidders

The effect of an outright exclusion depends on the size of government demand with respect to domestic output prior to the implementation of the policy.

*Initial situation at L.* Consider the following initial situation depicted in figure 1. The domestic country's total demand is represented by the curve  $D_T$ , which is composed of the horizontal sum of the private demand curve  $D_P$  and government demand curve  $D_G$ . The line  $S_h$  represents the domestic supply curve and its upward slope deserves some attention. The upward slope of  $S_h$  is the consequence of the fact that, in order to produce larger quantities of the commodity, the industry has to attract scarce resources from other sectors of the economy. Attracting resources becomes more costly as output expands which, in turn, implies higher average costs. Note that the upward slope of the  $S_h$  is consistent with long run adjustments and with constant returns to scale. Since the domestic country is assumed to be small, the excess supply curve of the rest of the world can be graphically approximated by a horizontal line. The total supply available for domestic consumers is then the kinked line  $S_T-L-S_T$ . The equilibrium price  $p_w$  is given by the world's supply curve.

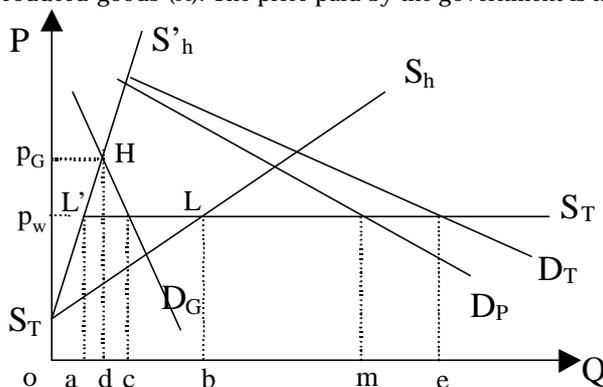
Total domestic demand at the world price is  $oe$ , which is the sum of private demand  $om$  and government demand  $oc$ . The quantity produced domestically is  $ob$  and the quantity imported is  $be$ .

It is important to note that the proportion of imports out of government's total purchases and the proportion of imports out of the private sector's total purchases remain undetermined. This indeterminacy is the consequence of the fact that the good in question is homogeneous and, therefore, consumers are indifferent about its country of production. This is one of the key-elements in determining the difference between the results in this section and the next section.

In this initial situation, suppose that the government decides to purchase only domestic output. Since we assumed that the country is small, the equilibrium world's price remains at  $p_w$ . At price  $p_w$  the quantity produced by domestic suppliers is  $ob$  and the quantity of domestic output demanded by the government is only  $oc$ . Because the quantity produced domestically is in excess of government demand (at  $p_w$ ) there is no effect on domestic output. The government buys  $oc$  from domestic producers who sell the rest of their output ( $cb$ ) to the private sector. Total imports remain unchanged at  $be$ , but there is a difference compared to the initial situation: now all imports are purchases of the private sector. The price paid by the government equals the price paid by the private sector (which is the equilibrium world's price  $p_w$ ).

Figure 1.

*Initial situation at L'.* Assume now the initial situation is such that supply curve is  $S'_h$  instead of  $S_h$ . Total supply is  $S_T-L'-S_T$ . At the initial price  $p_w$  domestic supply is only  $oa$  and it falls short of government demand for domestically produced goods ( $oc$ ). The price paid by the government is now determined by the intersection between  $S'_h$  and  $D_G$  at



<sup>20</sup> Excellent references are: Gandolfo (1998); and Krugman and Obstfeld (1997).

H; this is  $p_c$  in figure 1. Note that domestic supply and government demand now constitute a separate market with its own associated equilibrium price  $p_c$ . The world's price remains unchanged at  $p_w$ : private sector's demand equals imports at the quantity  $om$ . Total imports unambiguously fall from  $ae$  to  $om$ . This is ascertained easily. Total imports without discriminatory policy is  $IMP = D_c(p_w) + D_p(p_w) - S_h(p_w)$ .<sup>21</sup> Total imports under discriminatory policy is  $IMP = D_p(p_w)$ . Since, by construction,  $D_c(p_w) > S_h(p_w)$ , it follows that imports decreased. In conclusion, the discriminatory procurement policy in the second situation results in:

- a price wedge between the price paid by the government ( $p_c$ ) and the equilibrium world's price ( $p_w$ );
- an increase in the domestic output of the good in question from  $oa$  to  $ol$ ;
- a decrease the volume of trade.

Two comments are in order. The difference between the first and the second initial situation is that in the first one government demand at the initial price  $p_w$  is smaller than domestic supply while in the second one it is larger than domestic supply. The effectiveness of the discriminatory procurement policy depends, therefore, on whether the interception point of the domestic supply curve and the government demand curve is below or above the world's price  $p_w$ . A common misconception is to consider the size of government demand with respect to private demand as an indicator of whether discriminatory procurement is effective or not. It should be clear by now that what matters is the relative position of the curves  $D_c$  and  $S_h$  and not the relative position of the curves  $D_c$  and  $D_h$ .

A second observation is that the price wedge between  $p_c$  and  $p_w$  is neither due to inefficiency in the tendering process, nor to a political interplay between the government and domestic producers. The price wedge is simply due to the fact that the discriminatory policy separates the public procurement market from the private market (two separate markets naturally have two different prices). Taking the spread  $p_c - p_w$  as an indicator of inefficiency of the tendering process or of a political interplay is, therefore, not necessarily correct.

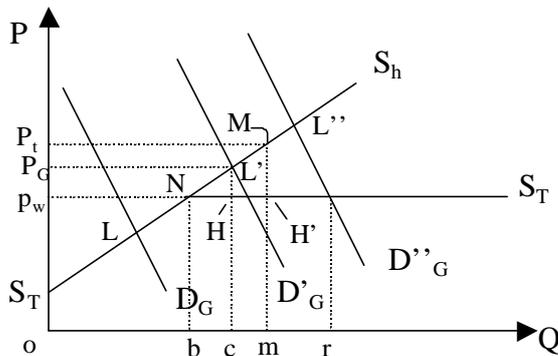
### II.1.2 Domestic content requirement

The domestic content requirement is a discriminatory policy that links the awarding of the procurement contract to a foreign firm under the commitment of the latter to purchasing domestic intermediate inputs. As long as intermediate inputs (as well as the final commodity) are produced under CRS-PC, the effect of the domestic content requirement can be analysed along the lines of the outright exclusion. All we have to do is to re-label the demand curve in figure 1. The commodity in question is now the intermediate input, and the curve  $D_c$  is the demand curve of the foreign firm who has been awarded the contract under a domestic content requirement. For simplicity, let us assume that the domestic content requirement is 100%. The conclusion is immediate. Unless the domestic content requirement is such that the demand for domestic intermediate inputs is larger than domestic output (at price  $p$ ), the domestic requirement policy is inconsequential.

### II.1.3 Price preference margin

Figure 2 illustrates the effect of a price preference margin. There is a strong similarity with the case of outright exclusion insofar as the consequence of the discrimination policy depends on the point of intersection between the government demand curve and the domestic supply curve. In the previous section we held demand curve constant and let the domestic supply curve to shift; in this section the government demand curve will be the shifting one. In order not to overload the picture, the private demand curve and the total demand curve (private + government) are omitted. It remains clear, however, that the country is assumed to be net importer of the good in question.

Figure 2.



<sup>21</sup> The notation  $D_G(p_w)$  means government demand at the price  $p_w$ ; similarly for  $D_p(p_w)$  and  $S_h(p_w)$ .

The supply curves have the same meaning as in figure 1. Figure 2 shows three government demand curves representing three possible sizes of government demand ( $D_g$ ,  $D'_g$ ,  $D''_g$ ). The government is supposed to apply a price preference margin, say  $x\%$  over the world prices so that the threshold price is  $p_t = p_w(1+x)$ . Thus the government that receives a bid of price  $p_w$  from a foreign supplier and a bid of price between  $p_w$  and  $p_t$  awards the contract to the domestic firm. If the bid of the domestic supplier exceeds  $p_t$ , then the government awards the contract to the foreign supplier.

*Initial situation at L.* If government demand is  $D_g$ , the intersection point between government demand and domestic supply is below the world price  $p_w$  (at  $L$ ). In this case, the price preference policy is ineffective. Domestic suppliers will supply government and private consumers at the world price  $p_w$ .

*Initial situation at L'.* If government demand is  $D'_g$ , the intersection between government demand and domestic supply is at  $L'$ . In this case the policy is effective. Total domestic supply is  $oc$  and is sold entirely to the government at price  $p_c$ . The private sector imports all its purchase of the good in question. Note that, in spite of the price preference, competition among the many domestic producers prevents the price charged to the government to exceed  $p_t$ . Any attempt on the part of a domestic firm to charge a price higher than  $p_t$  is out-bid by competing domestic firms. Price  $p_c$  is sustainable because it is the least price at which quantity  $oc$  can be produced by the industry in question.

*Initial situation at L''.* If government demand is  $D''_g$ , intersection between government demand and domestic supply is at  $L''$ . In this case, domestic supply is  $om$  and is sold entirely to the government at price  $p_c$ .<sup>22</sup> The quantity  $om$ , however, does not exhaust government demand. The government purchases the remaining quantity  $mr$  from foreign suppliers at the world price  $p_w$ . In conclusion, when it is effective, a price preference policy will result in:

- a price wedge between the price paid by the government ( $p_c$ ) and the equilibrium world's price ( $p_w$ ) of, at most  $p_t - p_w$ ;
- an increase in the domestic output of, at most,  $bm$ ;
- a decrease the volume of trade.

## II.2 DISCRIMINATORY PROCUREMENT IN THE NEW TRADE THEORY

The theoretical apparatus of the new trade theory hinges on the presence of economies of scale at the level of the firm (also known as internal economies of scale, or pecuniary externalities) and on a monopolistic competitive market structure. The classical reference in this domain is Helpman and Krugman (1985). Unfortunately, unlike the Heckscher-Ohlin theory, the new trade theory lacks of a simple graphical representation, a void that is felt even in most popular textbook (such as Gandolfo, 1998; and Krugman-Obstfeld, 1997).<sup>23</sup> For this reason, this section will rely heavily upon intuition.<sup>24</sup>

### Internal economies of scale and monopolistic competition

As already mentioned the new trade theory emphasizes the role of internal increasing returns and monopolistic competition. A monopolistic competitive market structure refers to a situation in which there are many (but not very many) producers of the same commodity, each of whom produces a different variety. Because of this product differentiation, each producer has some degree of monopoly power in the market for the variety  $s$ /he produces. His/her monopoly power, however, is not full for it faces the competition of many other producers of the same commodity. For what concerns the technology of production, it is assumed it is subject to internal increasing returns. This means that the average cost of production declines as output of the firm expands.

An industry that fits this description is surely the automobile industry (many brands but essentially one commodity). Other, less apparent examples may be intermediate inputs such as industrial machine, metal products, electric goods, just to mention some.

