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**PROBLEMS OF RUSSIAN PUBLIC PROCUREMENT REFORM\***

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**ПРОБЛЕМЫ РЕФОРМИРОВАНИЯ РОССИЙСКОЙ СИСТЕМЫ  
ГОСУДАРСТВЕННЫХ ЗАКУПОК\*\***

This article describes the problems of the Russian system of government procurement since reforming in 2005. The main problems are incorrect targeting of the State customer at the time of the conclusion of public contracts: budgetary savings orientation at the expense of quality products; insufficient or partial regulation of the methodology of public procurement; dysfunction of the International Institute of public procurement transplantation in Russia.

PUBLIC PROCUREMENT. COMPETITIVE BIDDING. PERFORMANCE. PRICING. COOPERATIVES. TRANSPLANTATION INSTITUTE.

Описаны проблемы функционирования российской системы государственных закупок после ее реформирования в 2005 г. Основными проблемами являются неверное целеполагание государственного заказчика при заключении государственных контрактов — ориентация на экономию бюджетных средств в ущерб качеству продукции; недостаточная или частичная регламентация методологии организации государственных закупок; дисфункциональность трансплантированного в российскую экономику международного института государственных закупок.

ГОСУДАРСТВЕННЫЕ ЗАКУПКИ. КОНКУРСНЫЕ ТОРГИ. ЭФФЕКТИВНОСТЬ. ЦЕНООБРАЗОВАНИЕ. КООПЕРАЦИЯ. ТРАНСПЛАНТАЦИЯ ИНСТИТУТА.

Government procurement system in Russia as an institute of market economy was formed in 1992 year by the Presidential Decree «On measures for the formation of the Federal contracting system», which initiated the establishment of a contractual mechanism for interaction between government customers and contractors and covenant of state contracts on a competitive basis. World Trade Organization considers a system of public procurement as a major tool to fight corruption in emerging market economies. In 1997, the President Decree «About urgent measures to eliminate corruption and budget cuts in the organization of the procurement of products for state needs» was issued with the aim to develop this principle in Russia. Nowadays, the main goal of public policy in the government purchasing market of the Russian Federation is to improve the contracting system, to increase the efficiency of budget spending, and ensure transparency of all procedures of the state order. To achieve this

goal, in 2005 the Federal Law № 94-FL «On placing orders to supply products, production performance, rendering services to satisfy public and municipal needs» (the 94-FL) was adopted.

Materials of official statistics from The State committee of statistics of Russia help to suggest the following conclusions. Public procurement market in Russia is developing rapidly. The volume of state orders grows every year, which makes the market more attractive to entrepreneurs. So, the total value of procurement conducted on a competitive basis at all levels of government increased in the year 2010 compared with 1999 7.3 times. Currently, the share of public expenditure in the form of public order is 8.5 % of the GDP [1].

Informal statistics data, expert opinions, business and government representatives, numerous publications in the mass media reveal that numerous attempts have been made to improve legislation, long-term reform of public procurement, but not all results are positive, namely, it has also

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significantly increased the size of corruption in the budget spending, and has made procedures for delivery of goods for public needs more complicated, which often leads to short delivery of the products and the decline of its quality.

The evidence of significant problems in this area are constant disruptions in the supply of medicines and drugs, poor quality, shortfalls and delayed implementation of the construction, repair and road works, the difficulties in organizing the purchases of scientific equipment and technically sophisticated goods, overvaluation and cost requirements of budget organizations in procurement, etc.

So, the question arises: why does the introduction of the international practice and a successful tool for ensuring the effectiveness of budgetary funding cause such unexpected and controversial results in Russia?

To explain the reasons of this phenomenon, we can divide them into three main groups of factors, determining the current level of low efficiency or inefficiency of the current system of public procurement:

1. Problems of evaluation and performance criteria of public procurement.
2. Disadvantages of methodology of public procurement.
3. Problems of transplantation of international institute and principles of public procurement.

Let us view each group of factors in details:

#### **1. Problems of evaluation and performance criteria of public procurement.**

From the point of view of many officials, public procurement seems to be effective, according to the official statistics, and the system of government orders has reached high efficiency.

