‘Sweet deals’: State-owned enterprises, corruption and repeated contracts in public procurement

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A B S T R A C T

We show how a price analysis of stable relations between customer and supplier in the public procurement of homogeneous goods can help differentiate opportunistic from honest behaviour among economic agents. We consider two types of stable relations: repeated procurements and connections based on the state ownership of suppliers. On the basis of a large dataset on the procurement of granulated sugar in Russia from 2011 to 2013, we find that for private suppliers, prices of repeated contracts were lower compared to one-time deals when procured through more transparent procedures and higher when procured through non-transparent procedures. For non-transparent procedures, we observe significant overpricing of contracts with state-owned suppliers compared to private suppliers, especially in the case of repeated contracts, whereas for competitive e-auctions, there is only a small difference between the contract prices of state-owned suppliers and private suppliers.

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1. Introduction

The identification of corruption in public procurement is a difficult task. The seemingly simple job of comparing the prices of similar goods in public procurement with the free market and revealing overpriced procurement contracts often does not work. Previous studies on relational contracts demonstrated that customers should consider not only the contract price but also the transaction costs and risks of suppliers’ non-compliance. From this point of view, the higher prices offered by suppliers with a good reputation can be optimal for public customers (Gulati, 1995; Parker and Hartley, 2003; Calzolari and Spagnolo, 2009). However, the relevant studies focused primarily on cases involving the procurement of complex goods. In these cases, any uncertainty in the quality of the delivered goods can provide an opportunity for price manipulation.

Nevertheless, a price analysis of simple homogeneous goods provides us with some opportunity to identify corrupt behaviour by comparing the prices of repeated contracts with the prices of one-time deals. The extensive literature on relational contracts provides evidence that stable relations between the customer and the supplier can produce both positive and negative effects. Such relations may lead to a reduction of the transaction costs and risks associated with the non-execution of contract obligations, but they may also create potential for corrupt behaviour between the customer and the supplier (Held, 2011; Lambsdorff, 2007). Repeated contracts decrease uncertainty and, for homogeneous goods, may lead to a
price reduction compared to one-time deals in the case of honest behaviour between customer and supplier. In this case, the economic agents prefer a competitive and transparent procurement procedure due to the stability of some procurement inspections. In the case of dishonest behaviour on the part of the customer and the supplier, repeated contracts are overpriced compared to one-time deals. Accordingly, the economic agents prefer a non-transparent procurement procedure that can be easily manipulated and difficult to inspect.

By dishonest relations between customer and supplier we understand such relations where an “abuse of public office for private gains” exists (World Bank, 1997), which is a particular case of opportunistic behaviour (Williamson, 1993). We suppose that both honest and dishonest behaviours are rational, but they have different purposes. Honest agents (both customer and supplier) have long-term purposes from repeated relations in mind. Suppliers enhance their long-term revenue and work for the reputation from such honest behaviour. Customer officers may have a long-term position or promotion in the office in mind, so they have to show effectiveness in their current activity and effectiveness of procurement activity in particular. Such honest behaviour of agents is also supported by a punishment system. Nevertheless, dishonest behaviour is also rational for suppliers and customers when both of them aim at short-term revenue and there is a weak punishment system.

Our attention was drawn to the problem of corruption in repeated contracts of homogeneous goods by an open corruption scandal in Russia resulting in the arrest of Colonel General Alexander Reimer, the former deputy Minister of Justice and director of the Russian Federal Penitentiary Service (FPS), in April 2015 (see http://tass.ru/en/russia/786150). Reimer was charged with fraud that occurred during public procurements conducted by the FPS and involved in the theft of approximately $50 million. Answering questions about Reimer’s arrest, Kremlin spokesman Dmitry Peskov referred to President Vladimir Putin’s statement that “anti-corruption activities are carried out and should be further conducted regardless of posts or cabinets.” (http://tass.ru/en/russia/787070). This corruption scandal began with a less visible investigation of fraud in public procurements for prisons (see http://rapsinews.com/news/20130307/266649776.html). The idea behind the fraudulent scheme was that the state-owned firm Selinvest, which is directly subordinate to and a regular supplier of sugar for the FPS, systematically overpriced public contracts. The total amount of theft was estimated to be $3.2 million. Moreover, Selinvest only supplied sugar through a single-source procurement procedure, which is non-competitive and non-transparent.

This example also shows that the effects of repeated contracts and state-owned suppliers may be complementary. Our research interest in this case was constituted by a combination of these factors: repeated procurement from the same supplier and the participation of a state-owned enterprise in supplying public needs. In this paper, we analyse the impact of the combination of these factors on the standardised final price of a simple homogeneous good acquired through various procurement procedures. We focus on the public procurement of sugar throughout Russia from 2011 to 2013. Following the logic of a previous publication (Yakovlev et al., 2016), we assume that the positive effects of repeated procurements (lower transaction costs and associated price reductions) are most likely observed when procurements are performed through more competitive procedures. Less competitive and less transparent procurement procedures provide opportunities for collusion between the supplier and the customer and lead to relative overpricing in repeated procurements. The connection between customer and supplier through the ownership structure provides an additional channel for stable relations. If honest behaviour prevails for both public customers and state-owned suppliers, then both parties are prepared to conclude contracts at lower prices. In the case of corruption, the participation of state-owned enterprises in public procurements results in overpricing. The state-owned status of suppliers may enhance the effects of repeated procurements.

Empirical analysis has demonstrated that, for private suppliers, the sugar prices were lower in repeated contracts compared to one-time deals when procured through valid e-auctions (the most transparent procedure). Prices of repeated contracts compared to one-time deals were higher when the procurement procedure was request for quotation (a less transparent procedure). These conclusions are consistent with the findings of our previous paper on the gasoline market (Yakovlev et al., 2016). For non-transparent procedures (request for price quotations and single-source contracting), we observe significant overpricing of contracts with state-owned suppliers compared to private suppliers. This effect is even more pronounced in the case of repeated contracts. At the same time, we observe only a small difference between contract prices of SOE suppliers and private suppliers when contracts are concluded through e-auctions.

This paper is organised as follows. Section 2 is devoted to a review of the literature on corruption and repeated contracts in public procurement. Section 3 describes the sugar market in Russia. In Section 4, general information on public procurement is presented and the database is described. Section 5 presents the research methodology and Section 6 discusses the results. The final section concludes the paper.

2. Literature review

Trustworthy relations between public customers and suppliers may be built on the basis of previous interactions and political connections, among other factors. On the one hand, any business interaction between public customers and suppliers involves an element of risk and entails transaction costs for both sides. Trust between these agents can therefore reduce these costs and risks in the case of honest behaviour. On the other hand, trustworthy relations may stimulate corrupt behaviour between public customers and suppliers because trust can lead to the overpricing of procured goods. The following literature review reveals these tensions.
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