One feature of these models is of crucial importance for the analysis of discriminatory procurement. For an open economy trading in an IRS-MC commodity, not only the total import of the commodity is determined, but also the

<sup>22</sup> A conceptual clarification is in order. If the government were to purchase the good in a single auction, then domestic suppliers would be all outbid by foreigners. Domestic supply would be at  $ob$  and it would go entirely to private demand. The result in the text obtains if one assume (more realistically) that government purchase is carried out over time (over the fiscal year for instance) through a sequence of auctions.

<sup>23</sup> An excellent attempt to fill this void is in Francois and Nelson (1988). The graphical tools developed in their work are yet too complex to be included in a non-technical paper.

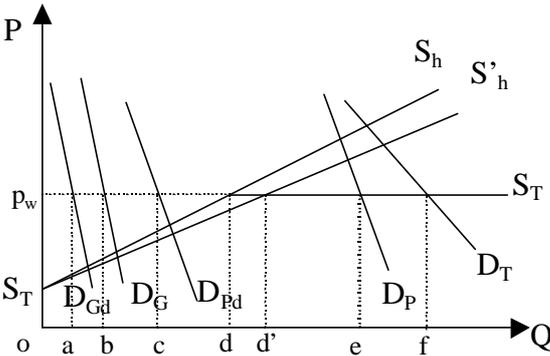
<sup>24</sup> A mathematical treatment of discriminatory procurement in the new trade theory as well as in the Heckscher-Ohlin model is in Trionfetti (1997a, and 1998) and, with empirical evidence, in Brühlhart and Trionfetti (1998).

imports of each component of expenditure (government and private). Without any discriminatory policy, the private sector and the government have the same import share which, in turn, is the import share of the economy as whole. This is an important difference with the Heckscher-Ohlin model, where, in the absence of any discriminatory policy, the total import of the country is determined but the imports of the private sector and the government are not.

II.2.1 Outright exclusion of foreign bidders

With a bit of imagination we can use the same graphical apparatus as in section I.1. In this context, however, we distinguish between demand for domestic varieties and demand for foreign varieties. Because of product differentiation, the import share (i.e., ratio foreign/domestic varieties purchased) is determined. Thus,  $D_{Gd}$  indicates the government demand curve for domestic varieties while  $D_G$  indicates its total demand curve (domestic + foreign varieties). Similarly,  $D_{Pd}$  indicates private demand for domestic varieties and  $D_P$  indicates the total demand curve of the private sector. The supply curve  $S_h$  deserves particular attention. Its upward slope is the consequence of the fact that the resources more intensively used in the production of the commodity become relatively scarcer as output increases. However, because of economy of scale, the larger is the demand for each of the domestically produced varieties, the lower – other things equal – is the unit cost of production. Thus, a higher demand for domestically produced varieties causes a clockwise rotation of the domestic supply curve. With this mechanism in mind, we can easily analyse the effect of discriminatory procurement.

Figure 3.



Consider the situation described in figure 3, where  $D_{GD}$ ,  $D_G$ ,  $D_{PD}$ ,  $D_P$ , and  $D_r$  are the demand curves and  $S_i$  is the domestic supply curve. The world price is  $p_w$ . The government purchase is  $ob$ , of which, the quantity  $oa$  is purchased from domestic producers and, therefore, includes domestic varieties only. The private sector purchases  $oe$ , of which, the quantity  $oc$  is purchased from domestic producers and, therefore, is composed of domestic varieties only. Total demand of the country is  $of$  and total imports are  $od$ . Suppose now that the government decides to buy only domestic varieties, i.e.,  $D_{GD} = D_G$ . This means an increase in total demand for domestic varieties by  $ab$ . Note that the import share of the private sector remains constant for product differentiation means that there is no perfect substitutability between domestic and foreign varieties. The increase in the total demand for domestic varieties, because of economies of scale, induces an increase in output and a decrease in the average cost. This is represented by the clockwise rotation of  $S_i$  up to the point where  $dd' = ab$ . Total demand of the country  $D_i$  remains constant but output has increased. Hence, country's import has decreased. In conclusion, the outright exclusion policy results in:

increase in output;  
decrease in imports.

Note that, contrary to the case of CRS-PC, the discriminatory policy in IRS-MC does not result in a price wedge. There is, however a limit, beyond which the  $S_i$  curve cannot rotate, that depends on the country's factor endowments. Beyond that limit, further expansion of discriminatory government demand results in an increase in output only at the cost of a price wedge.

There is another difference with respect to the case of CRS-PC. In the CRS-PC sector, the discriminatory procurement policy is effective only if the commodity is imported. This is so because, in order for the policy to be effective, government demand must be larger than domestic output and this can happen only if the commodity is imported. If the commodity is exported, domestic output is larger than total domestic demand, therefore, it is surely larger than government demand. In the case of IRS-MC, regardless of whether the country is a net importer or a net exporter of the differentiated commodity, it is always an importer of some of the varieties of the commodity. Therefore, the discriminatory policy is always effective because it creates a domestic market for the varieties that, without discriminatory policy, would be the imported ones.

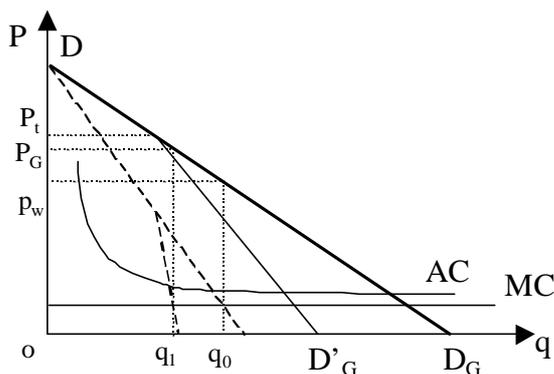
### II.2.2. Domestic content requirement

The effect of a domestic content requirement is analogous to the effect of the outright exclusion and, after re-labeling, can be analysed by use of figure 3. Let us re-label  $D_{GD}$  and  $D_G$  as the foreign firm's demand curves. Without domestic content requirement, the foreign firm's demand for domestic inputs is  $D_{GD}$ . Under a 100% domestic content requirement, its demand for domestic inputs is  $D_G$ . A domestic content requirement increases the demand for domestically produced intermediate inputs and, consequence of economies of scale, output expands and average cost declines.

### II.2.3. Price preference margin

One of the key element of monopolistic competitive market structures is that the producer of each variety has some degree of monopoly power. The producer, therefore, sets the price for her/his output exactly like a monopolist. From the point of view of the producer, a price preference policy is like having two consumers with two different elasticity of demand. The monopolist's response to it is price discrimination. Figure 4 depicts the situation of a typical monopolist producing under internal economies of scale. Economies of scale derive from a technology characterized by a fix cost (not shown in the figure) and a constant marginal cost  $MC$ .

Figure 4



Consequently, average cost AC declines as output increases.

The straight line  $D-D_c$ , represents government's demand curve in the absence of the price preference margin, the dashed straight line originating from point D represents the marginal revenue curve associated with it. In the absence of discriminatory policy, the competitive monopolist sets the price at  $p_w$  and sells the quantity  $oq_0$ .

The price preference margin is equivalent to a decrease in the elasticity of the demand curve. The broken line  $D-D'_c$  represent the demand curve relevant for the producer under the price preference policy, the broken dashed line originating from D represents the marginal revenue curve associated with it. Facing the new curve  $D-D'_c$  the monopolist sets the price at  $p_c$  for the government and sells to the government the quantity  $oq$ .

In conclusion, the price preference policy in presence of monopolistic competition results in:

an increase in the price paid by the government;  
a reduction in the total quantity supplied to the government.

### *II.3. HOMOGENEOUS COMMODITY PRODUCED WITH DIFFERENTIATED INPUTS*

Two stylized facts of international trade are relevant in this context. First, most of trade is intra-industry trade, this means that it takes place within the same industry classification. Second, most of intra-industry trade is in intermediate inputs. This is interesting in this context because it is possible that while the commodity purchased by the government is homogeneous and subject to CRS-PC, the intermediate inputs required for its production may be subject to IRS-MC.

#### **II.3.1. Outright exclusion of foreign bidders and price preference margin**

In such a case, the effect of an outright exclusion is the same as in section II.1.1. and the effect of a price preference margin is the same as in II.1.3. That is to say that, unless government procurement is very large, its discriminatory nature is inconsequential.

### II.3.2. Domestic content requirement

The domestic content requirement, however, becomes effective even if government purchase is small. The reason is very simple: a domestic content requirement increases the market for domestically produced varieties of the intermediate input. The logic is the same as the one in figure 3 where  $D_{cd}$  is re-labeled as the demand of the foreign firm to whom the contract was awarded. Without the content requirement the foreign firm would purchase  $oa$  of its intermediate inputs from producers in the country whose government awarded the contract. Under a 100% domestic content requirement, its purchase from that source is  $ob$ . Consequently, the size of the demand for local varieties increases and, because increasing returns, output increase and the average cost of production decreases.

### II.4. SUMMARY

In the Heckscher-Ohlin model, the three discriminatory policies are qualitatively identical. However, their effect may be different in magnitude. The difference is the consequence of the fact that the price preference policy ceases to be effective when the price paid by the government exceeds the preference margin. Thus, the consequences of the price preference policies have an upper limit that the outright exclusion and the domestic content requirement do not have. This difference is relevant only for large government demand. To see this, use any of figure 1 or figure 2. In figure 2, for instance an outright exclusion when government demand is  $D''_c$  drives up the price to the height of  $L''$ , whereas the price preference margin limits the price increase to  $p$ . A word of caution is in order. The price preference margin may contribute to sustain inefficient domestic firms at the expenses of efficient domestic firms. This is possible especially in the presence of asymmetric information among domestic suppliers about the peculiarity of public procurement contracts. In public purchasing, the "material" contract may differ substantially from the "formal" contract. Informational advantage about the true nature of the contract may compensate for a firm's inefficiencies and allow it to outbid domestic competitors. Another condition that favors inefficient firms is the presence of thin markets with limited entry. If the market is small (few suppliers) and there is no entry (for instance, because imperfect information about the true nature of public contracts) the price preference margin may effectively compensate for the inefficiencies of incumbent firms.

In the New Trade Theory, outright exclusion and domestic content requirement increase domestic output. The price preference policy, instead, results in an increase in the price paid by the government without an expansion of the output. The size of government demand with respect to domestic output (at  $p_w$ ) is immaterial in this context. Even small government demand will produce its consequences.

Finally, in the mixed case, the comparison is straightforward. While the price preference margin and the outright exclusion are effective only if government demand is sufficiently large, the domestic content requirement is effective regardless of the size of government demand. In addition, the domestic content requirement does not induce a price wedge.

## III. THE SIZE OF THE PUBLIC PROCUREMENT MARKET

The purpose of this part is to measure the size of the government procurement market by country and then by industrial sector. This exercise gives an approximate measure of the size of the market that becomes available to the firms operating in the countries that decide to join the GPA.

