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Procurement, Contracting Out, and Expenditure Management

I have come to feel more and more that the answers to many of the pressing social questions of our time are to be found ultimately in the recognition of principles that lie outside the scope of technical economics or of any other single discipline.

FRIEDRICH A. VON HAYEK, *The Constitution of Liberty*

In its daily operations, a government buys from the market—domestic or external—a variety of products that range from the small and ordinary to the gigantic and crucial. Each of these purchases is related, in the immediate context, to the needs of the government agencies, but in the final analysis, to the range of goods and services provided by the government to the community. As provider of goods and services, it is only natural that the government desires, as a purchaser, high-quality inputs at a competitive price that are fully matched with the requirements of its goals and the outcomes it is pursuing. In this pursuit the agencies issue millions of notices for purchases each year.¹ These purchases are expected to be made publicly so that full accountability is ensured. Most budget regulations therefore specify that adequate procedures should be established to ensure the transparency needed, which is to be achieved through an open tendering process. Thus, for example, Section 30 of the German Law on Budgetary Principles for Federation and Länder (Germany, 1988) states, “the conclusion of contracts for supplies and services shall be preceded by a public invitation to tender, unless the nature of the transaction or special circumstances justify an exception” (p. 50). Nevertheless, it is generally recognized both within the government and outside it that there is considerable wastage and

¹For example, the U.S. Department of Defense issues more than 60,000 purchase or related contracts a day. See Fox (1988). It is likely that this number has been reduced somewhat in recent years as a result of the end of the Cold War.

fraud. As President Reagan noted in a message in 1988, the picture was one of “unscrupulous contractors who bill the Pentagon, the doctors who overcharge the medical program, the welfare chiselers who collect benefits to which they have no right” and “the embezzlers who line their pockets with the taxpayers’ money.”²

These types of cases are by no means limited to democracies but have their counterparts in less democratic societies and in CPEs. The only difference between the experience of democratic and nondemocratic societies is that in the former failures receive undue publicity and, like Gresham’s Law, overwhelm the good deeds performed by the government. In the latter, they receive no publicity, nor do they figure in audit reports, for only a few have adequate and independent audit systems, but somehow they surface after a time. Notwithstanding this difference, which is becoming less distinct as more societies adopt a democratic form of government, government purchases are still enormously important for expenditure management. As governments increase purchases, their ability to be economical, efficient, and effective tends to depend on the sagacity shown in arranging those purchases. The budgetary outcomes, in money terms, depend on the convergence between the estimated and the actual prices paid, according to the share of purchases (as a percent of total expenditures). The ability to reduce the gap between the two is dependent on the realism, imagination, commitment, and skill of the buyer. These skills have acquired a new premium with the introduction of a competitive strategy for the provision of government services. Prolonged experience with the government as the sole provider of services through in-house facilities has shown that the government as an organization gives more attention to procedures than to performance, to services than to cost, and to its own perpetuation than to an orientation to the consumer. The high cost and poor delivery of services illustrated this experience. A recognition of these aspects helped greater emphasis to be laid on contracting out services that were traditionally and previously rendered by the government.

A number of common links exist between procurement for its own needs and contracting out services to the public. In addition to the common source of funding (the government budget), both rely on tendering, contracting, monitoring, and evaluating purchases as well as on third-party services provided by the contractor. Such tendering is an essential part of the accountability requirements of a democratic government. Both types of activities have been traditionally treated more as a practicing art that requires special professional skill. Although there is clearly a need for special skill, it must also be recognized that, given the

²United States, Executive Office of the President (1988), p. 2.

symbiotic relationships between expenditure management and contracting, an expenditure manager can hardly afford to consider contracting as somewhat remote and to limit his function to tendering or to payment. An expenditure manager must, as illustrated in Chapter 4 on compliance, ensure the delivery of a service with a set of defined standards within a given budget. He therefore needs clarity on the framework of objectives and resources and flexibility in the use of the resources given, to achieve economy and effectiveness. The pursuit of economy and effectiveness permeates not only his own actions but also the actions of contractors funded from the government budget. This chapter considers the expenditure manager's pursuit of economy, efficiency, and effectiveness in his role as a purchaser of goods and services and as a funding agency for contracted-out services. Chapter 9 deals with the applicability of these considerations in the activities directly provided by the government itself.

Procurement and contracting have traditionally been considered integral parts of the labyrinthine corridors of bureaucracy. Procurement, and in particular the level of inventories in wartime, have been studied in some detail by economists (including Keynes), statisticians, and operational researchers. Contracting, on the other hand, has been examined more as part of the law. Both aspects were to some extent considered part of the accounting of assets, their maintenance, and their replacement. Budgeting, if it is considered a distinct discipline, paid hardly any attention to the ramifications of contracts. In view of what has been stated above, if this neglect had continued, it would inevitably have had an adverse impact on effective expenditure management. The intent here is not to provide a user's manual on contracting, but to delineate the points relevant to expenditure management and to consider the issues that need to be addressed. Accordingly, procurement and contracting out are considered first and the concluding section discusses the issues.

