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## SME AND

**FOREWORD**

Small and medium-

## ***ACKNOWLEDGEMENTS***

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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

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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 Northeas









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.

**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.





**Unit 1**

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



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



### *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.

## 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:







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



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*

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, , 1

*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

### *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

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 a





## **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

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.



tend to lack formality in terms of registration for tax-purposes, labour legislation, business premises and accounting procedures. Examples of micro-

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.

**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**

1. CONSTRUCTION	2. SERVICES	3.HOLESALEERS/DISTRIBUTION
		W1 Automotive Parts W2 Building Materials / Hardware W3 Cleaning Supplies / Chemicals/ Pesticides W4 Clothing W5 Computer Equipment / Software W6 Curtains W7 Domestic Appliances W8 Medicines W9 Electrical Supplies &Equipment W10 Fire Extinguishing  W12 Floor Coverings W13 Food Supplies W14 Fuel Supplies W15 Furniture W16 Generating Sets W17 Industrial Catering Equipment W18 Laundry Equipment W19 Medical Supplies & Equipment  W21 Office Equipment W22 Paint Supplies W23 Recreational Supplies W24 Refrigeration&Air Conditioning W25 Vehicles W26 Workshop Equipment W99 Other

In the United States, there is a well-developed



allow a concern to exercise a major controlling influence on a national basis in which

## *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.



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

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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 417ocuremr8 0.n09 Tw (sca3 TD 0.0036  
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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.

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.







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 service capabilities of



**Unit 3**

**TOOLS AND EXPERIENCE II: PROCUREMENT REFORM**

- ◆ *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

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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

### **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



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.

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## **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

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 ELPRO, the European Electronic Public Procurement System that will

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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, el.7609 hichst SMEs are mo

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 "TD 0 TcRnternet.

necessary and justified, but require that each federal agency take steps to avoid unnecessary



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**



Legislation generated two pilot programmes managed by the SBA Office of Prime Contracts in



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.



*United States*

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.





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

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.



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

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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

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

companies throughout the year, and the *Dwight D. Eisenhower Award for Excellence*, its

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

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

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

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



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.

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

**ABE**                      A business which adheres to statutory labour practices, is a legal entity registered with the Department of Inland Revenue and an independent

	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:



**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 :		
	$N_p$	$= \frac{Z (1 - (P - P_m))}{P_m}$
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 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.	

**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

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





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-

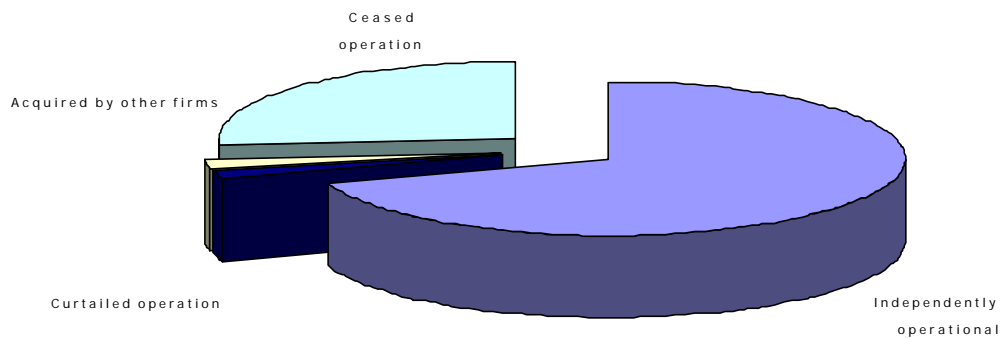
Supreme Court case calling into question programmes designed to assist disadvantaged groups when those programmes are not designed specifically to remedy actual past discrimination.<sup>10</sup>



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>
<p><b>Technical assistance</b></p> <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>	<p><b>Advantages</b></p> <ul style="list-style-type: none"> <li>• Less interventionist</li> <li>• Rewards SME efficiency</li> <li>• Optional features</li> </ul> <p><b>Disadvantages</b></p> <ul style="list-style-type: none"> <li>• Ineffective?</li> <li>• Interest group capture</li> <li>• Information problems</li> </ul>

## **POLICY IMPLEMENTATION**

This Unit provides guidanc



## 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.

### *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

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  
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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