### III.1. THE PUBLIC PROCUREMENT MARKET BY COUNTRY

This section compares the size of the government procurement market across countries in two ways: first, by comparing total government procurement; second, by comparing government procurement that falls on commodities that are traded internationally. The latter is the most relevant measure of the size of the market in relation to the GPA.

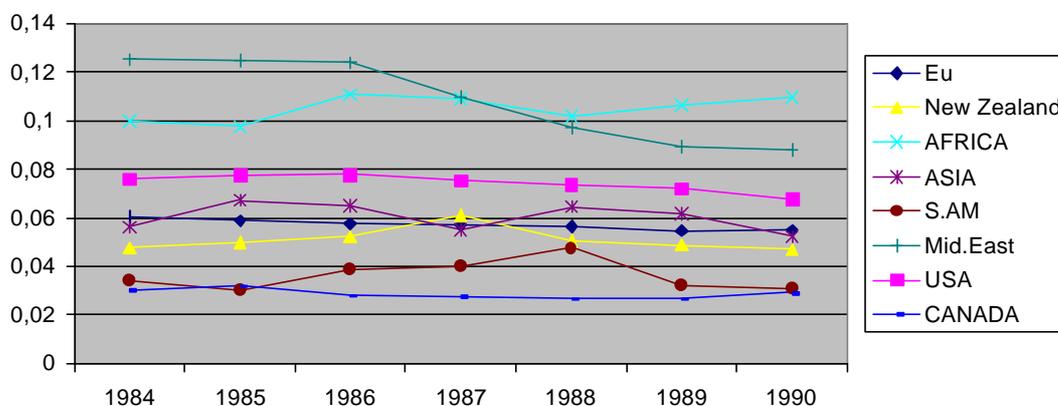
#### III.1.1. Data source

The IMF (1993, 1995) publishes data disaggregated by Central Government, State and Provinces, and Local Governments. Unfortunately, not all countries report data by level of government. However, almost all countries report data on central government's purchase of goods and service other than salaries to employees. I use these data for the international comparison in this section (III.1).<sup>25</sup>

#### III.1.2. Total government procurement

Chart 1 shows total Central Government Purchases of Goods and Services other than salaries (GPGS-CG) for the central governments of 27 countries grouped by regional areas.<sup>26</sup> The size of GPGS-CG varies considerably across countries. It is between 5 and 8% of GDP for most industrialized countries, except for Canada. The latter and the South American group seem to have very small GPGS-CG, between 3 and 4.5% of GDP. It would be interesting to investigate whether this is a reflection of the federal structure of South American countries or it is simply that South American countries have small governments.<sup>27</sup> For the Middle East and Africa, the size of GPGS-CG ranges between 9 and 13% of GDP. It is interesting to note that African and Middle Eastern countries have a small GDP, yet, proportionally, they have larger government procurement than, for instance, European countries. Formal statistical analysis confirms this stylized fact. Precisely, it appears that small developing countries have (on average) larger GPGS-CG than industrialized countries of equal size (see Trionfetti, 1997b). Finally, we observe that there is hardly any time trend or any significant fluctuation of the size of government purchase over time.

**Chart 1. GPGS-CG / GDP**



#### III.1.3. Tradable versus non-tradable commodities

Only government purchase that fall on internationally tradable commodities is of interest for the GPA. Therefore, it is desirable to separate government purchase on traded commodities from government purchase on non-traded

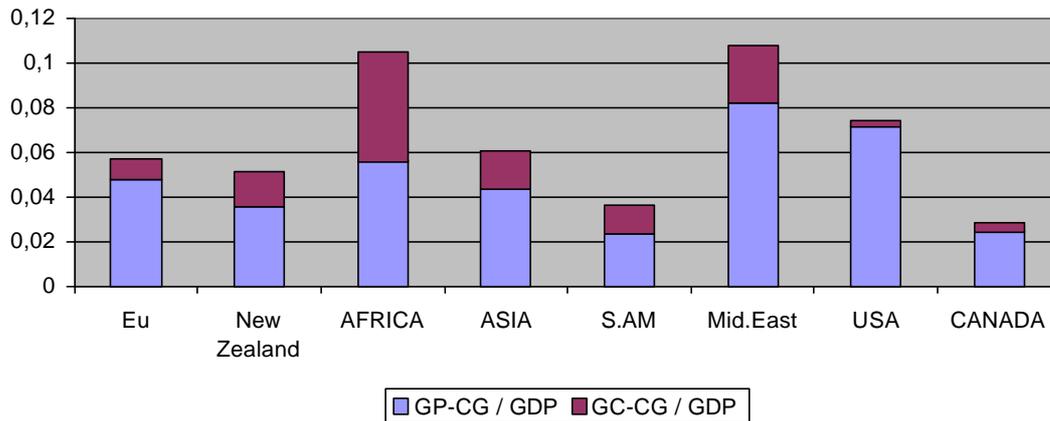
<sup>25</sup> In particular I use the following tables of the IMF publication: Summary Table, and Table C, row 1.3.

<sup>26</sup> The countries are: Austria, Belgium, France, Germany, Netherlands, Norway, Sweden, United Kingdom, U.S., Canada, New Zealand, Botswana, Morocco, South Africa, Tunisia, India, Republic of Korea, Malaysia, Singapore, Egypt, Israel, Jordan, Turkey, Brazil, Mexico, Uruguay, Venezuela.

<sup>27</sup> The federal structure of government is particularly important for Canada who has very small central government procurement but very large peripheral government procurement (see Trionfetti, 1997a).

commodities. To do so, one would need comparable input-output tables for all countries. These data are not available, yet, the IMF data distinguishes between (central) government purchase of construction (GC-CG) from all (central) government purchase of all other goods (GP-CG). Since construction is a non-traded commodity, netting out total purchase from construction gives an approximate measure of government purchase on tradable commodities.<sup>28</sup> This is indeed an approximation because not only construction but also some services are non-tradable. Chart 2 shows the break down by construction (GC-CG) and other purchases (GP-CG) a proportion GDP.

**Chart 2. Tradables and non-tradables.**



The size of GP-CG range between 2.5 and 8% of GDP. Note the same pattern highlighted before. That is, that the average of GP-CG/GDP is smaller for the industrialized countries than it is for the other countries.

#### III.1.4. Summary

lot across countries, ranging between 3 and 12 % of GDP. A large part of it is represented by expenditure in construction. Netting out construction, other purchases are in the magnitude of 2.5 to 8% of GDP. Trionfetti (1987b) attempts to measure the *actual* size of the government procurement market, that is the size most relevant for the GPA. The *actual* size results from netting out from GPGS the non-tradable and the contracts below threshold (contracts below threshold are not subject to the GPA). He uses three different data sources; the result is the following.

Table 1.

Sources →	UN-OECD	IMF	EC-97
Actual size.	2.75%	5.5%	4.25%

#### III.2. THE PUBLIC PROCUREMENT MARKET BY INDUSTRIAL SECTOR

This section focuses on government purchase of internationally traded commodities produced from the industrial sectors (GPI). Approximately, GPI is the same as GP in the previous section (III.1.3.). The difference is that, in this section (III.2.), the measure is taken from the directly from the input-output tables. In addition, the government purchase in this section (III.2.) refers to purchase of all levels of government, not only central governments. The sectoral disaggregation is interesting for various reasons, in particular, in relation to the discussion in the theoretical part (part II.1). That part emphasized the importance of the size of government purchase relative to domestic output. This sectoral disaggregation gives this information.

##### III.2.1. Data source

The data needed for the sectoral disaggregation are found in the input-output tables. It would be desirable to have data for the potential new entrants in the GPA. Unfortunately, data for these countries are not available, or not available in a way that is suitable for international comparison. The analysis, therefore, is limited to the USA and a subset of the EU countries labeled as Eu. These countries are: Germany (DE), Denmark (DK), Spain (ES), France

<sup>28</sup> The GPA includes the construction sector. This is welcome but also a bit puzzling for the output of the construction sector is hardly tradable.

(FR), Italy (IT), Netherlands (NE), and the United Kingdom (UK). The data shown refers to the industrial sectors producing traded commodities only. I make use of two data sources: (1) the OECD input-output database and (2) the EUROSTAT input-output tables. I use the first source to show data for the USA and the second source to show data for the Eu.<sup>29</sup> Comparison between the USA and Eu. is not entirely reliable for two reasons: (1) different sectoral aggregation, (2) the OECD data includes the government purchase used for fixed capital formation, while the EUROSTAT data does not. Aware of this limitation, one can nevertheless have a measure of the size of the procurement market by sector in the two largest integrated markets currently covered by the GPA. This is a measure of the size of the marked (by sector) that would open-up to new GPA members.

### III.2.2. Government procurement as percentage of domestic output

Charts 3 and 4 show the size of government procurement for each of the 13 industrial sectors (GPIs) as percentage of domestic output (GDPs) of the sector.

**Chart 3. GPIs / GDPs in the Eu7**

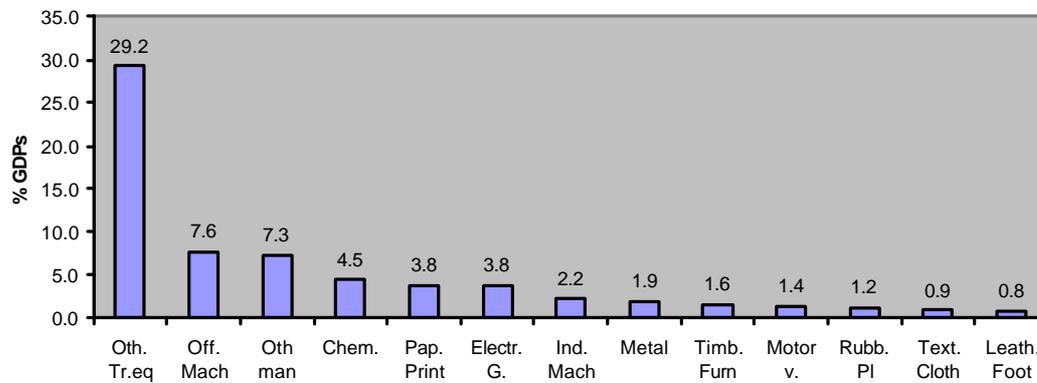
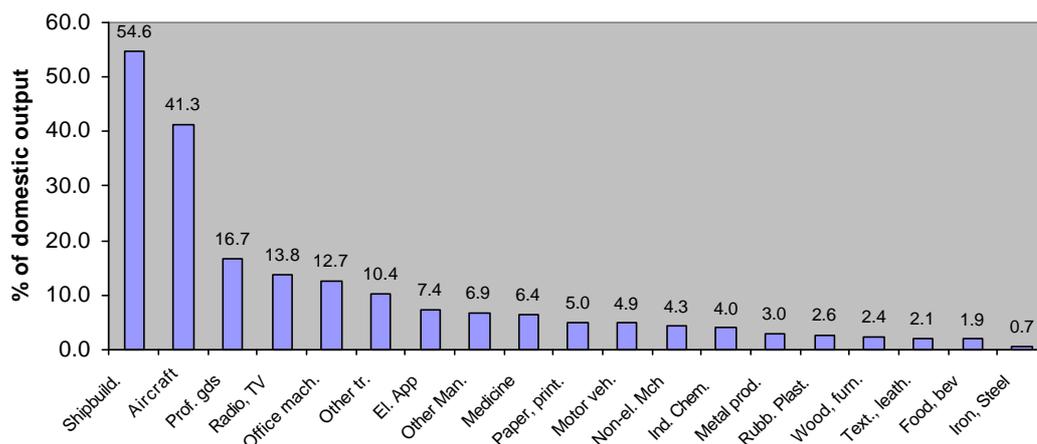


Chart 3 refers to Eu. Government demand is below 5% of domestic output except for three sectors. The sector "Other Transport Equipment" (which excludes motor vehicles) is clearly an exception. A possible explanation is in the fact that this sector includes aircraft and shipbuilding of which the European countries are modest producers (small GDPs), especially in military aircraft and ship.