PROCUREMENT CYCLE

The underlying principles and the various stages of the procurement cycle are illustrated in Table 13. Any procurement, regardless of the amounts of money and the quantity of goods, should not only be seen to be equitable and open but also be so in practice. It should provide a fair opportunity to all bidders, through an open and recognized channel of media. (The role of foreign bidders and the preference given to domestic bidders, which may sometimes be considered a negation of this principle, are considered below.) It should also have established procedures, and any changes in the rules of the game should be conveyed to all the participants. The manager in the government should, while paying due

regard to these principles, aim to secure the desired quality at the lowest cost.

A first step in the procurement cycle (which has a counterpart also in contracting out) is to identify the vendors to be given an opportunity to bid for supplies. The intent is not merely to be scrupulously legal and to avoid vendors with criminal backgrounds, but this identification is frequently used as an instrument of economic policy. In some countries, the procurement of medicines is a state monopoly. In some cases, foreign bidders or their local agents are not allowed to bid, to provide stimulus to local producers. The policy in several countries is to allow a premium for the local bidder compared with the foreign bidder. In either event, it is important that the requirements and prohibitions are stated at the outset, and that they in turn comply with the law.³ The same considerations apply to the goods and services to be procured.

The pursuit of economy and other considerations requires an adequate basis for assessing the prices to be offered later by the bidders. Without market research, the government would be at the receiving end of price information. If the contractors were aware of the knowledge and information available to the government, they would be more careful in submitting their bids. The price information should be reviewed regularly and compared periodically against similar operations. A distinction needs to be made between procurement for immediate needs and procurement for building up the inventories that will be used gradually. In the latter, prudence in terms of limiting supplies to the available budgetary resources has to be evaluated in the context of the medium-term price outlook for the goods to be procured. This involves looking into the future to determine whether more is to be gained by procuring immediately (even if that entails an additional strain on budgetary resources) or by deferring the procurement. The government should also have the facility to terminate the procurement plans, if progress is less than expected. Then, however, the availability of unspent funds has to be noted and their appropriate use determined.

Procurement should be viewed, as was its original intent, as a means to an end. Thus, costs should be minimal. (The various costs associated with procurement are illustrated in Table 14.) Where procurement is envisaged for adding to inventories, the holding costs and their impact on the current and future budgets and the running costs profile of the program should be assessed.

³Nader (1988) suggests that governments should use their purchasing strengths in a creative endeavor to promote practical but little-used innovations and to advance goals already recognized such as safety and energy conservation. He adds, "government contracts are often so large that the prospect of winning one convinces a company to make a product it wouldn't otherwise be willing to make" (p. 82).

Table 13. Procurement Cycle: Objectives and Stages

Objectives	Features
General	
Equity	To provide fair opportunity to all bidders
Integrity	To minimize chances of corruption and patronage
Economy and efficiency	To procure goods and services of the quality desired at lowest cost
Authorization	
Vendors should be authorized	To avoid making purchases from unauthorized vendors and other foreign vendors whose participation may be a violation of a country's import regulations
Goods and services needed should be authorized in accordance with regulations	To specify the range of goods and services needed and to indicate the quality as well as the price range, so as to avoid payment of unauthorized prices or procurement of goods and services that fail to meet quality expectations
Any adjustments to the above should be in accordance with law	To avoid payments that may prove to be incorrect because of change in specification
Procedures relating to procurement should be specified	Without such specification, ad hoc procedures may be followed; also provides a basis for identifying any circumvention
Economy, Efficiency, and Effectiveness	
Procurement plans should be formulated on the basis of needs and benchmark market surveys	To provide a basis for action and for subsequent evaluation; costs should be based on empirical findings
Economy and efficiency	To obtain goods and services at lowest cost; procurement costs should be periodically reviewed against estimates and comparable operations; accumulated inventories should be reviewed to avoid immobilization of funds; processing costs also need to be reviewed
Effectiveness	Fulfillment of procurement plans should be reviewed periodically so that activities that are not progressing well can be terminated
Transaction Processing	
Transactions that fulfill criteria specified only in the authorization stage should be processed	Processing is not an end in itself, but a means; while ensuring compliance with rules and regulations, the needs of the user should be given due weight

Table 13 (concluded).

Objectives	Features
Tendering and related procedures should be economical and should generally be related to the needs cycle of the user	Costs of processing should not be such as to jeopardize the benefits of bulk buying and add to the overall cost
Only goods and services requested should be accepted	To avoid unordered, canceled, duplicated orders, excessive quantities, or those with unacceptable quality standards
Accounting, Paying, and Reporting	
Goods and services received should be accurately reported	To prevent corruption and facilitate inventory maintenance or use by the agency concerned
Payment liabilities should be recognized promptly	As delays could entail payment of interest and related penalties, payment arrangements should be made immediately
Liabilities incurred, payments made, and remaining liabilities should be applied to the accounts of the agency and the vendor	To facilitate the periodic ascertainment of the financial status of the goods and services received
All purchases and related accounts should be classified in accordance with the classification system in use in the budget and chart of accounts	Incorrect coding and misclassification create many problems in the evaluation of payment liabilities and actual use of the goods and services procured
Recorded accounts should be reconciled with the payments due as well as the quantity of goods received	To ensure congruence between the physical and financial aspects and between the claims of the vendors and counterclaims of the government
Physical Safeguards	
Both accounting records and goods received should have adequate security arrangements	To prevent tampering of records and fraudulent use or theft of inventories