According to the letter of the Ministry of Economy of the Russian Federation № 2000AS-751/4-605, efficiency of budget expenditures is measured as the absolute and relative amount of budget savings due to holding of procurement procedures. This indicator is calculated as the

amount of money that wasn't spent due to holding of procurement procedures and due to usage of electronic platforms.

Indicators of savings are calculated as follows:

1) Absolute reduction of budget spending, as a result of all tenders for the supply of goods:

$$C_{\Sigma}^{abs} = C_n^{\Sigma} - C_c^{\Sigma} - C_{nc} - C^{\Sigma},$$

where  $C_{\Sigma}^{abs}$  – Absolute reduction of expenditures in government funds as a result of all tenders for the supply of goods, rub.;  $C_n^{\Sigma}$  – The total value of all the bids of the customer, rub.;  $C_c^{\Sigma}$  – Total value of customer contracts, rub.;  $C_{nc}$  – Total cost of the proposals that have not led to a contracts;  $C^{\Sigma}$  – The cost of the customer to organize and conduct competitions.

2) Relative reduction of spending of budgetary funds as a result of all the competitions for the supply of goods (%):

$$C_{\Sigma}^{rel} = \frac{C_{\Sigma}^{abs}}{C_n^{\Sigma} - C_{nc}} \cdot 100,$$

where  $C_{\Sigma}^{rel}$  – Relative reduction in budgetary funds as a result of all tenders for the supply of goods, %.

According to the Ministry of Economic Development, budgetary savings during the period from January 2008 to December 2011, shown in Tab. 1, are 210 109.944 million rubles.

The state order satisfies the state or, identically, the public demand and is aimed at meeting social needs. Such requirements are well known, their volume is due, on the one hand, to the theory of market failures, on the other hand, to measuring rod and the role of government in the economy. While carrying out procurement procedures, public authorities represent interests

Table 1

**Information about all orders in the period 01.2008–12.2011**

Method of placing orders	Number of placed orders	Number of customers	$C_c^{\Sigma}$ , mln rub.	$C_{\Sigma}^{abs}$ , mln rub.	$C_{\Sigma}^{rel}$ , %
Open tender	54473	9914	1306723.162	118866.187	9.1
Open auction	38981	5285	548566.869	55080.369	10.4
Request for quotations	493084	14574	162472.754	36163.387	22.26

of society. Under these conditions, the efficiency is defined as the utility maximization of consumption of public goods in conditions of budget constraints. Consequently, in the existing legislation, the idea of efficiency is replaced by the concept of economy; the objective function of the state being an economic agent is aimed to minimize budgetary costs. Such behavior is aimed at minimizing costs, for the care of the producers. However, manufacturers function in competitive conditions and an alternative to public goods may not exist or is not accessible to the entire population. The question arises: whose interests does the state government advocate during the bidding procedures for the purchase of goods for public needs?

The system of performance indicators of public procurement from the perspective of utility or satisfaction of society requires that the public administration reform and introduce results-based budgeting, where the purpose of government is to ensure the results, rather than budgetary savings.

2. Disadvantages of methodology of public procurement.

Russia »borrowed« the concept of government procurement from the US economy. The Federal Contract System (FCS) of the USA is considered as the most successful in the world. The history of its formation and development goes back to the 1890s: in that period, it was used extensively in the US military, and then gradually spread to other government departments. For more than a century, the establishment and development of the FCS has become a well-organized mechanism with a binding legislative regulation. According to many experts and lawyers, no sphere of the activity in the United States has such tight regulation as the FCS.

The FCS of the USA is based on the following methodological principles (Fig. 2): methods of procurement; methods of price-making; methods of contractor’s co-operation.

Fig. 2 highlights the principles which are not regulated in the Russian Federation. During the grafting of the institute of public procurement in Russia, procurement methodology was implemented only partially.