Chart 4 refers to the US Government demand is a considerable proportion of domestic output in the aircraft and shipbuilding sectors. This is probably a reflection of the military expenditure. However, government demand is above 5% of domestic output in the other seven sectors.

<sup>29</sup> At the time of writing, it was not possible to obtain from the OECD the entire data set. Only the input-output table of the USA was readily available. This is why for the EUROSTAT data was used for the European countries.

**Chart 4. GPIs / GDPs in the USA**

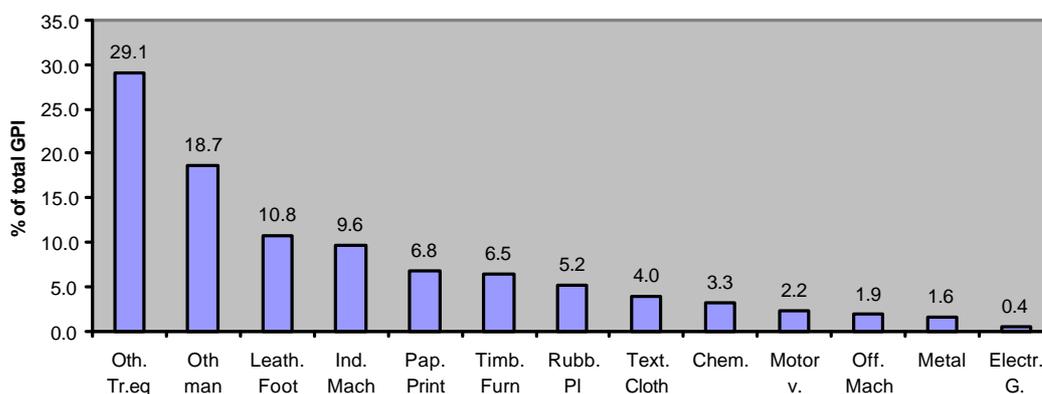


In spite of the different sectoral aggregation, one can note some similarities between US and Eu. The similarity is especially visible if, for the US, we group Shipbuilding, Aircraft, and Other Transport Equipment in one single sector. Then, two of the top 3 sectors in the Eu. group are also in the top 4 sectors in the US.

From this analysis, we can draw a conclusion in relation to the theoretical argument illustrated in section II.1. There, we saw that in order for the discriminatory policy to be effective in CRS-PC sectors, government demand needs to be larger than domestic output at the world price. Charts 3 and 4 show that, except for the military sectors in the US, government demand is not even close to be 100% of domestic output (that is, quantity *ol* in Figure 1 or quantity *oc* in Figure 2). Naturally, it is possible that a lower level of aggregation (that is, for some sub-sectors), government demand is a very large proportion of domestic output. Yet, it seems very unlikely that government purchase is, in any sector, large enough to exceed domestic output at the world price. Therefore, for the CRS-PC sectors, most probably, the discriminatory policy is ineffective. For the IRS-MC sectors, the situation is entirely different. We have seen in section II.2 that even small discriminatory procurement may pop up domestic output.

III.2.3. Sectoral allocation of government procurement

**Chart 5. GPIs / GPI in Eu7**



Charts 5 and 6 show the composition of expenditure. That is, the percentage of total government procurement allotted to each of the sectors. This is a measure of the size of the public procurement market by sector. This information is of interest for potential new entrants in the GPA.

**Chart 6. GPIs / GPI IN THE USA**

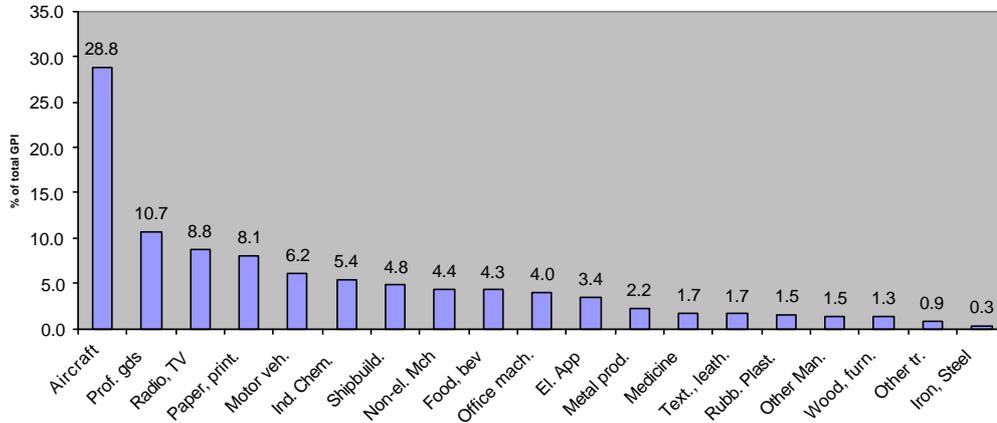


Chart 5 refers to the Eu. The top four sectors (out of 13) account for 68.2% of total government purchase. There is one similarity between the size of government purchase relative to domestic output (GPIs/GDPs) and the sectoral allocation of government procurement (GPIs/GPI). This revealed by observing that the two top sectors in Chart 3 are also the two top sectors in Chart 5. There is also one big difference. The sector Leather and Footwear ranks last in proportion to GDPs (Chart 3) but it ranks third in proportion to total GPI (Chart 5).

Chart 6 refers to the U.S.

The top six sectors (out of 19) account for 68% of total government purchase. Again, one can note some similarity between the size of GPIs/Os and the allocation of GPIs/GPI. For instance, three of the top five sectors in Chart 4 are also in the top five sectors in Chart 6.

There appears to be some differences between Eu, and the US. Take, for instance, three comparable sectors: Office Machine, Metal Products, and Electrical Goods. In the US they absorb a double proportion of the budget than in Eu, (4%, 3.4%, 2.2%, versus 1.9%, 1.6%, 0.4%). Paper and Printing absorb similar shares of GPI in the US and Eu. Motor vehicles in USA absorbs about three times the percentage of GPI absorbed in the Eu.

### III.2.4. Summary

In some sectors, government procurement is a considerable market for domestic producers. For the E.U. we see from Chart 3 that in four sectors government purchase absorbs between 4 and 7% of domestic output (and over 28% in the top sector). In the US, besides the military sector, there are four sectors where government procurement absorbs more than 10% of domestic output. Probably, in these sectors, the government is the largest single purchaser. Yet, the size of government purchase is unlikely to render the discriminatory policies examined in part II.1 effective for the CRS-PC sectors.

The sectoral allocation of government purchases of industrial goods shows a mild degree of concentration in a subset of the sectors. In the E.U. as well as the US, one third of the sectors account for approximately 70% of the budget. It would be interesting to know in which sectors the SMEs are mostly concentrated. This would give a measure of the size of the market that would become open to the SMEs in the countries that would join the GPA.

## IV. CONCLUSION

Are the discriminatory policies legitimate? The answer depends very much on the context. We can use what we have learnt in the theory part (part I) to assess whether there is any justification for a discriminatory policy.

Sectors (markets) subject to CRS-PC represent operate, by assumption, in optimal conditions and allocate resources efficiently. In these sectors, none of the policy is justified. Besides the fact that they are likely to be ineffective, the problem is that, when they are effective they generate a misallocation of resources, thus a welfare loss for the country that implements them. In addition, the price preference policy may contribute to sustain inefficient domestic firms to the expense of efficient domestic ones.

Sectors (markets) subject to IRS-MC are, by definition, imperfect. We are in a situation where the Second Best theory applies. The imperfection stems from the monopoly power of producers. Because of monopoly power, the level of output is always at a quantity where average cost is above marginal cost (in perfect competition instead, average cost equal marginal costs). If demand were larger, there would be more varieties produced. That is, a larger number of producers, each of them with a smaller monopoly power than before and, therefore, producing at an average cost closer to the marginal costs. The fact that the average cost depends on the size of demand may pose a problem to small countries contemplating the option of joining the GPA. This is due to the fact that firms in the small country may have a higher average cost than competing firms in large countries. Note that the difference in average cost is the consequence of the fact that firms in large countries benefit from a larger demand than firms in the small countries and not necessarily from differences in efficiency or technology. In this situation, a discriminatory policy aimed to expand the size of the domestic market of the small country finds an economic justification. But what policy? An outright exclusion means not to join the GPA. A country pursuing an outright exclusion can only expect retaliation from other countries, in which case, the effect of the outright exclusion is nullified by the retaliation. The domestic content requirement would allow the country to join the GPA and retain at the same time part of the effects of an outright exclusion. An additional advantage is that the domestic content requirement helps to strengthen the domestic sector in two ways. First, the foreign firm and not the domestic government selects, among the domestic producers, those that are more efficient at supplying intermediate inputs. This reduces the probability that inefficient domestic firms survive thanks to inefficiency of the public tendering procedures. Second, supplying intermediate inputs to the foreign firm may also bring about technological transfer and increase the incentive to invest in advanced technologies. One word of caution is in order. The domestic content requirement, like many other policies, is most effective if it is limited in time. The rationale of the policy is in the fact that domestic firms need time to adjust their scale of production and their technology to larger market (i.e. they need time to reduce their average cost). Only the awareness that the discriminatory policy will eventually end will stimulate domestic firms to undertake the necessary investments that allow them to compete in the world market.

It is interesting to note that Article XVI sub-2 of the GPA already allows for a moderate use the domestic content requirement on the part of developing countries. Its economic rationale is sound. Perhaps, the Article would be more successful in attracting developing countries to the GPA if it were a bit more permissive with the new entrants but rigorous on its time limitation.

## APPENDIX

This appendix is composed of two sections. Section A.1 provides a legenda for this paper that is also compatible with the acronyms used in Trionfetti (1997b). Section A.2 provides the analogous of Charts 3 and 5 at the individual country level for the countries in the Eu<sub>7</sub> group.

### A.1. LEGENDA

#### PART II

CRS-PC = A theoretical framework characterized by constant returns to scale and perfect competition.

IRS-MC = A theoretical framework characterized by increasing returns to scale and monopolistic competition.

#### PART III

GPGS = General government purchases of goods and services, excluding salaries to government employees.