The other elements of the procurement cycle relate to the processing of transactions, accounting and payment, and the provision of adequate physical safeguards. The processing of transactions involves other elements, in particular those with an expertise in law. The concern of the expenditure manager is with the costs of the materials, the timing of their supply, their warehousing, and their extended use through the life cycle of a project or a program. The expenditure manager is also

Table 14. Cost Types

Category	Features
Procurement costs	Refer to unit purchase price plus first-destination transportation cost adjusted to the "price savings" given to a bulk buyer.
Shortage costs	Essentially refer to extra costs incurred in rapid or premium ordering undertaken to ameliorate a shortage.
Process costs	Refer to the costs associated with a purchase order from the initial stage of identification to contracting, supply of goods, and the settlement of the related accounts. In some cases, a distinction is made between ordering costs and process costs. The concept of ordering costs is somewhat narrower because it is applied to the stages from identification to the delivery of goods. Process costs include accounting stage operations.
Holding costs	Associated with the maintenance of inventories and therefore include warehousing costs and inventory-taking costs.

concerned with the additional levels of staffing that may be needed to oversee the project and to continue its operational aspects after completion. Although these are all legitimate concerns, they should be couched in legal format and language, so that if a conflict arises between the two parties, the dispute may be referred to a judicial or quasi-judicial process such as arbitration.

Preparation of a tender, which is generally viewed as a technical (as distinct from managerial) operation, is an essential but only a preliminary step in a usually long process. Bids have to be invited and reviewed, preliminary decisions taken, and those decisions taken at an individual or a committee level have to be processed through the layers of administrative machinery and ratified. Ratification within the government is partly dependent on the nature of the project and partly on the magnitude of the financial outlays involved. It is not uncommon for certain tenders to need the approval of the cabinet, and, in some cases, of the ruler or head of state. Thus, there may be a long time lag between the closure of the tenders and the announcement of the final decision on the tender accepted. These process costs, although usually neglected, are an important element that needs to be kept in mind, while recognizing that the process cannot be changed too extensively.

The accounting aspects reflect the proper housekeeping aspects of the administrative process that completes the procurement cycle. Goods and services have to be accounted for, and where there is provision for advance payments or progress payments, due regard needs to be paid to constructive delivery. Payment schedules have to be maintained and

periodically reconciled with the actual payments made by the banking system as well as with the physical receiving of goods. Since cash-based systems do not usually show the remaining liabilities to be honored by the authorities, they should be supplemented by accrual-based systems.⁴ Where specialized centralized purchasing agencies are available, the initial payments may be made by that agency through a "suspense" account before being finally charged to the budget of the agency for which the goods are intended. The accounts of these transactions should be comprehensive, appropriately classified, and maintained in a timely manner.

CONTRACT MANAGEMENT

Contracts for procurement as well as for provision of services have a number of common and yet distinct features throughout the cycle of operations. In contracts for procurement, the government is engaged in procuring supplies deemed essential for its efficient operation. It therefore presupposes that its needs cannot be met from its own agencies. While this principle is generally valid, there are also a number of exceptions, much depending on what is to be procured.⁵ Two important preliminary policy matters need to be clarified before the "nuts and bolts" aspects of contract management are discussed.

The government as a procurement agency has to decide, first, whether it wants to procure from a spot market or through a long-term contract. Some items are needed by the government regardless of what it is doing, for example, food supplies for its defense personnel and petroleum and related products for its fleet of vehicles. If it chooses the spot market, that is, the prevailing prices at the time of the bid or purchase, it is more than likely that the buyer will lose out if the price is lowered later. Conversely, if it is a long-term contract with locked-in prices at the time of the contract (and with no provision for compensation if the price increases or the exchange rate depreciates), the government may benefit if the prices rise later. A spot market approach provides a degree of flexibility to the buyer on the assumption that he is aware of the risks, whereas a long-term contract, being binding, makes the buyer a hostage

⁴Most of these aspects are routinely specified in the manuals of the agencies whose primary activities depend on procurement. Public works, defense procurement, and health and education administration are generally the most dependent on procurement of supplies.

⁵Some agencies in the government are specifically created to meet the needs of other agencies. In other words, they are created to cater to internal markets, as, for example, printing.

of his contractor. In both events, there are risks with the attendant implications for gains and losses. Here it is not merely the intuitive skills of the expenditure manager but the validity of the forecasting methodology that has a profound and enduring impact on the final choices.