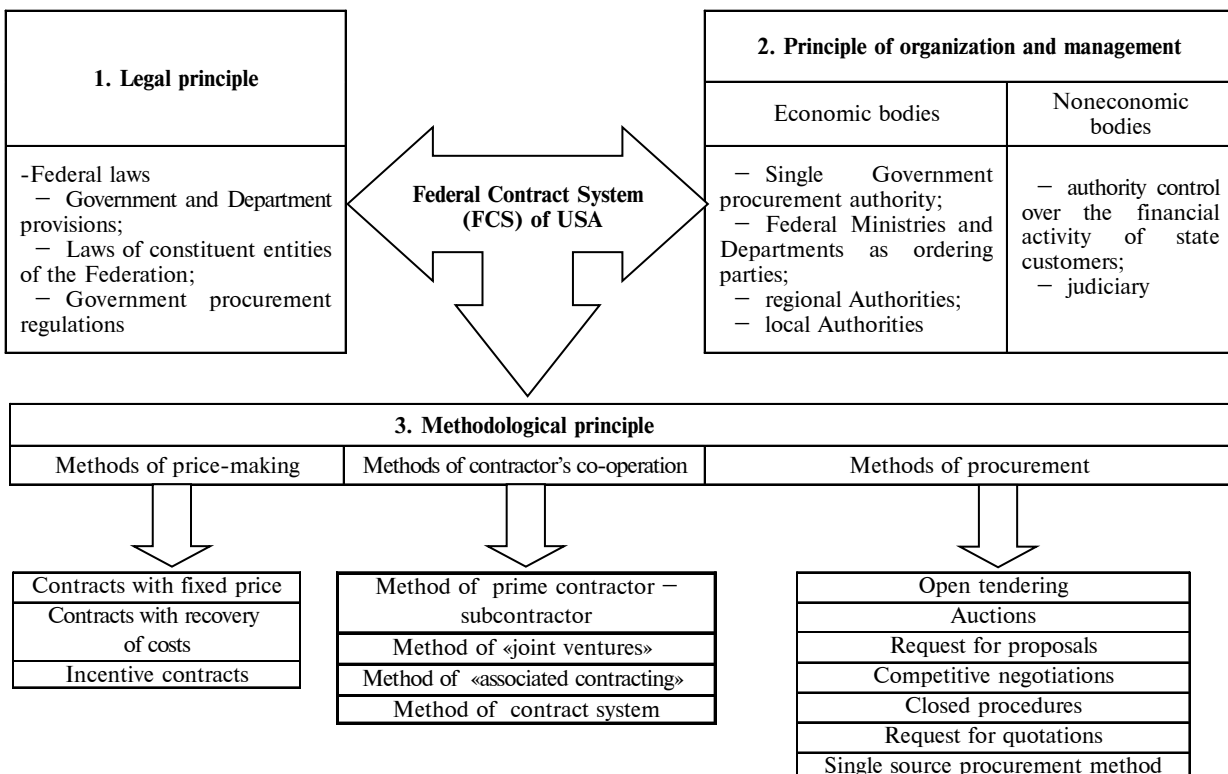


Fig. 2. Principle of public procurement in the USA

Table 2

**Basic methods of pricing in the contractual relations between enterprises and the state [3]**

Pricing methods	Calculation base	Method of profit determining	Sphere of using
Contracts with fixed price	planned costs and planned profit	Profit lies in the a predefined price of the contract	Used in areas where it is possible to predict the arising costs with a reasonable degree of probability
Contracts with fixed price promotional type		Correction of the final profit margin depends on the performance of the company	
Contracts with recovery of costs	Evidence costs	Earnings are established separately, usually as a percentage of the actual costs	Used in areas where it is impossible to predict the arising costs with a reasonable degree of probability
Contracts with costs recovery promotional type		Correction of the final profit margin depends on the performance of the company	

The current law establishes the use of competitive procedures, simplified procurement, such as auctions, request for quotations, and closed procedures. In Russia, methods of procurement for technically sophisticated products are not applied, thus it cannot effectively organize the procurement of major construction works, research projects and innovative products.

Let us consider the purpose and functions of different methods of pricing in the FCS. The pricing mechanism is based on such characteristics as technical parameters of the orders, target price and earnings, the actual price and profits, as well as a complicated matrix of incentives or sanctions in case the failure of the order or for not complying with the technical and economic parameters of the contract [2, 7].

Tab. 2 shows the basic pricing mechanisms which are used in contracts concluded between enterprises and the state, being currently developed and applied in practice with its numerous modifications.