GC = Government expenditure on constructions

GP = Government purchases of goods and services excluding construction (and excluding salaries to government employees).

Accounting identity:  $GPGS = GC + GP$

GPGS-CG = CENTRAL Government Purchases of Goods and Services excluding salaries.

GPGS-PG = PERIFERAL Government Purchases of Goods and Services excluding salaries.

Accounting identity:  $GPGS = GPGS-CG + GPGS-PG$ .

GPI = General government purchase of industrial commodities that are traded internationally.

GPIs = General government purchases of industrial commodity s.

Accounting identity:  $\sum(GPIs) = GPI$ .

GDP = Gross Domestic Product of the country.

GDPs = Gross domestic product of sector *s*. A synonymous of it used in part II is "domestic output" (of sector *s*).

*A.2. THE Eu7 GROUP COUNTRY BY COUNTRY*

TABLE A.1.  
GPGs/GDPs in Eu<sub>7</sub>

Nace	DE	DK	ES	FR	IT	NL	UK
Chem.	6.82	2.84	1.41	0.26	0.77	1.13	10.90
Metal	1.69	0.74	2.55	1.60	0.93	7.67	2.40
Ind. Mach	0.48	0.98	9.97	0.56	1.74	3.01	6.78
Off. Mach	10.29	1.12	16.91	0.57	2.43	0.19	15.31
Electr. G.	1.05	3.31	2.43	4.69	1.34	6.22	10.61
Motor v.	1.18	n.a.	0.28	1.58	0.73	1.53	3.45
Oth. Tr.eq	36.02	13.30	20.51	21.06	23.01	12.35	42.84
Text. Cloth	1.42	0.85	1.19	0.60	0.06	1.49	2.71
Leath. Foot	0.93	3.88	0.78	0.00	0.41	1.26	3.60
Timb. Furn	0.92	0.42	0.50	4.21	0.36	1.96	2.85
Pap. Print	4.65	4.52	3.53	2.26	4.80	5.20	2.79
Rubb. Pl	1.77	5.94	0.40	0.00	0.72	2.18	1.77
Oth man	3.63	2.81	4.74	5.16	0.37	7.13	16.70
max	36.02	13.30	20.51	21.06	23.01	12.35	42.84
min	0.48	0.42	0.28	0.00	0.06	0.19	1.77

TABLE A.2.  
GPIs/GPI in Eu

Nace	DE	Nace	DK	Nace	ES	Nace	FR
X170	32.9	X290	33.2	X290	23.1	X290	45.0
X290	20.5	X470	21.6	X210	21.2	X250	18.0
X470	12.6	X170	11.9	X230	14.9	X470	8.2
X230	11.5	X250	8.5	X470	8.4	X190	7.0
X270	5.1	X490	7.2	X190	8.3	X270	6.3
X190	5.0	X210	5.7	X170	7.0	X450	6.3
X250	3.6	X190	2.9	X250	6.1	X510	3.2
X490	2.5	X410	2.2	X410	4.0	X410	2.0
X410	2.4	X510	2.2	X510	3.4	X210	1.6
X210	2.0	X270	1.3	X430	1.1	X170	1.4
X450	1.0	X430	1.1	X270	1.1	X230	0.8
X510	0.8	X450	1.1	X450	0.7	X430	0.0
X430	0.2	X230	1.1	X490	0.7	X490	0.0
Sum	100.0		100.0		100.0		100.0

Nace	IT	Nace	NL	Nace	UK
X290	35.9	X250	21.4	X290	31.9
X470	19.5	X470	19.4	X170	18.5
X210	12.5	X190	19.4	X250	14.7
X250	7.0	X290	13.0	X210	9.8
X170	6.6	X170	7.3	X510	6.0
X190	5.8	X210	7.0	X230	4.7
X230	4.1	X510	4.2	X470	3.8
X270	2.7	X490	2.5	X270	3.2
X490	2.0	X270	1.9	X190	2.4
X450	1.4	X450	1.9	X410	2.4
X430	1.3	X410	1.7	X450	1.3
X410	0.6	X430	0.2	X490	1.0
X510	0.4	X230	0.0	X430	0.5
Sum	100.0		100.0		100.0

Table A3.  
Codes of industrial sectors.

Industrial Sectors	Description
X170	Chemical products
X190	Metal products
X210	Agr. & Ind. Machines
X230	Office Machines
X250	Electrical goods
X270	Motor vehicles
X290	Other transp. equip.
X410	Textile, clothing
X430	Leathers, footwear
X450	Timber, furniture
X470	Pulp, paper, printing
X490	Rubber, plastic
X510	Other manufactures

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## **ANNEX F**

### **The Public Procurement System and Small and Medium Enterprises in India\***

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# THE PUBLIC PROCUREMENT SYSTEM AND SMALL AND MEDIUM

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Public buying refers to procurements made with public funds and includes procurements made by the central Government as well as the State governments, the public sector units, owned by the central or the State governments and other public bodies like municipal corporations, etc. Spending public money imposes certain formalities and restrictions on the public buying systems as compared to other systems of procurement. Public funds should be spent in the public interest, as defined and safeguarded by the country's constitution and the Government's policies. Accordingly, public buying has to take into account constitutional provisions and government policies besides the legal requirements of the country.

The constitution of India contains specific references to drawing up contracts by the Government and provides that the executive powers of the central or the State governments shall extend to the performance of any trade and business and the drawing up contracts for any purpose. The operation of this article is further subject to other relevant articles of the constitution, the most notable being those relating to equality of opportunity to all citizens which in turn implies equality in government procurement and equality before the law.

These constitutional provisions have been amplified and to a certain extent modified by the courts through judgements and rulings given from time to time. It has been clarified that the State is not required or obliged to enter into trade and draw up contracts but if it does so, it is essential that it treats all its citizens fairly and without discrimination. A citizen, on the other hand has no specific claim to the State's largess and no right to be awarded a contract but if he participates in a tender, he has a right to be considered without discrimination and with equality.

There are also provisions in the constitution dealing with redress of grievances which may arise if the rights granted under these provisions are violated. A citizen may seek justice directly from the respective high courts for complaints against the State government and from the supreme court for complaints against the central Government.

The Indian constitution does not make any special provisions for state-owned production enterprises generally referred to as Public Sector Undertakings (PSUs) nor for small and medium sized enterprises (SMEs). The Government however, by invoking its executive powers, has issued orders and directives from time to time in matters relating to PSUs and SMEs. It has granted special status to these units and has provided for preferential treatment to be given to them in public buying. These specific provisions have been operative for a fairly long time and have withstood legal scrutiny.

All purchases in India are governed by the same set of laws and there is no separate legislation for public buying. The Government stands at par with any private purchaser in matters relating to contracts. In other words, the Government has the obligation to carry out, as provided under the constitution while entering into contracts but it has no special rights before the law to demand or receive any special treatment while acting as a purchaser.

### **Public buying policy**

The policy on public buying is contained in the General Financial Rules, 1963, (Chapter 8 - Stores) published by the Ministry of Finance. These general rules are applicable to all ministries and departments of the Government and form the core of instructions governing their public buying programme and procedures. The detailed rules and instructions relating to individual ministries and departments, which are responsible for or concerned with large purchases are contained in the departmental manuals of the departments concerned.

The fundamentals of the policy have been summarized in the preamble to the rules, as extracted below:

“The policy of Government is to make purchases of stores for the public service in such a way as to encourage development of indigenous production of stores to the utmost possible extent and to make the country self-sufficient in the matter of its own requirements. The following rules which supersede all previous orders on the subject and which are applicable to the purchase of stores (except stationery stores) for the requirements of Government and Union Territories are prescribed in accordance with this policy.

*In order to give effect to the above-mentioned policy, preference in making purchases will be given in the following order:-*

*FIRSTLY, to articles which are produced in India in the form of raw materials or are manufactured in India from raw materials produced in India, provided that the quality and delivery are suitable.*

*SECONDLY, to articles which are wholly or partially manufactured in India from imported materials provided that the quality and delivery are suitable.*

*THIRDLY, to articles of foreign manufacture held in stock in India, provided that they are of suitable type and requisite quality.*

*FOURTHLY, to articles manufactured abroad which need to be specially imported . (Preference to be given to offers received for supply through Indian Agents or India-based Establishments.)*

The Central Purchase Organisation and other officers specially authorised in this behalf may, when they are satisfied that such a measure is justified allow price preference (i) in respect of articles produced or manufactured in India wholly or partially over imported articles, (ii) in respect of articles produced by

Cottage and Small Scale Industry over the articles manufactured by Large Scale Industry.”

A copy of an extract of the relevant rules governing “purchase and acquisition of stores” along with Appendix 8 to the chapter has been placed at Annexure I.

The purchase preference given to domestic supplies over the duty paid price of imports has recently been withdrawn by the Government.

### **Public buying administration**

The government instruction quoted above makes a reference to the Central Purchase Organisation. It was created as a specialized agency to make purchases in a professional and efficient manner for meeting the requirements of all the ministries and departments of the central government. This organization is designated as Director General of Supplies and Disposals (DGS&D) and it has its headquarters in New Delhi and regional offices located at Mumbai, Calcutta and Chennai. The individual ministries and departments also have their own procurement agencies which cater to their specific needs and also to their small value requirements. The Central Procurement Organisation, because of its nature, was entrusted with demands which were over a certain minimum value so that its energy is not wasted away in dealing with small value purchases. Demands for items, specific to only one ministry was also considered unsuitable for business by the Central Purchase Organisation for the same reasons and over time, procurement of such demands was left to the consuming ministry, whenever possible.

The Central Purchase Organisation operates under the Department of Supply, which is part of the Ministry of Commerce. The Department of Supply is the central agency of the Central Government on all procurement matters. It formulates the Government’s policy on procurement and may issue directives and procedure orders on various aspects of government procurement. All ministries of the Government are required to follow these directives and procedure orders while making their own purchases.

In the State governments, procurement is dealt with by the concerned departments independently. Only one State has tried to create a Central Procurement Organisation but it had a limited agenda and thus limited success. The State governments have freely sought the assistance of the Central Purchase Organisation of the central government and traditionally such assistance has been granted.

The Central Purchase Organisation had existed in India before independence also, but it operated on a small scale. The organisation was enlarged and strengthened after 1947 and its scope of operations was considerably broadened. It was entrusted with many responsibilities in order to meet the demands of a growing nation.

Procurement of a large number of items was centralised in DGS & D to achieve economy of scale in purchases and also to optimize the production capacity available in the country. However from the mid-1970s, the activities of the Central Purchase Organisation have been on the decline because of

the gradual industrialization of the country resulting in easier availability of materials in all parts of the country. The Government, in recognition of this trend, encouraged decentralization of purchases and directed various ministries to make more direct procurement for their specific and individual needs. The common user items which are required by several ministries and where economy of scale can be achieved on account of consolidation of demands continued to be handled by the Central Procurement Organisation. The other ministries which have emerged as major buyers during this process are the Ministries of Railways and Defence.