The choice of what and how much to buy (in particular the latter) is dependent, in addition to the estimated needs of the government, on the choice it makes to utilize the procurement instrument to provide economic stimulus as well as to stabilize the economy. Completed industrial goods or structural fabrications are two areas frequently utilized to provide stimulus to specified sectors of the economy. Procurement of food (grain, rice, wheat, or cereals) is influenced by whether the prices are intended to provide a floor or a ceiling, respectively, to protect the producer and the consumer. These are economic policy choices rather than technical procurement choices and therefore may be determined by a wide variety of government bodies rather than by expenditure managers. Once decided, however, they provide the relevant guideposts for the technical operations.

The choices in regard to contracting out are far more varied and are formidably complex. First, a decision has to be made on what is to be contracted out. The choice is by no means limited to contracting out the services provided by the government. In some cases, a determination may be made to contract tasks and responsibilities that have traditionally been considered essential ingredients of government armor. History offers numerous examples of tax farming, under which contractors collected taxes on a commission basis in ancient Greece and Rome.⁶ The government may not have the facility to provide the services required, or the services may involve a technical skill not available in the government. On the other hand, the operation may only be able to be carried out by the government at a high cost and would therefore be inefficient. Or it may be a service where the immediate costs to the government are less but the long-term implications of hiring regular employees and paying their pensions prove more expensive than if they were provided by outsiders. It has also to be determined whether the contract is to be issued on a regular basis or on the basis of one-time help.⁷ In some cases, the services may be parceled out to other levels of

⁶Brewer (1989) gives numerous examples of this experience. See also Donahue (1989). In India, the permanent revenue settlement system introduced in 1776 contributed to a kind of tax franchise and a new social class. The people who obtained the initial franchise later perpetuated the system, which, while insulating the Government from the vagaries and vexations of tax collection, also led to exploitation by the new class.

⁷Rehfuss (1989) provides a series of choices to be determined as part of the process of contracting out.

government, such as local bodies that may be entrusted with the task on an agency basis, or to nonprofit organizations. Although the decision on what to contract out is influenced by the philosophical or political approaches of the government, financial considerations will also weigh heavily. Politically influenced decisions in this sphere cannot be sustained for long if the costs are high, the impact is adverse, and the whole operation is in the public eye.

At a technical level, the pre-tender activity, which is common to procurement and to contracting out, a determination of the relationship to organizational goals, the timing of the supply, and most important, the financial implications of the proposed tender have to be made. Later, the type of bids to be offered has to be determined—whether on a competitive or a noncompetitive basis. Contracts are not always offered on a competitive basis, and much depends on what is contracted out. In a major sector like defense, there may be no competitive bids and the supplier may be chosen for other practical reasons. Although competitive tendering has increased,⁸ the choice is determined by the competence of the supplier and the goods to be procured. (More detailed aspects of competitive and noncompetitive bids and associated matters are illustrated in Table 15.)

From an expenditure management point of view, the major element of a contract for both types of bids is the price at which delivery is assumed. Broadly, the contract may be a fixed-price contract, or a cost plus fixed-fee contract, or one between the two, in the form of an incentive contract. For budgetary stability, in intent and outcome, the fixed-price contract has much to commend itself. To be successful, however, the quality of goods and services must be specified so that no undue gains are made by the contractor at the expense of quality. The cost plus contract, however, is likely to prove hazardous in that the final outcome will not be controllable. While an attempt is made to prevent this by imposing a budgetary ceiling with flexibility for the government to terminate the contract, if appropriate, it is also likely to lead to a substantial gap between financial and physical aspects. An acceptable middle ground between the two approaches is an incentive contract, which aims at a negotiated settlement of any savings that may accrue. This represents another application of the principal-agent relationship discussed in Chapter 4.

⁸In the United States, according to the information published by the Office of Management and Budget, the percentage of government-wide procurement dollars awarded competitively increased from 41 percent in 1981 to 58 percent in 1987. See United States, Executive Office of the President (1989). Although comparative data are not available, there seems to have been, in general, a growth in competitive bidding.

The contract oriented to a management fee is applicable to contracting out services. Its advantages are few, as the entire cost of operation is borne by the government. Assured of his fee, the contractor has little incentive to economize, except for a yearning for recognition and goodwill (which can often be substantial). In fact, cases of asset stripping are not unknown in contracts of this type. Yet another type of contracting is determination of the unit prices on the basis of which contracts may be awarded. Since the unit price includes a rate of return, and as the volume is usually large, it has some strength in attracting bids. But a unit price has to be periodically updated and should include any weight that may be given to competitive strengths. In some cases, even a lower unit price may have advantages in that it induces the contractor to resort to innovations that would have the effect of reducing costs. In some cases, the contractor selected may even buy out his competitors and turn the initial low unit cost into a sizable bargaining strength later.

