

Methods of selection of external suppliers of local public services and the impact of the quality of selection procedure on the effectiveness and efficiency of local public service provision in the Czech Republic

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Abstract

The public procurement is very important instrument to guarantee effective use of a great part of public expenditures. Because of its importance in any developed country guarantees of a transparent and professional system of public procurement should exist. During last years the size of public procurement market in the CEE transition economies increased. As of today we estimate that public procurement in CEE represents more than 10 % of GDP (in the Czech Republic even 17 % of GDP). Because of decentralization a large proportion of public procurement is realized on the level of local governments, and not only for simple procurement of goods and services, but also to cover costs of delivery of local public services produced by external suppliers (contracted/outsourced services).

In the first part of the paper I will try to estimate by several methods the value of real public procurement market in the Czech Republic for 1995-2003 period. The main tool used is the system of national accounts, theory of institutional economy and the concept of transaction costs. We can show that calculated values are significantly different from official reports on public procurement; this means a large part of procurement is not realized by competitive methods.

The second part of the paper provides empirical data concerning the situation of local public service delivery in the Czech Republic. I will sort data according to the form of delivery. The analysis of the award strategies of municipalities will highlight main factors of decision making - namely the size of municipality, the character of service and the procurement legislation.

The third part of the paper focus on evaluation of the relation between the award method used and outcomes (costs of the service). I suppose that competitive award should lead to increased effectiveness (lower unit costs of the service delivery of given quality).

The last part will provide synthetical conclusions. It will highlight the fact that the public procurement legislation and principles are abused in many cases of external delivery of local public services, with negative impacts on effectiveness of the delivery. I provide also several suggestions, how to improve existing situation.

Key Words: Czech Republic; Effectiveness; Public Expenditure; Public Procurement. Transaction Costs

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I. Introduction

Public procurement is a very important instrument of the public sector how to increase effectiveness. On the municipal level this institute is used to contract the provision of some public services when the municipality decides not to produce them directly but to award them to an external contractor.

Transparent awarding methods are a condition for the utilisation of its benefits. But this is not still self-evident in transition economies due to the insufficiently developed institutional environment, which has negative impacts on the effectiveness of public sector and on general economic effectiveness, Ochrana (2001).

The objective of this article is to analyse the use of the institute of public procurement on the local level in the Czech Republic in the sector of public services. In the framework of this analysis the volume of funds expended for these purposes is estimated, and a detailed analysis of the relationship between the awarding method and cost effectiveness of a provided service is done. In the final chapter, based on the findings recommendations are formulated the implementation of which should increase the effectiveness of this institute.