Profit for contractors is considered as the main incentive for efficient performance of government contracts. The difference between forms of government contracts firstly is that the profit is included in the price of the contract and all the risks associated with over-cost are run by the contractor. Secondly, the profit is established by the state customer individually, as a special contractor's fee, a percentage of the costs and the state runs all risks of overspending of planned costs. Finally, there is a risk of overstating the actual costs of the contractor and the introduction of this method of pricing is only possible in ensuring effective control over contractor's costs.

In the world practice, the fixed-price contracts are most common. Restrictions of the use of fixed price contracts is the ability to obtain reasonable estimate of future costs, for example, when dealing with high degree of scientific and technical uncertainty.

In the system of government procurement, Russian methods of pricing are not regulated by any legal act, the only exception being the price index for the procurement in the Ministry of Defense. Usually, the method of fixing prices is used there.

The Russian legislation and public procurement practice does not establish that profit is the main promotion tool for companies participating in tenders and obtaining the state contract. State customers are not interested in cost and size of the contractor's profits, as in the case of using the fixed-price, when all risks associated with inflation, rising prices of raw materials, changes in customs tariffs and currency fluctuations are taken by the contractors. As a result, government contractors try to compensate the possible risks in the contract price, which increases the cost of similar products for state needs, compared with market purchases. If this is impossible in view of high competition during the bidding procedures, government contractors seek to collude in order to divide the market of public contracts, for example, on a territorial basis, to reduce competition and establish monopoly power, which, subsequently, affects the growth of prices of products for public use. If there are uncompensated state contractor risks during the implementation of the state contract, government contractors do not accomplish work to save costs,

do not deliver goods or make them with a lower quality. As far as a final consumer of products and a purchaser of products are different economic agents on the public orders market, facts of violation of public contracts conditions are usually hidden from the consumers by purchasers and contractors. In this case they are usually forced to collude.

In the event of unforeseen risks, the contractor is unable to fully meet the conditions of the contract and the only way out, in order to minimize the risk of a breach of contract and the legal consequences of liability for failure to comply with the conditions of the contract, is collusion between government customers and contractors, which leads to the signing of acts of acceptance of outstanding work or contracting for additional budget funding.

The next important methodological principle of public procurement in the FCS is the methods of contractors' co-operation. In order to insure successful implementation of government contracts, there are forms of cooperative contractors ties or sub-contracting system. These forms differ in the distribution of responsibilities between the co-executors of work, their relationships with customers and among themselves. In the essence, they conform to traditional forms of private business market, i. e. have the character of private companies, partnerships, associations or corporations. The choice of the form is usually made by the state customer, given the complexity, scale, urgency of the contract, as well as proposals of applicants.

In Russia, the forms of cooperation of state contractors are not governed by any regulation. In practice, this leads to the fact that the government customer concludes a contract with one firm for execution of work, and he enters into several subcontracts in turn, and work is performed by a third company. This company has not participated in the bidding system, its experience and qualification of staff may be insufficient, but the government customer has neither the right to interfere in the economic activities of the contractor, nor the control over its relationship with other contractors. On the one hand, involving subcontractors in the execution of works for public use leads to an overestimation of the value of the contract. On the other hand, there are orders for large civil works, where a contract with one firm is

unreasonable, because such firms do not have enough production capacity.

In order to reduce the concentration of the industry, the state may require the main contractor to transfer part of the contract according to the subcontracting system. The main advantage of the customer in case of not spontaneously formed subcontracting system, but regulated by the state, is that the state has the ability to monitor the implementation of the state order over all sub-contractors to choose the optimal form of interaction, providing a higher level of performance of government contracts, promoting cross-sectorial and intra-industry cooperation and specialization, and the decrease of concentration in sectors of the national economy. The choice of optimal form of interaction is important in an innovation economy, where a small innovative firm can lead the large industrial enterprises of different industries.

3. Problems of transplantation of international institute and principles of public procurement.

In our opinion, the reasons of an unsuccessful transplantation of international institute of public purchases or procurement, whose effects are expressed in the growth of corruption and inefficient spending of budget funds, are in violation of the principles of reforming of the national economy and the low level of development of basic institutions of the market economy in Russia. The process of transplantation involves the process of borrowing institution which developed in different institutional environments [4].