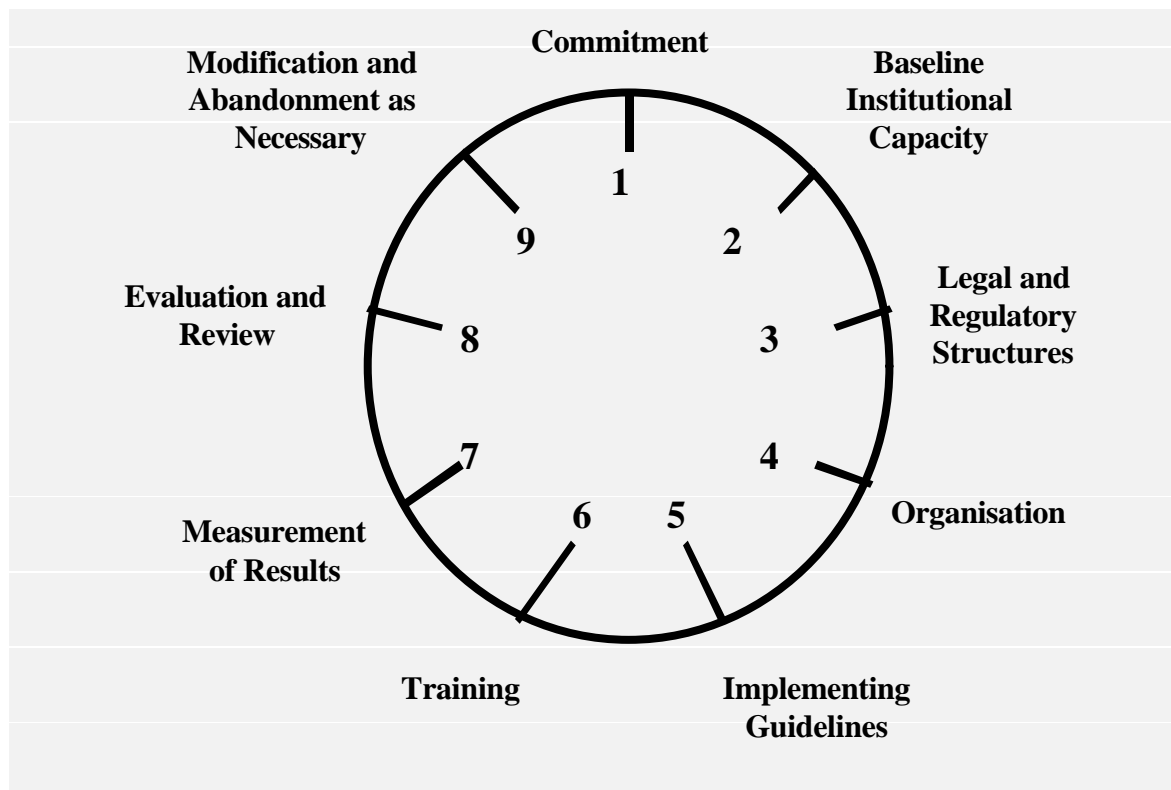
Governments should be prepared to evaluate SME programmes on a periodic basis. The relevant law or regulation can set the time period or the public bodies in charge of the programme can set it. The data to be used and the measurements to be taken will depend on the findings as set forth in section 5.7. 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 wh

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

- 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

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.





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;
-

## **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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**\*Prepared by the Enterprise Research Institute, 1001 Connecticut Avenue, N.W., Washington D.C.  
and presented at the UNCTAD Workshop on Procurement, 5-6 November 1998.**

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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>

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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 profit

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

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 owners0 Tw 49 Tc 0.1049 d13.ese issues in more deta

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.