II. Estimation of the size of public procurement market on the municipal level

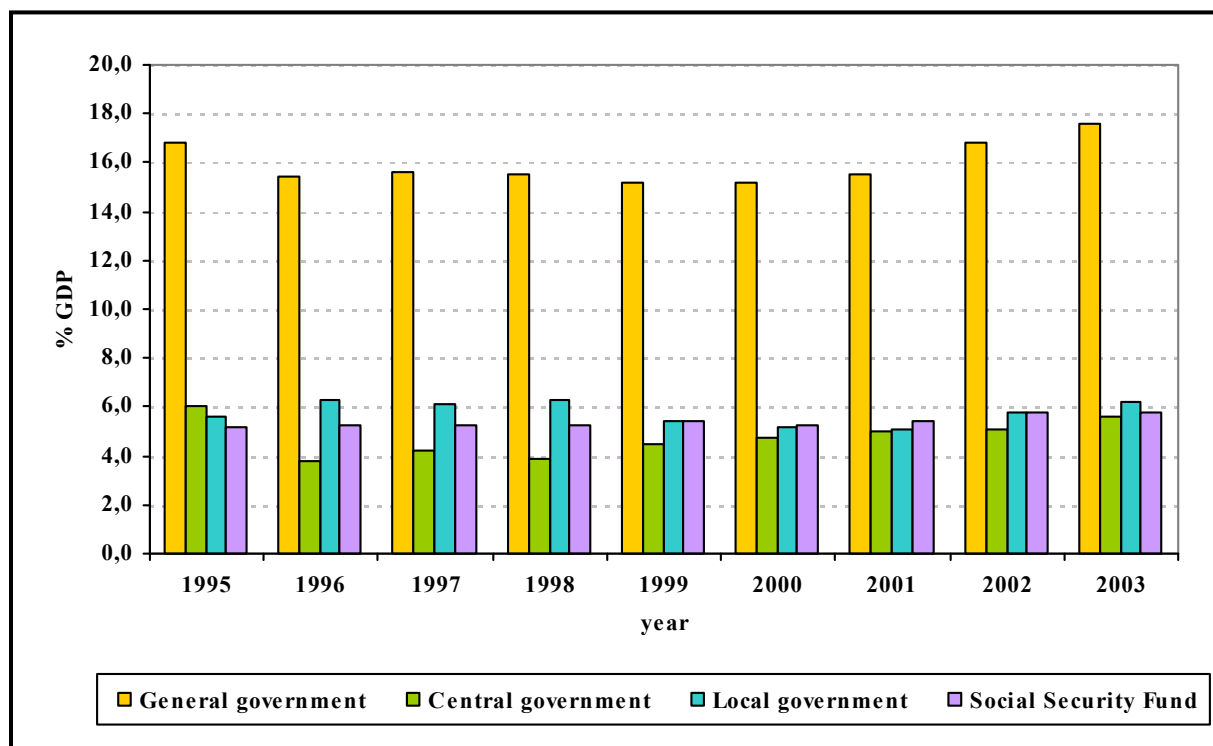
A great part of public expenditure is allocated through the institute of public procurement, and it is not simple to determine its volume exactly because of many methodological problems (Pavel 2005). Considering data availability the use of OECD (2001) methodology based on statistics of national accounts appears to be the most suitable. The results, i.e. the estimation of the size of public procurement market in the Czech Republic in 1995-2003, are shown in the following table and graph.

Table 1: The value of public procurement market in the Czech Republic in 1995 – 2003 as % of GDP

	1995	1996	1997	1998	1999	2000	2001	2002	2003
General government	16.8	15.4	15.6	15.5	15.2	15.2	15.5	16.8	17.6
Central government	6.0	3.8	4.2	3.9	4.5	4.7	5.0	5.1	5.6
Local government	5.6	6.3	6.1	6.3	5.4	5.2	5.1	5.8	6.2
Social Security Fund	5.2	5.3	5.3	5.3	5.4	5.3	5.4	5.8	5.8

Source: own calculations

Figure 1: The value of public procurement market in the Czech Republic in 1995 – 2003 as % of GDP



Source: Table 1

It is to state on the basis of my calculations that the volume of funds expended by the public sector on the purchase of goods and services from the private sector, expressed as % of GDP, did not change very much in 1995 – 2003. In the examined period a certain decrease can be identified when the value of public procurement market decreased from 16.8% GDP in 1995 to 15.2% GDP in the years 1999 and 2000. Then there was a change in the trend, and in 2002 and 2003 a substantial increase occurred when the resultant value rose up to 17.6% GDP. From the aspect of disaggregation between the particular government levels a decentralisation tendency slightly prevails in the CR when except 1995 more funds for the purchase of goods and services were expended on the level of local budgets than on the central level. It is also necessary to take into account that a part of funds expended on the central level (ca. 1.3% GDP according to OECD 2001) is spent in the army sector; many times these funds are allocated in a specific regime of restricted tenders. If the above-mentioned values were translated into 2003 absolute figures, it would show that the government spent almost 450 billion CZK on the purchase of goods and services: 143 billion were expended on the central level, 159 billion on the local level and almost 148 billion CZK on the level of Social Security Funds.²

In the Czech Republic a higher volume of public expenditure is allocated through the public procurement market than in the OECD countries (Pavel 2005a). But the transparency of this market, which may be expressed as the volume of this expenditure the awarding of which was published on the Internet or in another form, is problematic. Based on the analysis of data sources from 2001-2003, only about 33% of the calculated theoretical volume of public procurement market was evidently announced publicly. It is a very low figure, documenting that the problem of public procurement market transparency in the CR has not been paid attention enough (Pavel 2005a).