The institution is a social good, but some groups of population may benefit from its introduction, others may suffer losses. Consequently, the same institution can be both a positive and a negative good. Since the earliest stages of the implementation of public procurement market, it has been impossible to define the population group (without members of the shadow economy), which benefits from its implementation: consumers consume low-quality products, companies have additional costs and risks, the state budget overruns. Ultimately, the more negative the demand on the institution, the higher the transformation costs of the state, relating to the maintenance and operation of the institute. Resistance force on the introduction of the institute was that during the first ten years of

reform (from 1992 to 2003) the Antimonopoly Committee, the main supervisor in this area, noticed that most regions of the country do not organize competitive bidding for the purchase of goods for state needs and buy mostly from a single source and this is the main type of breaking the law [5]. As a result, from 2003 to 2005 a new law was developed and adopted now in force: 94-FL.

The current institution of procurement in Russia is dysfunctional. This dysfunction shows up the atrophy and degeneration of the institute. Its destructive function intensified as a result. In the USA, the Institute's country donor, the level of corruption in public procurement is estimated 60 % of the value of all major contracts [7]. In Russia this rate reached 90 % or more of the cost of all government contracts [6]. The Institute maintained a formal identity, but has become a tool of the shadow economy for managing flows of budgetary funds.

Polterovich V.M. identifies three causes of dysfunction of the institution [4]:

- socio-cultural characteristics;
- initial social and macroeconomic conditions;
- technology selection transplantation.

The degree of functional differences of market economy institutions in Russia as a recipient, and the USA as a donor of the institution, is great. The level of the development of entrepreneurial culture, the degree of effectiveness of the judicial system, the degree of community participation in the control over the actions of the state, have significant differences. It should be noticed that the institute was grafted after carrying out lots of reforms and changes in a market economy.

The lack of institutional infrastructure of the market economy make a barrier to successful transplantation in Russia. Successful operation of the judicial system, an open civil society would limit the conclusion of corruption or disadvantageous contracts for the sake of society view as a consumer of public services and contributed to the redistribution of losses and their compensation as a result of judicial decisions, but this does not happen.

The way of transfer of the public procurement institute also leaves much to be desired: this institute was copied only partially. As it was mentioned above, in Russia there were implemented only parts of the International Procurement Institution, such as organization of

tenders in form of advertised bidding and closed bidding, requests for quotation and auctions. Such important elements of public procurement as method of pricing and co-operation, which ensure achievement of objectives for government contractors and customers and ensure risks management for government contracts, were not implemented. Mechanisms of public procurement were also affected by mistakes in organization and management, such as the absence of a single body coordinating and controlling operations of the system at federal, regional, and local levels.

The implementation of the Russian Federation system as the FCS in a direct way is impossible, due to the impossibility, in the short term, to build a complex hierarchical system with strong vertical links, and with a strong system of regulation and control. The lack of a single coordinating authority in Russia leads to a constant problem of control over the budget spending.

**Conclusion.** To sum up, we can distinguish the following reasons for the failure of reforming the public procurement system Russia from 1999 till 2010. which appeared in the growth of corruption and the delivery of low-quality public goods.

The first reason is incorrect behavior of government customer whose aim is to save budgetary funds during creation of government contracts, while the primary aim should be the satisfaction of social needs and interests of society during the procurement operation. Thus, in Russian practice the main goal of public procurement is not efficiency but money savings, which leads to delivery of low quality goods, works and services to the public market.

The second reason is due to inadequate or partial regulation methodology of public procurement. Transplantation of only separate elements of the American FCS – tender and «fit to meet international standards» of federal law has not led to effective spending of budgetary funds. On the contrary, it triggered a rise in corruption. Such important elements of government procurement as pricing methods, which encourage the contractor to make a profit providing qualitative products and to control the level of the costs, and also methods of cooperation, which ensure to control all the contractors and subcontractors, are completely excluded from the Russian legislation. As a result, the system is absolutely dysfunctional for

concluding important contracts for construction or purchasing innovative products and researches.

The last but not the least reason of failure is due to unsuccessful reforming of Russia's institutional environment to take the institute from advanced market economy, which resulted in the dysfunction of the transplanted institution.

The underdeveloped institutional environment is attributed to the low level of entrepreneurial culture, a low degree of effectiveness of the judicial system and the lack of public participation in controlling the actions of the state, the lack of public confidence in government and non-professionalism of civil servants, and reformers.

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