### **Small and medium size enterprises (SMEs)**

Industries in India are classified into the following categories according to size:

Large-scale industries (LSI).

Medium-scale industries.

Small-scale industries (SSI).

Tiny sector.

There are no official definitions of the large scale and medium-scale units. The following definitions have been accepted.

Large-scale industry refers to those units, where the investment exceeds Rs. 100 crores (US\$ 25 million) and medium-scale industry refers to units whose investment falls between those of SSI and LSI.

SSIs are units where the total investment on plant and machinery does not exceed Rs. 3 crores (US\$ 750,000). The definition of investment does not cover money spent on buying land and erecting buildings and workshops nor does it include working capital. The investment limit has been revised from time to time and always upwards, the only exception being the current revision downwards from US\$ 750,000 to US\$ 150,000.

Tiny Sector Units, as the name suggests, have an investment limit of Rs. 25 lakhs (US\$ 62,500), which is also likely to be revised downwards. In general, it is considered part of the SSI sector.

In addition, there is the cottage industry sector, which does not fall into any of the above categories.

The Public Buying Programme recognizes the industry as classified between the SSI sector and the LSI sector, the latter comprising the medium-scale industry sector also.

### **Small scale industries (SSIs)**

The Government of India supports the growth of SSIs as a matter of policy and it has been an important and permanent feature of its industrial policy. There has always been an emphasis on the establishment of new SSIs, particularly in industrially backward areas, and concern for their growth. A

number of incentives have been announced by the Government occasionally to achieve this broad objective. This includes providing land at concessional rates or free of cost for establishing new SSI units, and easy credit at lower than prevailing commercial rates for procuring plant and machinery. In addition, to help the SSIs to remain profitable, exemptions from certain statutory duties and levies like excise duty and sales tax are generally granted.

The Government has also created institutional support to guide and help the SSIs, which may be promoted by inexperienced entrepreneurs, through the National Small Industries Corporation (NSIC). This is a national organization with adequate infrastructure and expertise to help SSI units in their various operations. It provides training to the entrepreneurs and their workers, testing and quality control facilities for their products and most important, it helps them in marketing their products.

The State governments have separately and independently extended similar benefits to SSIs located in their territory. However they created no independent organization. The entire work is handled by the State's administration under the Director of Industries of the State.

NSIC and the Director of Industries have been entrusted with the responsibility of certifying an industrial unit as an SSI unit. In other words, a small-scale unit has to be registered with NSIC or Director of Industries of the State concerned to be eligible for the benefits available.. This registration is essential for participation in the public buying programme.

### **Public buying and SMEs**

Encouragement to SSIs and the cottage industry sector in the public buying programme is one of the earliest policy decisions taken by the Government. It recognized the importance of cottage and small-scale industries to the national economy and the scope they offered for village and cooperative enterprises and for the rehabilitation of persons displaced after the partition of the country in 1947. Observing that the public buying programme could effectively be utilized for development of cottage and small scale industries, a decision was taken that it should be an objective of the public buying programme to encourage production and utilization of cottage and small-scale industries products.

### **Cottage industry**

Cottage industry refers to production of traditional goods in the villages by very small units. It is also done by illiterate persons with no formal training who work in their own homes and not in factories. They acquire the skills from their elders and have no exposure to machines. The units use local raw materials, develop local initiatives and cooperation and promote the artisans' skills. They require only low capital investment to generate income and employment.

The best example of products of cottage industries is the "Khadi" or hand spun and handwoven fabric, which is traditionally produced and worn in India in all parts of the country. Blankets and soap are other well-known products. In all these cases, the production

is done without machines (unless one classifies the wheel or hand-driven loom as a machine) or electricity. By its nature and tradition, cottage industries offered many opportunities for employment in the rural areas, generally helping the economically and socially underprivileged to supplement his or her income and it continues to do so in modern India also. This explains the importance given to the cottage industry sector in the public buying programme.

The cottage industry sector functions under the umbrella of Khadi and Village Industries Commission (KVIC) which is a statutory body established in 1956 under an act of Parliament. The commission supports individual cottage industrial units at the village level and markets their products. Its other objectives are skill improvement through training and transfer of technology, promotion of self reliance, building a strong rural community base and rural industrialization.

The Government of India, when it announced its public buying policy in 1952, accordingly provided for purchase and price preferences to be given to goods produced by the cottage and the SSIs. As a result certain items were reserved for procurement from Khadi and Village Industries Commission and certain other items were reserved for procurement from the small-scale sector. The items selected were such that the needs of the public buying programme for these items were fully met from these two sectors. In case of other items, the public buying policy recommended a price preference for the cottage and the SSIs. The price preference however, was dependent on circumstances and the merit of each case and was not given automatically.

These criteria have continued to remain at the core of the Government's procurement policy over the following four and half decades, though the policy acquired more features over time. In the subsequent reviews of the policy, the list of reserved items has been modified and revised and the extent of price preferences has also been defined and quantified. An important modification was made in the review conducted in 1989, when Women Development Organisations were brought into line with Khadi and Village Industries Commission. A Women Development Organisation is defined as an organized group of women artisans and workers, engaged in production of goods falling under the ambit of cottage industries. The Government, through this modification, supported the products of such groups under the policy for the improved conditions of women workers, especially because they came from the economically weaker sections.

A standing review committee was set up at the highest level in the Government for periodically reviewing the list of items reserved for exclusive procurement from the SSIs. This committee was responsible for new items and removing old items from the list so that it meets the basic objectives of the policy with changing times, keeping in mind the needs of the consuming ministries and the country's production capacity. According to the latest review, 356 items are reserved for exclusive procurement from the small-scale sector.

A copy of the Government's latest circular on the policy of reservation of items for the small-scale sector and the list of 356 items so reserved can be found in Annexure II.

The cottage and small-scale units are entitled to a price preference of up to 15% on merit when competing with large-scale units. This price preference is permitted even when they compete with a State-owned enterprise, called Public Sector Undertakings (PSU).

It is worthwhile at this stage to look into the basic principle behind the policy of price preference for SSIs. The preference is necessary because there are cases where the SSI units cannot compete with large-scale sectors and need protection. The price preference is a logical safeguard in such cases and for such cases only. Therefore it is to be accorded on a tender-to-tender basis, keeping in mind the basic considerations of the purchaser with regard to specifications, quality, deliveries, etc. The purchase officer must exercise his discretion while granting price preferences. It is not the policy's intention that SSIs should have a claim to higher rates in public buying and the purchaser should pay up to 15% higher rates irrespective of the merit of the case. To safeguard his interest and to make economical purchases, the purchaser may, where considered necessary, call for a detailed breakdown of cost of production if there are reasons to believe that a higher price is being quoted by a SSI unit only to avail of the price preference.

### **Procurement policy and the State governments**

The above policy, though formulated by the Government of India for its own public buying programme, are also followed by all the State governments. There may be minor modifications to the policy to accommodate local or special needs of the State. An example may be the purchase preference given to the products of the State over products of other States. In some cases, items may be reserved for the exclusive procurement of the units established in the State itself. An analogy for this is the reservation of products from the cottage and small-scale sectors by the Central Government. The underlying principle remains the same--to encourage the growth of specific types of industry and to protect it from outside competition

## **Other incentives for SMEs**

There are several other incentives which have been given to the cottage and the SSIs to improve their competitiveness in the public buying programmes.

The bid invitation is supplied free of cost to these units. A copy of the bid invitation is also sent directly to NSIC for circulation amongst its members. This considerably reduces the lobbying cost of these units because they are assured of getting the bid invitation on time and also of receiving the bid invitation forms without any marketing efforts on their part.

Copies of drawings and specifications, even if they are priced documents, are supplied free of cost to NSIC for distribution amongst its members.

Under the single-point registration scheme, the SSI units registered with NSIC are treated as having been registered with the Government's purchasing agencies and are entitled to the benefits available to the registered firms. No fresh capacity verification is required when such firms participate in a bid. It saves their time and efforts and enables them to participate in bid invitations at short notice. Without this facility, a SSI unit may need to register itself with many government agencies. Restrictions, however, apply for safety items and the requirements of the Ministry of Defence in general.

These units are exempted from payment of bid guarantees while submitting their offers. They are not required to submit performance guarantees also when the contract is awarded to them. Besides simplifying the bid submission and contract procedures for these units, these measures help the units to reduce their working capital requirements.

During the public opening of bids, a representative of NSIC is permitted to be present and to record the necessary information. This is communicated to the SSI units who may have participated in the bid. It saves labour and expenditure of these units, which they would otherwise have incurred for obtaining this information. The information is also useful to other units of NSIC who may like to participate in the bids in future.

KVIC units are exempted from paying any penalty for delay in the supplies. This concession recognizes that KVIC units are part of an unorganized sector and cannot be equated with professionally managed units.

There have been persistent complaints that payments to SSI units were not being made promptly by the purchasers. Delay in payment reduces the available working capital of a unit and affects its production capacity and profitability. The Parliament has recently approved an act which seeks to compensate SSI units against delay in payment. The purchaser, under the act, shall be liable to pay interest to the SSI unit at a rate of 5% higher than the prevailing bank rate, if payment is delayed beyond 90 days.

To provide further financial support to SSI units, the Government has issued a notification allowing 24% equity participation in SSI units by other industrial units. This

opens another avenue of financing to SSI units in addition to promoter's capital, bank loans and government loans.

### **Growth of the small-scale sector**

The small-scale sector has recorded a continuous growth in number of units as well as in volume of production. The statistics for the last four years are given below:

#### **No of Units & Production in SSI sector.**

<b>Year billion)</b>	<b>No. of units</b>	<b>Production at current prices (\$</b>
1993-94 60.41	23,84,000	
1994-95 68.99	25,71,000	
1995-96 89.05	27,24,000	
1996-97	28,57,000	103.16
1997-98	30,14,000	117.34

The number of units during the last four years has grown by 26% and production by 94%. During 1996-1997, the growth in production was 11.3% compared to an overall growth of 7% for the entire industrial sector.

Production in the cottage industry sector, through KVIC in 1955-1956 was at a level of US\$ 4.12 million (Rs. 16.47 crores) consisting of Khadi US\$ 1.39 million (Rs. 5.54 crores) and village industries US\$ 2.73 million (Rs. 10.93 crores). In 1996-1997 this increased to US\$ 1.22 billion (Rs. 4,880 crores) consisting of Khadi US\$ 190 million (Rs. 760 crores) and village industries US\$ 1.03 billion (Rs. 4120 crores).

**Source of statistics quoted in para 9:** Annual Report for 1996-1997 of the Ministry of Industries:

**Note:** (a) The value of production is given in Rs. Crores which has been converted into US\$ at US\$ 1 = 40 Rs.

(b) Figures for 1996-1997 are provisional for the KVIC sector and for 1997-1998 for the SSI sector.

## **Issues on SMEs and Public Procurement**

### **The procurement system**

#### **Volume of purchases**

The statistics of the total value of purchases made in the Public Procurement Systems in India are not compiled by any organization in the country. Even the figures of the total purchases made by the Central Government are not compiled: only the Central Purchase Organisation and the Ministry of Railways compile and publish statistics of their own purchases. Thus it is not possible to quote authentic figures of the total purchases made under the public Procurement Systems. An effort has been made, however, in the following paragraphs in order to obtain an estimate of the procurement level.