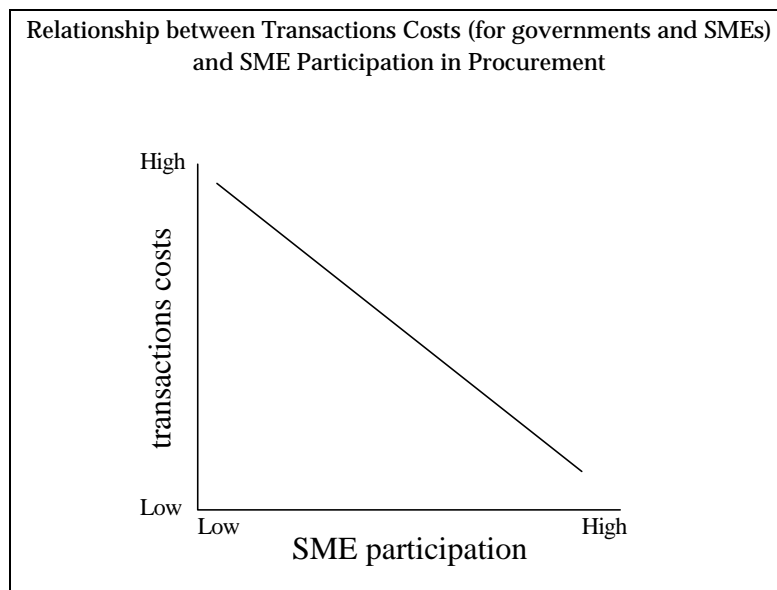
### **Reducing transaction costs**

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.



## Centralization

**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



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, hhelp. A c 0.6 0 T08 - 0.35aj 3 -3 243.6 0 TD -0012 State. A fosu

## **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

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.

The costs of increasing or introducing digital and electronic dissemination for the government are not high. They are usually more a diversion or reappropriation 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 readily available.

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 entsow2Fdmlr220.0lu3D 0.0555 m89 622.2 re W n BT 391.8 685.8 TD 0.0942 T7303.3807 Tw (wi739try) Tj18 th 55 br wed

## **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.

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 optio



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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\*Discussion paper presented at the Workshop on Public Procurement Market Opportunities for Small and Medium Enterprises (SMEs) at the International Trade Centre UNCTAD/WTO, 5 to 6 November 1998.

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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".

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 :

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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).

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

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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.



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.



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.

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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 :*

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

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.





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

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## **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.

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

government officials and private-sector consultants was appointed to research and draft new policy proposals.

## **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.*

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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-

## **Overview**



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

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>	100 points
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*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>	100 points
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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

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 :

$$Np = Z \left( 1 - \frac{P - Pm}{Pm} \right)$$

**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



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.

## 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  
Spatial 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





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 S tsrs0 verified during

## 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 :

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**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 Business 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		Tender Value
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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

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 by banks, and provided to

A comprehen



- 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-



**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
C1 Airconditioning Systems	S1 Accommodation	
C2 Alarm Systems / Security Systems / Access Control	S2 Advertising / Public Relations	
C3 Autoclaves	S3 Auto Repairs & Services	
C4 Automatic Hanger Doors	S4 Bookkeepers	
C5 Automatic Sliding Doors	S5 Carpet Cleaning	
C6 Automatic Sprinkle Fire Protection	S6 Catering / Vending / Food Supply	
C7 Brickwork / Masonry	S7 Cleaning Services	
C8 Cabinet / Furniture Making	S8 Computer Supplies / Services	
C9 Carpeting / Tiling / Floor Covering	S9 Diesel & Petrol Engines	
C10 Ceilings, Partitioning and Shopfitting	S10 Debt Collection	
C11 Cladding Contracts	S11 Educational Services	
C12 Cooking & Related Systems	S12 Florists / Garden Services	
C13 Compressed Air Installations	S13 Food & Beverage / Entertainment	
C14 Concrete works	S14 Funeral Services	
C15 Demolition	S15 Handyman	
C16 Electrical Contracts	S16 Horticultural Services	
C17 Evacuation Systems	S17 HV Fault Finding, Jointing & Terminations	
C18 Fencing	S18 Insurance / Employee Benefits	
C19 General Building Work	S19 Interior Decoration	
C20 General Electrical Work	S20 Interior / Industrial Design	
C21 Glazing	S21 Laundry Services / Dry Cleaning	
C22 Hauling / Heavy Equipment / Transport	S22 Locksmith Services	
C23 Hot Water Installations	S23 Mailing / Courier Services	
C24 Incinerators	S24 Medical / Ambulance / Health Care	
C25 Landscaping / Earthworks	S25 Municipal Services	
C26 Lift & Escalator Equipment	S26 Personnel Services	
C27 Mechanical Contracts	S27 Pest Removal Services	
C28 Metalwork and burglar guards	S28 Printing / Photography / Graphic Design	
C29 Painting	S29 Real Estate	
C30 Paving	S30 Safety & Security Services	
C31 Paving	S31 Security & Access Control	
C32 Plumbing	S32	
C33 Precast Concrete Manufacture		
C34 Pumping Installations		
C35 Road Marking + Signage		
C36 Roadworks & Site Clearing		
C37 Roofing & Waterproofing		
C38 Sewage Installations / reticulation		
C39 Specialist Contracts		
C40 Steam Installations & Ancillary Equipment		