² According to OECD (2001) data the value of public procurement market in the Czech Republic is 17.03% GDP. The difference from the above-mentioned results stems from the fact that OECD calculated the value of public procurement market as an average of the values for a definite time period. Moreover, the values of fixed capital consumption and indirect taxes were not available to OECD, these values were estimated on the basis of average values in the other countries. Therefore the public procurement values in the particular subsectors are different from the OECD calculations.

III. Provision of public services on the local level

As stated above, municipalities may provide public services either as their own production or by means of external provision, i.e. through the institute of public procurement. The extent of external provision may be estimated from the calculated size of public procurement market on a municipal level. But we are facing a methodological problem because the expenditure for the purchase of goods was also included in this macroeconomically estimated market. Therefore a sampling survey carried out on a representative sample of municipalities seems to be a better variant.

An analysis of the provision of public services on the local level will be done on an example of four types of public services in the Czech Republic: road maintenance, municipal waste collection, maintenance and operation of public lighting and care of the appearance of a municipality, especially maintenance of public greenery. The data presented below were acquired by a pilot collection of data from 100 municipalities in the CR in 2005. In the framework of this data collection municipalities were inquired about the methods of providing the above-mentioned public services. The costs of their provision were taken over from ARIS database³ of Ministry of Finance of the CR, which contains data on the expenditure of local authorities categorised from the functional aspect. The sampling survey was carried out accentuating the size and regional diversification of the sample in order that its structure will correspond to the structure of municipalities in the CR from the aspect of their size. The municipalities of non-traditional character such as mountain or spa resorts were not included in the sample because large deviations from average values can be assumed in them.

Table 2 contains the results of research on the methods of providing public services of selected types. The first column shows the frequency of these methods, in the second column this data is adjusted to acquire data on the relative proportion of expenditure allocated in this way. Such an adjustment is necessary to prevent data distortion by virtue of the municipality size. The data indicate what volume of national expenditure for the provision of these services passes through the particular types of operators. The capital of Prague was not considered in this analysis because it is highly specific from these aspects.

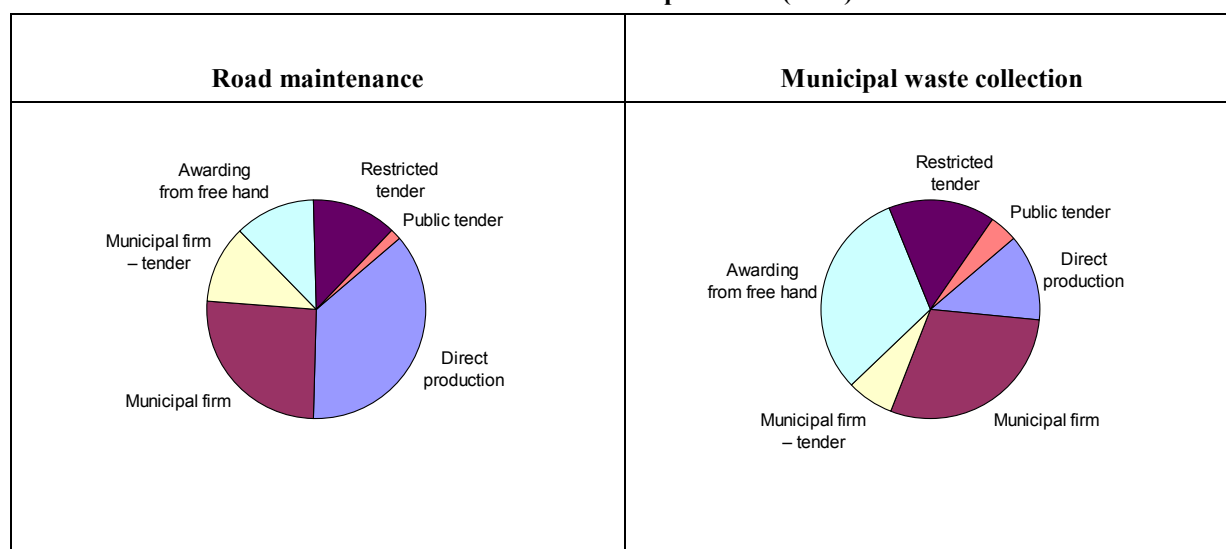
³ <http://www.info.mfcr.cz/aris/>

Table 2: Methods of the provision of selected types of public services in the CR (data in %, 2004)