#### **Purchases made by the Central Government**

The Ministries of Railways and Defence are the major purchases of the Government. During 1996-1997, the Indian Railways made a total purchase of US\$ 2.13 billion (Rs. 8526 crores). The purchases of the Ministry of Defence may be estimated to be at the same level, as far as their civilian requirements are concerned. The Central Purchase Organisation (DGS&D) made purchases of US\$ 0.52 billion (Rs. 2092 crores) during 1996-1997. The total for these organizations comes to US\$ 4.78 billion (Rs. 19,144 crores). This is further estimated to be about 70% of the total purchases of the Government as the other ministries are not involved with procurement of materials on a large scale and their requirements are much smaller. Multiplying by 100/70, the figure comes to US\$ 6.82 billion (Rs. 27,300 crores).

#### **Purchases by Public Sector Undertakings**

Public Sector Undertakings of the Central Government are big buyers in their own rights, particularly the larger units that produce steel, petroleum products, electrical plants and machinery, aircraft, etc. The total purchases made by PSUs are estimated to be of the same level as that of the ministries of the Government, i.e. another US\$ 6.82 billion (Rs. 27,300 crores).

#### **Purchases by State Governments**

The procurements made by the States (total number, 25) and Union Territories (total number, 7) can be estimated to equal the procurement made by the ministries of the Central Government, i.e., another US\$ 6.82 billion (Rs. 27,300 crores).

### **Purchases by public bodies**

The procurements made by the public bodies (municipal corporations and other civic bodies, societies, etc.) is not considered in this estimate. The level of procurement is low and not comparable to the figures being compiled for the government sector.

### **Total value of purchases**

This estimate is US\$ 20.46 billion (Rs. 83,440 crores) as the value of the total annual procurements in India by the Public Procurement Systems.

### **Number of contracts**

The total number of contracts placed by DGS & D are as below:

#### **No. of contracts placed by DGS & D.**

<b>Year</b>	<b>No. of contracts</b>
1993-1994	3,413
1994-1995	3,316
1995-1996	2,976
1996-1997	2,884

Statistics on the number of contracts are not compiled and published in any other ministry. In the Ministry of Railways these figures are compiled by each unit but are not available as a published document. Information obtained informally from the Ministry of Railways shows that the total number of contracts placed during 1997-1998 was 120,000.

No efforts are being made to extrapolate these figures for the central Government or the entire public procurement system.

### **Value of purchases from SMEs**

The Ministry of Railways and the Department of Supply are the only ministry/department which publish the value of purchases they made from the cottage industry sector and the small-scale industry sector. These are quoted below.

### Purchases from SSI and Cottage Industries

(value in Rs. Crores)

Year	Railways	DGS & D
1994-1995	223	228
1995-1996	258	204
1996-1997	411	196

The total for 1996-1997 comes to Rs. 607 crores. Adopting similar logic as was done for estimating the total value of purchases, the estimate for all the ministries comes to  $100 / 70 \times 605 = \text{Rs. } 864$  crores i.e. US\$ 216 million.

The procurement made by the Public Sector Units from this sector is estimated to be higher at Rs. 1200 crores (US\$ 300 million). This brings the total to US\$ 516 million (Rs. 2064 crores).

Independent estimates of the value of orders executed / received by NSIC units from the government department and the PSUs are made by NSIC also. For 1997-1998 the total was Rs. 1583 crores. Since this compilation is not only for the value of executed orders but also includes received orders, these figures are not likely to tally with the estimate made earlier. The NSIC figures should be ignored and the estimates made above considered to be the more realistic and representative figures.

Procurement from this sector by the State government is estimated to be higher than that of the central government because of the nature of the items generally bought by the State governments. The total procurement by various State governments and the Union Territories may be estimated as equal to the sum arrived at earlier.

The value of the total procurement from the cottage industry and SSI sectors in the Public Buying programme thus comes to US\$ 1.03 billion (Rs. 4124 crores) or US\$ 1 billion approximately. This is around 5% of the total procurements.

**Source of figures quoted above:** Annual Report of Ministry of Railways and Department of Supply, Ministry of Commerce for the years 1994-1995, 1995-1996 and 1996-1997. **Note :** US\$ 1 IS equal to Rs. 40.

### Legal authority of the SME programme

There is no legislation in India to guide, direct or provide authority to public bodies to implement programmes for the benefit of SMEs. A legislation was enacted in 1996 to protect the interests of SSI sectors from delayed payments by purchasers. The act provides that the purchaser shall pay interest at a rate of 5% higher than the bank lending rates if payment to a SSI unit is delayed by more than 90 days. This act is intended to relieve SSI units from a shortage of working capital caused by delayed payment. However, it is concerned with a part of the total working of SMEs.

A high level committee was organized by the Government in December, 1995 to address the needs for reforms in the existing policies and design new policies for SMEs. The committee submitted its report in January 1997. One of the major recommendations of the committee is to create separate legislation for SMEs. The recommendation have been examined and are being considered by the Government.

There are no legal provisions in India that restrict public contract awards to domestic industry or provide preferences to domestic industry in public procurement. There were earlier government directives for preference to be given to articles manufactured by domestic industry rather than to imports. This issue has been discussed in detail under "Public Buying Policy". However, as noted there, these directives were withdrawn in 1993 after the Government of India took a policy decision on liberalization of the Indian economy.

#### **Customary Authority for SME programmes.**

Development of SMEs has been recognized as an effective tool for rapid industrialization and balanced regional growth of the country. The Government issued directives and orders for the development of SMEs resulting in implementation of programmes by various ministries, departments and public bodies. Since the earliest orders are more than four decades old and have withstood legal scrutiny, this authority is well established and well recognized.

The Department of Small Scale Industries and Agro and Rural Industries, which is a part of the Ministry of Industry, is the central department of the Government on all matters relating to SMEs. The various orders and directives are issued by this department which is also responsible for their implementation.

#### **Costs and benefits of SME programmes.**

No cost-benefit analysis or data on the cost of implementing the SME programme are available. Efforts made by individual ministries have been limited to the costs each incurred whereas the total cost incurred would involve more than one ministry or department.

The benefits of SME programmes, unlike the costs, cannot be translated directly into monetary terms. For example, the benefits of the equitable growth of different regions of the country will involve many parameters which could be interpreted in monetary terms. No comprehensive analysis of these benefits has been attempted and they have been measured by other visible parameters.

## **BENEFITS**

### **Export development**

SMEs have played a significant role in the development of exports. The products of SMEs are cheaper than those of large-scale units because of lower capital outlay and lower production costs. The incentives provided by the Government also help to reduce the

production costs. The products of SMEs therefore, have an edge in the global market because of their lower rates. The Government recognizes the potential of the growth of exports through SMEs. It also encourages the establishment of purely export-oriented units. The performance of the SSI sector in exports is closely monitored and assistance is provided to help these units meet their targets. The contribution of SSIs in exports has been significant and is maintaining a level of around 40% of the total manufacturing sectors' export. The actual value of exports for the last four years are given in the table below:

### Exports by SSI Sector

<i>Year</i>	<i>Exports</i>
	(US\$ billion)
1993-94	6.33
1994-95	7.27
1995-96	9.12
1996-97	9.81

**Source:** Annual Report for 1997-98 of Ministry of Industry.

**Note:** Value of exports is in Rs. Crores and has been converted in US\$ at \$1 = 40 Rs.

It can be seen that the growth during a three year period has been 55%, but a decline in the rate of growth during 1996-97 is noticeable.

### Employment potential

SMEs provides many more employment opportunities than those offered by large-scale units. On account of its relative small size, several production tasks are carried out manually which in a large-scale unit would either be automated or be bulked and performed with less manpower with proper mechanical help. Examples are conveyance of materials inside the units or packaging of the finished products.

Rapid increase in gainful employment is one of the major objectives of the Government and so it emphasizes the development of the village and the small-scale industries. The actual growth in employment achieved in these two sectors has justified the optimism of the policy, as may be seen from the table below:

### Employment in SSI Sector

<b>Year</b>	<b>Employment</b>
1993-94	13,938,000
1994-95	14,656,000
1995-96	15,261,000
1996-97	16,000,000

1997-98

16,720,000

Employment, as can be seen, has been growing at a constant rate of about 4.5 to 5.0% and an increase of 20% in employment has been achieved in four years.

The growth of employment in the cottage industry may be expressed in identical terms i.e., the number of persons employed. KVIC, however, measures its growth in terms of the number of villages where its programmes are operative, as well as in terms of persons fully employed.

In 1997-1998, the number of villages covered by its programmes reached 248,000, which is about 30% of the total number of villages in the country.

#### **Employment in the cottage industry**

<b>Year</b>	<b>Employment</b>
1955-1956	964,000
1996-1997	6,022,000

**Source:** Ministry of Industry's Annual Report, 1997-1998.

**Note:** figures for 1997-1998 are provisional.

#### **Balanced regional growth**

Large-scale units lead to concentration of industrial activities at selected points. Only those sites are chosen that offer distinct advantages for production, as for example proximity to raw materials, well-developed infrastructure facilities, etc. Large-scale units tend to cluster around such favoured locations and ultimately a large industrial complex is established. It helps the surrounding areas to grow and brings prosperity to the area. It is, however, not possible to build such industrial complexes all over the country for the obvious reason that all locations can not be favoured locations.

Therefore the contributions made by large-scale units, though substantial in absolute terms, are not uniformly spread over the entire State and do not touch the lives of a large population. Its benefits are geographically concentrated and available to the few who live in that area.

SMEs, by its nature achieve what large-scale units fail to do. SMEs can be established almost anywhere in the country. The smaller the unit, the greater is the ease in locating it. As far as the benefits of an industrial unit are concerned, an SME provides the same benefits to the area, though on a smaller scale. In other words, the small-scale industry and the cottage industry provide the means through which the benefits of industrialization may be brought to any part of the State and backwardness may be removed. A balanced regional growth can therefore be achieved by development of the SMEs.

### **Helping the underprivileged.**

The underprivileged and the weaker sections of the society find easy access to SME programmes which is made possible because of the wide geographical distribution of SMEs, as discussed in the preceding paragraph and as well as the small size of the units. The cottage industry sector, in particular, plays the most important role in this regard.

The Khadi and Village Industries Commission in India targets that sector to establish its units which is living below the poverty line. It promotes self reliance among the people, so that a strong rural community base is created. As discussed above in the section on the cottage industries, the Khadi and Village Industries use local raw material and need low capital investment, which puts the units within the reach of the weaker sector of society. The policy of the Government giving special status to Women Development Organisations is a further step in this direction. These units also are in the category of cottage industry and have a rural base, but are run entirely by women. They have been placed at par with KVIC units and enjoy all the privileges granted to KVIC units.