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		<b>4. PROFESSIONAL SERVICES</b>  P1 Accountants / Financial Advisory Services P2 Architects P3 Attorneys / Legal Services P4 Consulting Engineers (Civil/Structural) P5 Consulting Engineers (Electrical) P6 Consulting Engineers (Mechanical) P7 Consulting Engineers (Multidisciplinary) P8 Land Surveyors P9 Medical Practitioners P10 Pharmacists P11 Project Managers P12 Quantity Surveyors P13 Teachers P14 Town Planners P15 Training Providers 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-

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,







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 edge.

#### 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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## **APPENDICES**

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## **ANNEX D**

### **Assisting Small Businesses through Government Purchases An Overview of United States Policies and Practices**

Judith A. Roussel

United States Small Business Administration  
Washington, D.C.

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How does the Government Contracting Program Work?

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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.









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 TDc 0.3139 ISk -12.u28-O TD 0 Tc 0.TD ( )

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

## 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 pomonth

**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-<sup>e</sup>

**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.





## 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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Trade and Public Procurement:  
The Perspective of Small Open Economies

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 Bland and Mrazec, 1997). Out of 22 signatory countries only 2 (Israel and the Republic of Korea) are not Tj 0 721 signatory countries on

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.

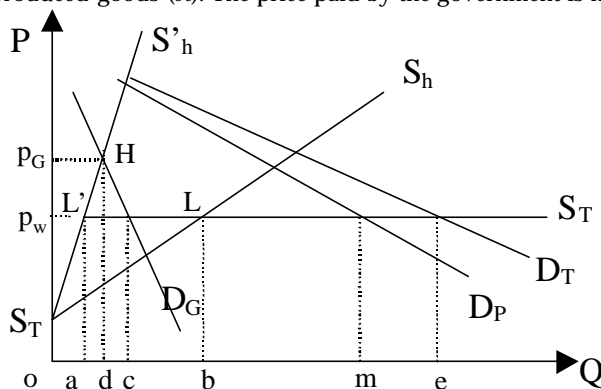
Total domestic demand at the world price is  $oe$ , which is the sum of private demand  $om$  and government demand  $oc$ . The quantity produced domestically is  $ob$  and the quantity imported is  $be$ .

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 10.8 TD2hambiguously fall from  $ae$  to  $om$ . This is ascertained easily. Total 10.8 TD without discriminatory policy is  $IMP = D_c(p_w) + D_f(p_w) - S_h(p_w)$ .<sup>21</sup> Total 10.8 TD2hder discriminatory policy is  $IMP = D_f(p_w)$ . Since, by construction,  $D_c(p_w) > S_h(p_w)$ , it follows that 10.8 TDdecreased. In conclusion, the discriminatory procurement policy in the second situation resul TDin:

- a price wedge between the price paid by the government ( $p_c$ ) and the equilibrium world's price ( $p_w$ );
- anDincrease 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 1n 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 anDindicator 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 anDindicator of inefficiency of the tendering process or of a political interplay is, therefore, not necessarily correct.

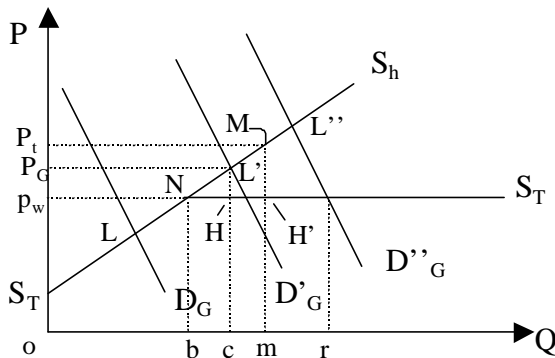
### II.1.2 Domestic content requirement

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 canDbe analysed along the lines of the outright exclusion. All we have to do is to relabel 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 hasDbeen 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 thanDdomestic 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 willDbe 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  $D_f(p_w)$  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  $p_c$ . Any attempt on the part of a domestic firm to charge a price higher than  $p_c$  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 in 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.