The major problem area, from an expenditure management point of view, comes during contract implementation. It is not merely a case of arranging orderly cash payments against the receipt of goods as specified in the tender. Three aspects need to be reviewed frequently. First, a contract may have to be interrupted for scarcity of funds or for poor performance. Although the effect of both these types of contracts first appears broadly comparable, the major difference is that, if a service is contracted out, it stands to affect the clientele adversely. This impact may have a greater fallout depending on the nature of the service rendered and the associated political implications. If the service is considered vital, alternative arrangements may have to be made. In the case of procurement, the main party affected is the government itself. In deciding to interrupt a contract, there is an implicit recognition that the broader economic gains through the reduction in aggregate public expenditures are more than the costs associated with the interruption. In either event, however, initial alternative arrangements should include contingency contracts, division of the contract among other bidders, or agency sharing within the government. In the provision of a service—and if the funding problem is expected to be more persistent—the alternative of reducing the level of service, or introducing or revising a user charge, or eliminating the service from the purview of the government (if alternative sources of supply are available) would also have to be considered. Exploring alternatives is as important as pursuing a specified course of action.

Second, experience indicates that the completed cost of a project differs from the original estimate primarily because of midway changes in design. This is also true in contracted-out services as the criteria of eligibility may be revised or the quality of the services upgraded. In both cases, the result is increased contractual costs. While some design

Table 15. Contract Management

Category (1)	Contracting for Goods and Services Needed for Use by Government (2)	Contracting Out for Services to Community but Funded by Government (3)
Pre-tender activity	Organizational responsibility; nature of goods and services needed and their relationship to policy goals; timing of supply; estimated cost of needed goods and services; arrangement for securing budget funding; conditions of tender.	Features enumerated in column (2) have equal application except that they concern the services that are being contracted out to be provided to citizens. In both cases, it is essential to have market testing to ascertain the competitive edge and the likely cost, and the continuity in budget funding is vital.
Tendering Process Competitive Invitation to bid	Open invitation with a specification of terms and provisions, quantity and quality of goods needed, bidder qualifications, provision of performance bonds, specification of payment procedures, reporting responsibilities, guarantees, penalties, etc.	As in column (2), with the continued exception that they concern the specification of the quantity and quality of services provided to citizens.
Tendering Process Noncompetitive Requests for bids	Refers to negotiated bids under which both parties (government and supplier) discuss and agree on the terms, provisions, and cost elements of the contract.	As in column (2)
Proprietary items— single tender	Where the supply involves patented items that are provided by a single supplier. Price is usually determined by the supplier because of his monopoly.	Not applicable
Preferential procurement	In some countries, preference is given to public enterprises or domestic suppliers (even where the procedure of competitive bidding is in force).	Applicable when the provision of a service is provided by another level of government or a non-profit organization at the behest of the sponsoring government.

Contract Types

Fixed-price contract

Specifies the price at which an item is delivered. Facilitates accurate budgeting and may prove particularly attractive to contractors with flexibility to manage their costs. Conversely, it will be expensive to the government as no economies accrue to it other than those that have already been built into the initial price through being a bulk buyer. Care would be needed to ensure that the contractor is not economizing at the expense of specified quality.

As in column (2)

Cost plus fixed-fee contract

After establishing an initial cost level, a fixed fee is added, usually as a percentage of cost. This provides no incentive for the supplier to economize, and could be a perverse incentive in that the contractor has everything to gain from increased costs; adds uncertainty to the budget outcome and in a worst case scenario of a budgetary ceiling, expenditure estimates would be met while physical targets would be far behind schedule.

As in column (2)

Incentive contract

Primarily applicable to negotiated bids (see above). Involves negotiating a target cost (considered appropriate to perform the task) and a target profit, which together make up the target price. A sharing formula is agreed to divide the savings between the government and the supplier. Applicable in areas like defense research or arms design, which are solely government sponsored. Much depends on the contractor's accounting integrity.

In general, as in column (2) and has greater applicability where the service is provided by another level of government or by a nonprofit organization (but funded by a higher level of government).

Management fee

While bearing the entire cost of a service, a management fee is paid to the contractor. Assured of fee, the contractor has little incentive to economize. Although this appears to facilitate budgeting, in practice it is problematic.

Table 15 (concluded).

Category (1)	Contracting for Goods and Services Needed for Use by Government (2)	Contracting Out for Services to Community but Funded by Government (3)
Unit pricing	A basic ingredient of contracts. Has the potential of contributing to cost savings. An essential condition precedent is that the government itself should have adequate data on prices and own competitive strength.	As in column (2)
Contract implementation	<p>(I) Emergency provisions for contract interruptions. Usually resolved through (a) contingency contracts (to others for supplying the same goods); (b) partial contracting (dividing the contract among competitors); and (c) agency sharing (where work may be divided with other government agencies).</p> <p>(II) Changing designs of works needed. Available experience shows that governments change their designs, in turn contributing to higher costs. Such design changes are rarely motivated by a desire to procure economies.</p> <p>(III) Low-balling approaches: In general, contractors show low-cost estimates initially. With time they tend to escalate exponentially and therefore need to be reviewed with care.</p>	<p>As in column (2)</p> <p>When funding uncertainties arise, governments may have to reckon with the possibility of reduced level of services to be in conformity with reduced level of resources.</p> <p>As in column (2)</p>

changes are inevitable, if they are too large and too frequent, the payment burdens also inevitably increase. In turn these changes contribute to the notion that contracting procedures are lax and controls weak, and the contractor is depicted as a predatory character raiding the precious and depleting balances of a public treasury. Both notions, even if somewhat overdrawn and simplified for the purpose, reflect a reality that cannot be brushed aside.