### **Balanced social growth**

The development of SMEs provides opportunities that did not exist earlier, whether these are in a backward area of the country or among the underprivileged of the society. It creates employment which was neither possible nor available. Consequently, it brings money and affluence to a larger percentage of the population. The large-scale units on the other hand distribute their benefits only among a few people and only among those who have resources and wealth. SMEs distribute their benefits more widely and create conditions for balanced social growth.

## **COST VARIABLES ON SME PROGRAMMES**

### **Administrative costs.**

The programmes for the SSI sector are administered through the Small Industries Development Organisation (SIDO). It works through a network of 28 small industries service centres, 30 branch institutes, 2 extension centres and 10 field-testing centres. In addition, there are Tool Rooms, regional test centres, product and process development centres and entrepreneurship development institutes which are run as autonomous bodies but are supervised by SIDO. The cost of running the entire network is the administrative cost to the Central Government.

As discussed in the first part of this paper, the State governments have established their own network but on a smaller scale. The district industries centres are the field units in States supporting SME programmes.

The cost of the establishment is not available as a published document.

### **Premium Cost - Contract price**

A number of items in the Public Procurement Programme are reserved for exclusive purchase from the cottage industry sector as well as from the small-scale sector. For other items, these units compete with large-scale sectors and are entitled to a price preference of up to 15% over the large-scale sector. The conclusion that the purchaser has to pay higher rates on account of this reservation and price preference is inescapable. The only question is of the quantity.

In many cases, experience shows that SSI units are able to stand on their own and win a contract by quoting rates lower than the LSI units. It would be reasonable to assume that on average a price preference of 7.5% is given to the small-scale sector.

**The case of the cottage industry sector is similar. The rates at which materials are procured from the cottage industry are always higher than the existing market rates and even those of the SSI sector. In case of items exclusively reserved for the cottage industry sector, the increase may even be 100% . As most of the procurement from the cottage industry sector is taken from the list of exclusive items, it would be reasonable to assume that the extra expenditure for the cottage industry purchases would proportionately be higher.**

In the section entitled Value of Purchase, above, an estimate of the total purchases from the SSI and the cottage industry sector is US\$ 1 billion (Rs. 4000 Crores). Taking an overall view, the extra expenditure due to reservation and price preference is estimated at 10% of this figure, i.e., US\$ 100 million (Rs. 400 Crores).

## **Premium Cost - Contract Performance**

The performance of the SMEs has been satisfactory and on an average not worse than the performance of LSIs. Therefore no cost aspect is involved on account of contract performance.

## **Transfer costs**

Incentives to the cottage industry sector and the SSI have been discussed above. These include exemption from statutory duties and levies, the most common being the exception from excise duty for annual production up to US\$ 75,000 (Rs. 30 lakhs) and sales tax. The loss of revenue to the Government is only partially offset by lower rates. The real beneficiaries are the cottage industry and the SSI sector, who are able to sell their products at a higher cost. In the event of free competition with the LSI sector, they will be obliged to sell at lower rates.

Other incentives, in general, also have a monetary aspect and result in loss to the Government directly or indirectly. An example of the latter is non-levy of penalty on the cottage industry sector for delayed supplies. Some of the incentives are in the form of subsidy, for example, the allotment of land at subsidized rates or free of cost, credit facilities at rates lower than normal commercial borrowing.

Data on these costs are not available and it is not possible to make any reliable estimate.

## **Lobbying cost**

The incentives given to SMEs has been discussed in detail in the first part of this paper. Marketing support is one of the mainstays of the SME development programme. Reservation of items for exclusive purchase from the cottage sector and the small-scale sector is another important constituent of the policy. This insures business for these units and also provides total marketing support for items reserved for the sector. Thus the lobbying cost is not a significant factor of cost, specific to this sector.

## **International Trade Aspects of SME Programmes.**

India is a founder member of WTO in 1995 and also of GATT, its predecessor in 1947. The Public Buying Policy of India has been discussed in detail above and later with specific references to SMEs. It was in recognition of the international obligations that the price preference which was traditionally being given to domestic products over imports was abolished in 1993.

The Government of India is not yet a party to the WTO Agreement on Government procurement. The views of the Government are being discussed in WTO. It is understood that the WTO Agreement on Government Procurement does not yet have a significant number of

signatories. It is, however, unlikely that the country's SME programme will be affected by the agreement.

The Government of India adopted a policy of economic liberalization in 1991 and various measures have been taken in this regard. It is a continuing process and liberalization of trade is a part of the programme. The policy with regard to SME development may not be affected by trade liberalization, though it is difficult to assess the impact in general terms.

The objectives of the policy on the development of SMEs has been discussed in detail in the section entitled "Public Buying and SMEs" and also under "Benefits of SME Programmes". It was pointed out that trade liberalization is not one of the goals of the SME programmes.

### **SME Programme Implementation**

The Department of Small Scale Industries and Agro and Rural Industries, which is a part of the Ministry of Commerce, is responsible for formulating the Government's policy SMEs and for implementing SME programmes. An apex body has been created under the department - Small Industries Development Organisation (SIDO) - which is responsible for the administration of SME programmes. Details on SIDO are given above in the section entitled "Cost and Benefits of SME Programmes" and "Administrative Costs".

**Extracts from the annual report of the Ministry of Industry for 1997-1998 concerning the department of small-scale industries and agro and rural industries appear in Annexure III. It contains details of current programmes and their implementation.**

At State government level, the programmes are implemented by the Director of Industries concerned, and supported by district level organizations at the field level.

### **SME Programme Types**

#### **Preferences**

In the section entitled "Public Buying and SMEs", the policy of the Government on price preference for the cottage industry and the SSI sector is discussed and also the principles behind the policy. The preferences are based on the origin of the product, whether it has been produced by a cottage industry or a SSI unit, as certified by the authorized agencies (the KVIC, the NSIC or the Director of Industry). Nationality is not a relevant criteria here. According to the above procedure, the product would be of Indian origin only.

**There are no evaluation criteria and under the scheme there does not appear to be any scope for such criteria either.**

### **Set aside Programme**

A number of items are reserved for exclusive procurement from the cottage industry and the small-scale industry sector. The policy on reservation has been discussed under "Public Buying and SMEs"

For the cottage industry sector, the set-asides are exclusive. The Khadi and Village Industries Commission (KVIC) is the sole agency to whom bid invitations are sent and KVIC may nominate one or more of its units to supply the item.

**In the case of the small-scale industry sector, the reserved items are purchased through competitive bidding. The eligibility criterion for the competing units is their registration as a SSI unit by the nominated authorities.**

For the cottage industry sector, KVIC, which is the sole authority for selecting a unit, it is not required to disclose the criteria of its selection to the purchaser. In case of SSI units, however, the norms of competitive bidding apply and a transparent procurement system is required to be followed.

## **Subsidies**

Incentives to SMEs have been discussed in section entitled "Other Incentives for SMEs". These include subsidies also. Free allotment of land for establishing a SSI unit is a direct subsidy given to this sector. Exemption from excise duty and sales tax are examples of indirect subsidy. Other indirect subsidies include exemption from payment of bid guarantee and performance guarantee, providing credit at rates lower than commercial borrowing rates and payment of interest by the purchaser on delay of payment of bills.

**KVIC units may also receive a direct subsidy on their sales. The Government pays a specified percentage on the market rates at which the products are sold.**

## **Eligibility for SME Programme Benefits**

An industrial unit is certified as a SSI unit by the Director of Industries of the State government concerned or by the National Small Industries Corporation (NSIC). This certification is essential to make the unit eligible for the benefits under the SME programmes. The above authorities also monitor the general performance of such units and provide assistance and guidance to the unit as may be required.

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- NOTE: The papers in the Annexes also contain bibliographies that are an integral part of the Guide.

## END NOTES

Jannik Lindbaek, Executive Vice President, International Finance Corporation, 1996 Annual International Finance Corporation Luncheon Address, which can be found on the World Bank Web site, [www.worldbank.org](http://www.worldbank.org).

This 20% can be contrasted with the data in figure 1. There apparently is a significant difference in the two measurements.

The countries and regions, in accordance with figure 1, are: (1) Europe: Austria, Belgium, France, Germany, Netherlands, Norway, Sweden, United Kingdom; (2) New Zealand; (3) Africa: Botswana, Morocco, South Africa, Tunisia; (4) Asia: India, Republic of Korea, Malaysia, Singapore; (5) South America: Brazil, Mexico, Uruguay, Venezuela; (6) Middle East: Egypt, Israel, Jordan, Turkey; (7) United States; (8) Canada.

Of course, there are risks associated with defaults by large firms, particularly when a government depends on a large firm for an important good or service. Risks of default can be mitigated, but not eliminated completely, by careful procurement planning and execution.

South Africa promulgates public policy in advance of legislation in Green Papers and White Papers. This is similar to the approach used in the United Kingdom. A Green Paper is earlier in time, less firm and designed to bring tentative policy into public discussion. A White Paper, on the other hand, states relatively advanced firm policy from which a government will not deviate lightly. For a discussion in the United Kingdom context, see Zander, 1994.

What is electronic commerce? A description provided by the European Community is as follows: Electronic commerce is about doing business electronically. It is based on the electronic processing and transmission of data, including text, sound and video. It encompasses many diverse activities including electronic trading of goods and services, on-line delivery of digital content, electronic fund transfers, electronic share trading, electronic bills of lading, commercial auctions, collaborative design and engineering, on-line sourcing, public procurement, direct consumer marketing, and after-sales service. It involves both products (e.g. consumer goods, specialised medical equipment) and services (e.g. information services, financial and legal services); traditional activities (e.g. healthcare, education) and new activities (e.g. virtual malls) (Communication to the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions COM(97)157).

If a goal is mandatory, it may be a subcontracting programme, covered in section 4.4.

This language also would appear to make impermissible targeted procurement programmes, such as those discussed in section 4.6.

Although 8(a) firms, which have to be small, can certainly participate in set-asides, since set-asides are not restricted on the basis of ownership and control of small business concerns. The sole focus of eligibility criteria in set-asides is on small business status. Of course, firms still must meet standard qualification criteria relating to good public procurement: they must possess the ability to perform as well as the requisite socio-economic status.

In June 1998, the SDB programme was reinstated allowing, under certain circumstances, a price evaluation adjustment for SDBs certified by the US SBA. The programme also seeks to increase subcontract awards to SDBs by offering evaluation credits and monetary incentives to large-business prime contractors for exceptional levels of subcontracting with SDBs. This new programme is more like targeted procurement, discussed in section 4.6, than a pure set-aside programme.

This figure includes field office expenses (US\$ 15.5 million) and management and technical assistance (US\$ 2 million), in addition to the US\$ 4 million budgeted for programme administrative costs (SBA, 1996).

Much of the discussion in section A is based loosely on *The World Bank Participation Sourcebook*, which can be found at [www.worldbank.org/html/edi/sourcebook](http://www.worldbank.org/html/edi/sourcebook).

The costs to SMEs are from increased reporting and paperwork requirements and those to governments are due to designing and implementing systems of data collection.