Public service Method of provision	Roads		Waste		Lighting		Greenery	
	Freq.	Volume of expenditure	Freq.	Volume of expenditure	Freq.	Volume of expenditure	Freq.	Volume of expenditure
Direct production	50.4	36.4	11.6	12.8	43.4	33.7	76.0	57.4
Municipal firm	12.6	25.9	13.0	29.1	7.5	25.7	9.8	18.1
Municipal firm – tender	3.3	11.7	3.0	6.8	3.1	5.8	4.4	8.0
Awarding from free hand ⁴	19.4	11.9	54.8	31.1	28.2	16.5	4.4	4.2
Restricted tender ⁵	14.2	12.5	14.6	15.9	17.6	15.9	5.3	10.1
Public tender ⁶	0.2	1.7	2.9	4.1	0.2	2.4	0.2	2.2

Source: own calculations

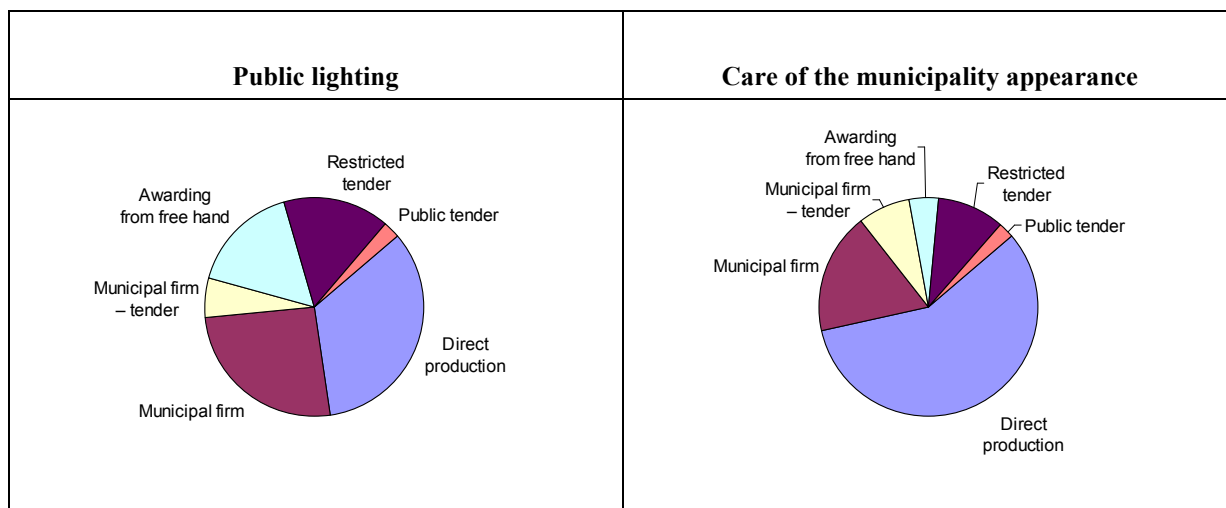
Fig. 2 – 5: Public services funded from municipal budgets, expressed as proportions of the particular types of realisation in total expenditure (2004)



⁴ In this text the awarding from free hand is taken to mean “the call for one tenderer” and “the contract of small size” pursuant to Act No. 199/1994 or “the negotiated procedure without publication” and “contracts up to 2 mil. Kč” pursuant to Act No. 40/2004.

⁵ In this text the restricted tender is taken to mean “the call for more tenderers” or “the simplified award” pursuant to Act No. 199/1994, or “the narrower awarding procedure” or “the negotiated procedure with publication” pursuant to Act No. 40/2004.