Third, experience also indicates that contractors use "low-balling," the submission of low estimates to win award of the contract. Once the contract is awarded, however, the government may become a captive that is cleverly manipulated through the creative accounting practices of the contractor.⁹ This aspect, which is closely connected with the availability of proper cost data, needs to be carefully reviewed. Success depends partly on knowledge of the costs, partly on the competition in the area, and partly on the flexibility of government regulations that permits the choice of a bid other than the lowest on the basis of superior quality.

Implementation also requires a reasonable monitoring system as illustrated in Table 15.

ISSUES

Regulations covering the above areas exist (and have long existed) in most governments. But if the availability of regulations was the only criterion, there would be few problems for a contract administrator or an expenditure manager. It is like the argument that if there was perfect competition, there would be hardly a need for a regulatory framework or for regulators. What then are the problems that arise in implementation? Why is there the perception that the government is not getting any advantages despite being the biggest buyer, or, in technical terms, why are the advantages of the relative price effect not discernible? The answers to these questions do not come solely from the expenditure management side but cover a wide variety of fields. As, however, the main conduit for contract management is the expenditure process, it is appropriate for the issues, insofar as they are judged to be within the broad area of expenditure management, to be considered here.

The first issue is the determination of the areas to be utilized for procurement and for contracting out. Procurement may seem straightforward because the government will be inclined to procure those items that it needs and that it cannot produce internally except at a high cost. In such cases, it is assumed that the requirements will be put to the test of competition and that prices as determined by the market will be paid

⁹The problem of contract rigging also exists, but, for these purposes is viewed as a violation of the law (and therefore more of a legal problem) and is not considered here.

by the recipient. If competitive forces were the main determinants of prices, the government should not, in principle, be adversely affected. In practice, however, although competitive forces do determine prices (particularly for those types of goods and services that are also needed in the nongovernment sector), there are problems associated with areas such as pure public goods where the government alone is the consumer. Specifically in regard to defense, the government is the only buyer (on the somewhat weak assumption that there is no leakage into the market) and price may not be the overriding factor. In such cases, as Fox (1988) pointed out, "product and quality are determined, not by the management of the firm, but by governmental authority, and competition normally focuses on proposed design rather than physical product, and on promises of performance rather than the performance itself. The supplier often holds a monopoly and the purchaser holds a monopsony (i.e., one buyer only)" (p. 17). An inevitable result of such a mutual dependence is cost overruns with other manifestations like schedule slippages and performance shortfalls, not to mention "widespread fraud, waste and abuse."¹⁰ These aspects have been studied several times by commissions and other bodies. One such commission—the Packard Commission in the United States (in 1986)—suggested that law and regulation "should provide for substantially increased use of commercial-style competition, relying on inherent market forces instead of governmental intervention. To be truly effective, such competition should emphasize quality and established performance . . ." ¹¹ While the intent is unexceptional, the problem, as Math (1989) noted, is that the set of proposals for reform "never seems to bring about any real change. The same problems are cited, the same solutions are proposed, the same frustrations recur" (p. 4). The same problems continue in situations where only part of the issue is considered and solutions are proposed without explicit action on the linked areas. This suggests that the issue needs to be tackled in terms of the techniques of budget formulation and presentation, expenditure and contract processes, and other areas enumerated below.

As for contracting out, the scholarly literature offers only limited guidance on the direction in which further contracting out should go. Comparative studies by Ascher (1987) and Donahue (1989) for the United Kingdom and the United States, respectively, suggest that contracting out does not necessarily assure cost economies for the government. Several qualifications should be made. For one, the experience, at the time the studies were undertaken, was rather limited in terms of the time and the level of government. The periods covered were rather

¹⁰Math (1989).

¹¹United States, Executive Office of the President (1989), p. 89.

short, and most of them focused on the delivery of services at the local level, and in narrow areas. On the other hand, the movement to contract out that ushered in the mid-eighties represented a major break from previous practice and transmitted the idea that not every service funded by government also has to be provided by it. The most significant aspect is the desire to promote competition and to eliminate regulations and practices that hinder the promotion of competition.¹² It is equally significant that government departments were encouraged to bid along with outsiders, and managers were required to account for decisions to retain work in-house. This process of market testing has the inherent merit of offering a vast cost-saving potential. As an extension, the development of internal markets should also be considered a spillover benefit. Traditionally, services provided within the government rarely received such attention as they were paid out of a central budget. But the identification of full costs and services within the government offers hope that knowledge of these costs will contribute to more informed judgment.

No system by itself offers a viable and durable solution for all problems experienced. The considerations, for both procurement and contracting out, have to be more pragmatic than ideological, sector-oriented rather than applicable to the wide spectrum of government activities, and subject to periodic review as any system that becomes routinized tends to lose those virtues that first contributed to its introduction.