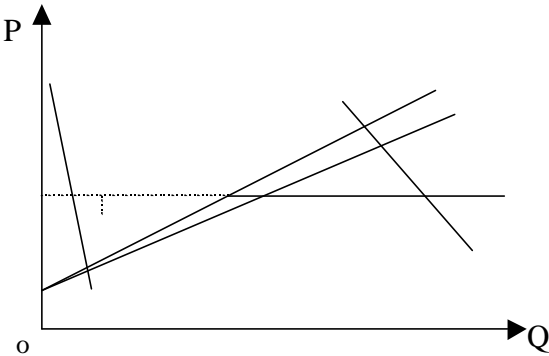
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imports of each component of expenditure (government and private). Without any discriminatory policy, the private sector and the government have the same import share which, in turn, is the import share of the economy as whole. This is an important 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



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

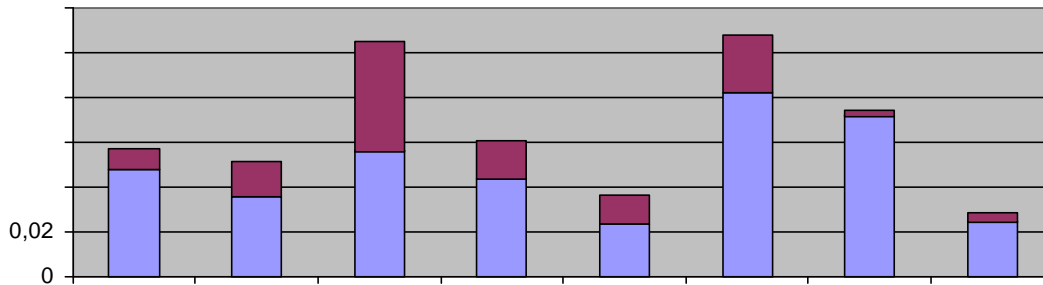
The domestic content requirement, however, becomes effective even if government purchase is small. The reason is very simple: a domestic content requirement increases the market for domestically produced varieties of the intermediate input. The logic is the same as the one in figure 3 where  $D_{cd}$  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



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**

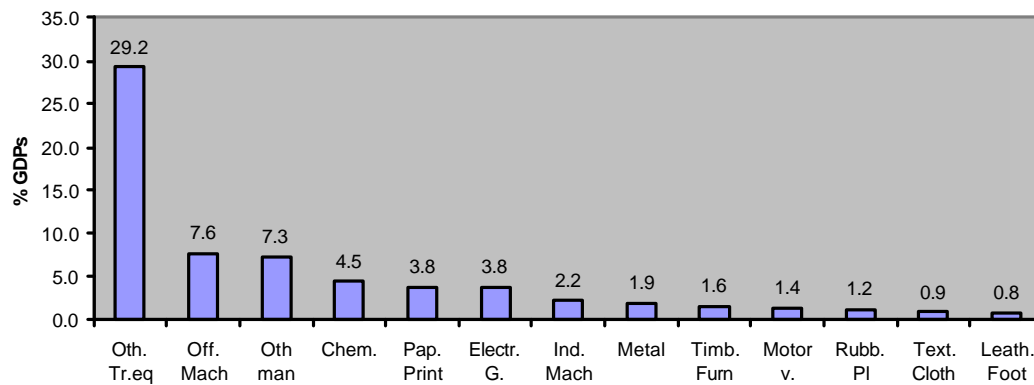


Chart 3 refers to Eu. Government demand is below 5% of domestic output except for three sectors. The sector "Other Transport Equipment" (which excludes motor vehicles) is clearly an exception. A possible explanation is in the fact that this sector includes aircraft and shipbuilding of which the European 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.

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,

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 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.

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



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	



Table A3.  
Codes of industrial sectors.

Industrial Sectors	Description
X170	Chemical products
X190	Metal products
X210	Agr. & Ind. Machines

Hoeckman, B. M., 1997, Operation of the Agreement on Government Procurement, 1983-92, in: B. M. Hoeckman and P.C. Mavroidis, Eds, Law and policy in public purchasing. Michigan Press. Ann Arbor.

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## **ANNEX F**

### **The Public Procurement System and Small and Medium Enterprises in India\***

Keshav Prasad Varma  
Procurement Consultant,  
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        Number of contracts

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# **THE PUBLIC PROCUREMENT SYSTEM AND SMALL AND MEDIUM**

## **Enterprises in India**

### Overview

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



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



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

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 ent

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 an 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.

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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 purch

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.





### **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>
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### 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.

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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



### **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



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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## ***END NOTES***

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