⁶ In this text the public tender is taken to mean “the public tender” pursuant to Act No. 199/1994 or “the open awarding procedure” pursuant to Act No. 40/2004.



Source: own calculations

The presented data document that distribution according to the type of public service provision is largely variable. The highest proportion of direct, i.e. internal provision of service was found in the care of the municipality while the lowest proportion was found in the municipal waste collection. It corresponds with findings concerning the institutional approach to public procurement (Brown – Potoski 2002) that accentuates the negative correlation between public service measurability and suitability to external provision. The service ‘the care of the municipality appearance’ is an example of the service when the measurement of an output is very problematic because its utility value has mainly a qualitative aspect. On the other hand, the collection of municipal waste is quite easily measurable.

Based on our research it is possible to identify the fact that the type of provision of the given service (in the sense internal x external provision) is influenced by the size of the municipality and capital intensity. In general, small municipalities tend to provide the majority of public services as direct production except the capital-intensive ones for which they do not have the necessary financial capacities. Among the services analysed in this study the preferences of small municipalities are to provide directly first of all the cleaning of roads and streets, lighting and care of the municipality appearance; on the contrary, the preferences to external provision are in the municipal waste collection. As stated above, the last example may be influenced by the capital intensity of this service. A certain role will also be played by the economies of scale.

There arises a question what is hidden under the preference of direct provision in small municipalities. Based on the existing theory (Pavel 2006) it can be explained by an insufficient administrative capacity of these municipalities that could not ensure effective monitoring and high-quality public services. In general, the risk of the abuse of incomplete contracts is higher in smaller municipalities, Nemeč et al. (2004). If small municipalities decide on the external provision, they will mostly choose the method of awarding from free hand. It is in accordance with law because the value of these contracts is relatively low, not exceeding the limit above which it is necessary to call a public tender. Another factor is the insufficient administrative capacity of these municipalities that avoid labour-consuming selection procedures.

The existence of so called municipal companies is a specific problem of public service provision in the CR. In the text below this term is taken to mean artificial persons established in accordance with the Commercial Code in which the municipality and/or administrative region or voluntary association of municipalities holds a majority property control (i.e. they hold more than 50% of shares or property share). In practice these are limited companies and joint-stock companies while the former form is substantially more frequent because its establishment and subsequent management are administratively less complicated and smaller capital participation is necessary.

The existing municipal trading companies can be divided into two groups on a general level. The first group comprises companies founded by the respective municipality primarily to do business in the “classical” competitive market; their objective is profit and provision of additional sources of funds for the municipal budget. The other group of municipal trading companies, which will be dealt with below, is artificial persons founded by the municipality in order to provide certain public services that should otherwise be provided by the municipality at its own cost or that should be awarded to an external contractor in the framework of public procurement. In general, a part of the activities is separated from the local authority. Contrary to the classical external awarding the proprietor remains the same.

As the proprietor remains the same in municipal firms, it is necessary to answer a question whether the existence of competition or the change in ownership when a public service is provided externally is the primary originator of effectiveness growth. Many empirical studies tried to answer this question, but the results were not unambiguous. While e.g. Domberger et al. (1995) stated that the importance of private ownership was negligible compared to the admission of competition, Szymanski (1996) did not agree and proved that by contracting greater savings were achieved if a private subject was chosen as a partner. In case Szymanski were right, it would mean that municipal trading companies would be less efficient than the private external contractor and their establishment would automatically be the waste of public funds.

The presented data document that in the Czech Republic municipal trading companies play a very important role in the provision of public services on the municipal level. In all four presented examples they have a share in the market higher than 25%. If a more detailed analysis of collected data were done, a clearly positive relationship between the size of the municipality and the probability that the service would be provided by a municipal firm could be found. E.g. in municipalities above 20 000 inhabitants municipal firms provide more than 50% of public services.