The second aspect relates to the approaches to budget formulation and as an extension thereof to budget presentation. Governments buy goods and services from outside as well as from inside. In both cases, the interest of the government as a "buyer" (and not as an "owner") is to pay a reasonable price for a stated quality. But in paying a "book" price, without any competition or contestability in the market, the government is forgoing some beneficial opportunities. If it is not able as an owner to achieve a rate of return for comparative effort in the open market, public production is lowering the wealth of the country. In such cases, despite the emphasis on the value-for-money approaches, the government would gain little. This, however, can be resolved if the government is satisfied as a buyer that it is paying the same price that it would have paid if it had acquired the goods from an alternative source. A degree of contestability either with domestic or with foreign sources is required. Such arrangements are possible in almost all government operations, including defense and related ordnance purchases. But the feasibility of such an approach in the government has been thwarted less by a lack of

¹²For example, in the United Kingdom, when it was recognized that the imposition of a value-added tax was adversely affecting the competition prospects of contractors, arrangements were made to refund it. See United Kingdom (1991b), p. 5.

inclination and more by the institutional or systemic bottlenecks. The first major impediment is the absence of an accrual-based full-cost disclosure system providing for adequate transparency of in-house costs. The routine application of cash-based accounting, as noted in Chapter 7, has contributed to an unintended neglect of debt obligations. In addition, it appears to have contributed to a neglect of the full costs and their recovery. The availability of accrual accounting, by itself, does not lead to full cost recovery, but it would facilitate a heightened awareness of the cost implications.

The format of budget presentation as practiced in several countries does not permit an informed assessment of the government as a buyer of goods and services. To overcome this difficulty, the Government of New Zealand has introduced some changes in the form of presentation of appropriation requests. The change in the presentation of the budget format, which is an integral part of a major overhaul of fiscal management, envisages classifying appropriations in terms of outputs, capital, and transfer payments.¹³ In the first category, goods and services bought are related to each category of outputs (or programs), which in turn distinguish between operating costs (purchases of goods and services) and capital expenditure. Capital appropriations deal with the purchase of assets that reflect an increase in the investment of the department, permitting a distinction to be made between the two roles of the government as a buyer and as an owner. But in the latter capacity, and with a view to building contestability, the budgets of the departments concerned are expected to report the full cost, including depreciation.¹⁴ To enable the computation of costs, the framework of public sector accounting includes a variety of statements including a statement of the cost of services.¹⁵ The third type of appropriation refers to departments acting as agents for money transfers either for benefits to individuals or grants to other levels of government. These efforts to provide transparency should, when completed, go a long way toward changing the approaches utilized by governments to determine its purchases.

A third major issue relates to the process in the government for dealing with bids and contracts. This process, on the admission of governments, is fragmented, reactive, rigid, and is excessively reliant on statute

¹³For a more detailed description of this wide-ranging reform, see Ball (1990a and b), Scott, Bushnell, and Sallee (1990), and New Zealand (1989) and (1990).

¹⁴A further distinction is made between the gross and the net basis, and departments earning revenue are shown, following the general conventions, on a net basis. These changes were to be effective from July 1991.

¹⁵Miah (1991). The other statements include statement of objectives, statement of service performance, statement of accounting policies, statement of cash flows, statement of resources, and statement of financial position.

and regulation.¹⁶ An exhortation to be flexible is not equivalent to an invitation to violate the regulations, but should be considered an essential opportunity to assess the continuing relevance of those regulations. An examination of the practices of several countries reveals the insistence on accepting the lowest bids. Such practices, while contributing to immediate economies, indicate a hidden cost that may be more enduring than the economies. The story goes that when John Glenn was asked, on returning from the first manned space flight, what was the biggest danger in space travel, his response was that it was being hundreds of miles above the earth in a ship made up of 50,000 component parts, each purchased from the lowest bidder.¹⁷

Investigations by the Commission chaired by Grace (1984) and the study by Kelman (1990) into the acquisition of computers by the U.S. Government reveal the impact of fear of discretion on the quality of government performance. These studies conclude that by accepting the lowest bid, the government became technologically obsolete; Kelman suggests that the system should be significantly deregulated to allow public officials greater discretion. Although these findings were made primarily in the context of the United States, they appear to have wider applicability. Procurement and related contract management are areas where the government's actions may have become slightly counterproductive. As de Tocqueville remarked, a little more than one and a half centuries ago, "every central government worships uniformity: Uniformity relieves it from enquiry into an infinity of details, which must be attended to if rules have to be adapted to different men, instead of indiscriminately subjecting all men to the same rule." When such uniformity and zeal for overregulation yield wrong results, they suggest an urgent need for review and for efforts devoted to simplification, codification, and the introduction of flexible management. Managers cannot function in a straitjacket. But alternative arrangements for accountability should provide basic safeguards and an adequate basis for imparting some flexibility to the system. Controls should not be reactive but proactive in that compliance reviews are needed that anticipate the problems rather than deal with them as and when they arise.

