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A political economy analysis of preferential public procurement policies

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Abstract

In this paper, we analyze the role of political forces in the formation of protectionist policy in the award of procurement contract. Firstly, we consider the optimal policy designed by a utilitarian government maximizing the expected sum of the consumers' surplus and of the domestic firm's rent. Then, we characterize the awarding rule that would be optimal for a shareholders' majority and for a nonshareholders' majority and we compare the welfare effects of each rule. We show that the preferential treatment of the domestic firm increases when the proportion of shareholders having the majority decreases and that the domestic firm may have a greater expected profit when the awarding rule is left to the discretion of politicians for some high values of procurement contracts for the consumers.

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1. Introduction

The existence of preferential public procurement policies is a well-known fact in many countries. Favoritism in the awarding of public contracts can result from an explicit “buy local policy” when the government offers a specified preference for domestic suppliers. One example is the US “Buy American Act”. Another is the price preference in natural monopolies sectors given by the EU directive 90/531. Favoritism can also be implicit

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when the government uses policies based on discriminatory product quality standards or restriction of information (such as inadequacies in publishing tender notices or response deadlines too short for foreign suppliers bid submission). Many empirical studies of government practices support the view that public procurement entities are more protected than private agents (for instance, see [Hoeckman and Mavroidis, 1997](#); [Trionfetti, 2000](#)). Although there is a general agreement that discriminatory policies should be eliminated, favoritism continues. Though the main objective of the Government Procurement Agreement, signed in Marrakesh on April 15, 1994, was to subject public procurement to international competition, numerous instances of noncompliance were notified during the first years of implementation.

Discrimination in favor of domestic agents is often explained by the power of interest groups. Instead of maximizing the welfare of all the citizens, governments are captured by domestic producers and choose awarding rules in favor of domestic firms. However, two arguments have been developed in the theoretical literature to justify such a practice by rational decisions of governments. Firstly, [McAfee and McMillan \(1989\)](#) showed that the government should discriminate in favor of domestic firms to stimulate competition and minimize expected procurement costs if there are cost advantages for foreign firms. Secondly, [Branco \(1994\)](#) and [Vagstad \(1995\)](#) showed that governments have incentives to discriminate against foreign suppliers if they prefer domestic to foreign profits. Considering simultaneously the *competitive stimulation effect* and the *protectionist effect*, [Naegelen and Mougeot \(1998\)](#) showed that the government should not always offer preferences to domestic firms even if the domestic firm's profit enters the government objective function positively. The optimal policy depends on the trade-off between comparative advantage, the social cost of public funds and the weight attached to domestic profit, and should vary from industry to industry according to competitive advantage. However, current preferential procurement policies are always in favor of domestic firms. In the absence of comparative advantage, this widespread practice can be explained by the *profit shifting argument* of [Brander and Spencer \(1981\)](#). This is proven by [Branco \(1994\)](#) and [Vagstad \(1995\)](#) under a symmetric distribution assumption. However, in an economy with comparative advantage or disadvantage, if domestic and foreign firms draw their cost parameters from different distributions, the normative approach developed in the auction theory framework may be insufficient to explain this practice. It is necessary to consider a *positive approach* and to analyze the role of political and social forces in the formation of protectionist policy in the award of procurement contracts. This is the aim of this paper.

If foreign suppliers are always discriminated against, it may be the case that the government is not benevolent. If the majority in power can appropriate the domestic firms' rents, the trade-off between the competitive stimulation effect associated with comparative advantage and the profit shifting effect resulting from systematic procurement preferences is modified. If public expense is financed by distortionary taxation, an increase of the procurement cost is supported by all the citizens, while an increase of the rent of the domestic firm winning the procurement auction is appropriated only by the agents in power. Thus, if we assume that the government takes only the interests of the majority that has selected it into account, a shareholders' majority will consider an objective equal to the sum of its consumers' net surplus and of the rent of domestic firms. For a nonshareholders'

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