Data presented in Table 2 is alarming because it reveals that 75% of the expenditure for the provision of public services by municipal trading companies did not undergo the institute of a tender. This fact that arose either before the respective legislation entered into force or as a result of direct violation of the present contemporary legislation shows that the majority of expenditure does not undergo the competition test and so it is possible to have justified doubts about its effectiveness.

IV. Relationship between the provision of public services and effectiveness

Based on data presented in the preceding chapter, the method of providing public services on the municipal level obviously shows a high variability not only from the bipolar aspect of external vs. internal provision but also with respect to the method of awarding to an external contractor. A key question arising in this context is about the influence of the type of awarding on the effectiveness of provision of the given service. Table 3 shows a comparison of the level of per capita costs for the above-described three types of public services while the comparative base level is the internal provision of a service within the local authority.⁷ The presented data clearly indicate that direct production is the most effective form of public service provision, but such a conclusion cannot be accepted because the presented values do not include overhead costs, which logically leads to their underestimation. For the above-mentioned reasons this level should be taken as benchmark.

The presented values document that a municipal firm charged with the production of public service without a tender is undoubtedly the least effective solution. Only in the collection of municipal waste are worse results obtained by the awarding from free hand. But the difference is on the boundary of statistical significance. The results unambiguously confirm an opinion that the absence of competition and public ownership do not provide sufficient stimuli for the effective allocation of resources.

⁷ Data on the service “care of the municipality appearance” were not included in the cost analysis because we did not manage to collect data of sufficiently high quality.

Is it possible to conclude on the basis of the above information that a municipal trading company is automatically ineffective? Of course not. If we focus on data from municipal trading companies that received a contract in a certain type of tender, we will see a significant decrease in costs. It is 16% on average of the above-mentioned services. This value can be considered as potential savings that may be reached if competition is let enter into the given market.

Except the service 'road maintenance' the presented data confirm an assumption about the ineffectiveness of the institute of awarding from free hand. The price level is very high due to the absolute absence of any competition pressures.

Table 3: Relative level of the costs of public service provision in 2004 (direct production = 100)

	Road maintenance	Waste collection	Public lighting
Direct production	100	100	100
Municipal firm	161	142	138
Municipal firm – tender	139	137	102
Awarding from free hand	119	149	136
Public or restricted tender	149	117	93

Source: own calculations

Based on data presented in the above table it can be summarised that the existence of competition in the external provision of a public service has positive impacts on its cost effectiveness. On the contrary, the type of ownership (public vs. private ownership) appears not to be significant.

V. Conclusion

In the Czech Republic a large volume of public funds is expended on the municipal level (ca. 159 billion Kč in 2004) whereas a portion of these funds is spent on the provision of public services. They are provided either externally or internally; a conclusion can be drawn that the smaller the municipality, the more probable the provision in the form of internal production. An exception is capital-intensive services in which the opposite relationship can be identified. The legislative environment also influences the fact that the method of awarding from free hand is chosen if a small municipality decides on external provision, i.e. the selection is done under the absence of competition pressure.

The choice of the awarding method also has a significant influence on the effectiveness of service provision. In case no competition is admitted in external provision either in a municipal firm or in an external private contractor, costs are very high. On the contrary, the type of ownership appears as an insignificant factor because after the admission of competition municipal firms reach a cost level comparable with external contractors.

These recommendations are formulated on the basis of the above findings:

- Transparency of the public procurement market should be increased on the municipal level by increasing its volume allocated through open public tenders.
- The administrative capacity of small municipalities should be increased so that they will be able to award public services to an external operator through a public tender even though the value of the contract does not exceed the legally set limit.
- Municipal firms established to provide public services should receive the contract through an open selection procedure. It is necessary to terminate the illegal situation existing in many municipalities.

- When inviting to these tenders, it is essential to avoid a temptation to set such selection criteria that the victory of the controlled trading company will be ensured. This completely eliminates the advantages of an open selection procedure.

All the above-mentioned measures are aimed to increase competition pressures in this market, which will have positive impacts on the effectiveness of provided services as documented by the analysis in the preceding chapter. Finally, it will contribute to an increase in the effectiveness of public expenditure as well as in total economic effectiveness.

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