An associated aspect relates to the need for professionalism in procurement management. Several writers suggest that if a professional cadre is entrusted with procurement, there would be fewer problems. This issue is somewhat peripheral to expenditure management. The preceding discussion should not be construed as a plea for widening the

¹⁶See, for example, United States, Executive Office of the President (1988) and Math (1989).

¹⁷Cited in Ascher (1987), p. 261.

scope of an expenditure manager. Rather, it is to show the points in the administrative process that converge with the concerns of the expenditure manager. The establishment of a separate professional cadre would complement the tasks of those engaged in expenditure management.

Within the narrow realm of expenditure management as it relates to the payment process also, there are problems. They relate to the advance payments to contractors and delays in payments to them. In some countries, advance payments are made to contractors to facilitate their work. In some, the intent is to promote the small-scale contractor who may have difficulty in obtaining credit from the banking system as he may not have any assets for hypothecation purposes. What makes the provision of advance payment problematic is the amount of the advance and the lag between provision and actual utilization by the contractor. In some countries (such as the Philippines), 15 percent of the contract is advanced soon after it is concluded and is adjusted against payments due after the first year. This feature is primarily applicable to public works. Elsewhere (as in Australia),¹⁸ sizable advance payments are routinely made to contractors much before they are due. In addition to being a less acknowledged subsidy to the contractor, it also contributes to higher interest costs as a whole for the government. The other side of the picture is that enormous delays occur in the payments to them.¹⁹ This is observed particularly in countries that limit credit to government, either on their own or as part of a stabilization program funded by international financial institutions. Where payments are delayed, interest is paid to the vendor. The stoppage or deferral of payment, except when a completed contract is being adjudicated, could only add to the cost rather than alter the underlying stance of expenditures. In some countries, however, the payment systems are sophisticated and provide for direct electronic transfers, when payments are due, to the credit of contractors who are obliged to maintain accounts with the banks through which government transactions are made. It is therefore appropriate to review in every case the extent to which payments systems are either inhibiting or facilitating a government's relations with its suppliers.

Fourth, the most common allegation about contract management is what is perceived to be the corruption with which it is associated. It seems to be a situation that recalls George Bernard Shaw's definition of marriage: "It combines the maximum of temptation with the maximum of opportunity." Although corruption has been in existence from ancient

¹⁸See the case study of Australia in Premchand (1990).

¹⁹In some countries of the Sahel and sub-Saharan regions, vendors have consequently demanded and obtained full payment before supplies are made.

times and has become an integral part of the rituals of society,²⁰ three types of corruption may be distinguished in expenditure management.

The first is defalcation or misuse of public moneys for personal purposes. From any point of view, it is illegal and therefore punishable under a country's penal code. There is also an insidious aspect to such use of public moneys, which is generally less visible and has therefore become intractable. It concerns the use of public assets and properties for personal use. The general dictum that public moneys should be used in the same manner as personal moneys has in some cases been taken literally rather than metaphorically, as was the intent. In ancient times it reflected the notion that the civil servant represented the state in all its aspects and little distinction was made between personal status and the status derived from being a servant of the crown. But it amounts to a misuse of power and state property. Because a full inventory of government assets is lacking and because the perquisites attached to an office are not specified, this misuse goes unpunished.

A second form of corruption is payment for services provided by a civil servant of an agency. Although the official is expected to provide the service as part of his duties, he uses his leverage (the scarcity value of the service provided) to extract a rent from the client. This practice is particularly applicable in the areas that constitute the "cutting edge" of government operations at all levels, but this phenomenon is not directly associated with expenditure management.

A third form of corruption relates to the payments made to officials for changing a policy, a law, or an interpretation of law in favor of an individual or group of individuals, where changes are made not because of any inherent need but to serve the needs of specified individuals.²¹ Although this form of corruption may be far more extensive than is normally believed, it is not directly within the purview of expenditure management and belongs more to the realm of ethics to be followed by governments in all phases of their work. Although expenditure management, as one of the segmented if important processes of government, is concerned with the proper use of public money, it cannot replace the law

²⁰See Macmullen (1988) for an interesting discussion of the practices of corruption in ancient Rome.

²¹Under the Indian Penal Code, a person is considered guilty of corruption who "being or expecting to be a public servant, accepts, or obtains, or agrees to accept, or attempts to obtain from any person, for himself or for any other person, any gratification whatsoever, other than legal remuneration, as a motive or reward for doing or forbearing to do any official act or for showing or forbearing to show, in the exercise of his official functions, favour or disfavour to any person or for rendering or attempting to render any service or disservice to any person." Quoted in Goode (1984), pp. 310–11.

of the country and by itself cannot aim at eliminating all forms of corruption. In the long process of the procurement cycle and contract management there are numerous points where the supplier may provide kickbacks and the official may accept them. To that extent, the field of contract management becomes an area of "shared interest." The damage of such shared interest can be minimized only through strong internal controls, transparent decision making, and a code of ethical conduct governing both contractors and governments.