THE IMPACT OF PUBLIC PROCUREMENT LAW TO THE SYSTEM OF PUBLIC FINANCE

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Abstract

Public procurement law lays out the processes and procedures that public agencies, authorities, or departments should follow when procuring work or service using public funds. The law stipulates the threshold at which public entities should use public procurement instead of private procurement. Effectively, public agencies spend a considerable amount of government revenue on public services. However, controversy exists on the relationship between government spending and private sector investment. It also remains unclear as to whether public procurement law improves financial management. Thus, the purpose of this study is to determine the relationship between public procurement law and the crowding-out effect, taxes, and finance. The study relies on quantitative research design where data was collected from a sample of 130 participants who comprised of public procurement officials, private investors, and the public. Using a questionnaire, the findings showed that public procurement law increases government spending that in turn crowds out the private sector instead of crowding-in. The need to fund projects often compels government to increase taxes and in turn incur budget deficits due to lack of adequate finances. However, public procurement laws enhance financial planning and control.

Keywords: *Public procurement law, crowding-out effect, financial management, taxation*

1. Introduction

Public procurement entails the acquisition of good, works, and services by a public authority or a procuring entity with the aid of public funds. With the need to ensure a level playing field in the procurement process, countries have enacted public procurement laws to regulate the purchase of public services. The authorities are mandated to follow the established procedure in awarding the contract. The law requires the procuring entities to put in place mechanisms for public procurement for services exceeding a specified threshold (European Commission, 2011).

The regulations govern the management and expenditure of public resources and effectively help in ensuring prudent financial management. However, the rise in public spending is considered to affect investment in the private sector in what is popularly known as crowding-out and crowding-in effect (Basar, Polat, & Oltulular, 2011; Devarajan Swaroop & Zou, 1996). Similarly, public procurement plays a critical role in financial management. It requires the concerned entities to follow the best practices and observe the principles of transparency, accountability, and efficiency in the procurement process. However, it remains unclear whether the public procurement regulation has a positive impact on financial management. Thus, this paper aims to address the relation between public procurement and the crowding-out effect, public finance, and taxes. So finally the main objectives of the paper are: to determine the relation between public procurement and the crowding-out effect; to examine the relation between public procurement law and taxes and to investigate the relation between public procurement law and public finance.

2. Theoretical Principles of public procurement law

Public procurement is a powerful exercise. It demonstrates policy choices and represents the processes involved in the delivery of public services. It provides economic freedom and depicts trade relations among economic players. Essentially, public procurement is a significant non-tariff barrier and it works as an obstacle to the functioning of a competitive internal market (Koninck & Ronse, 2008). Regulation of the procurement process encourages competitiveness and contributes to significant cost savings in the public sector. The EU law provides a platform for all businesses operating in the region. It sets out the minimum public procurement rules that guide procurement process. These public procurement rules are transposed into member states' laws and apply to tenders whose value exceeds certain threshold amounts (Baldan & Pirvu, 2013). If public tenders do not reach a certain threshold value (or below it), national rules of member states' budgetary laws will apply. Although the EU aims to ensure that its economic policy obeys the principles of an open market

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economy and free competition, public procurement requires authorities to develop a positive regulatory approach. That is why public procurement has now become an essential element of the EU in ensuring a competitive economy. The purpose of this research paper is to examine the EU public procurement law and recommends ways to improve enforcement and the procurement process in the region.

2.1. Directives

The primary legislation that regulates public procurements within the EU is in the public procurement directives. They include Directive 2004/17/EC that coordinates procurement procedures in the energy, transport, postage, and water services (McCrudden, 2007). A recent 2014/25/EU supersedes that 2004/17/EC Directive. Directive 2004/18/EC coordinates procedures involved in the award of public works, service, and supply contracts (OJEC, 2017). Similarly, a recent 2014/24/EU one supersedes the 2004/18/EC directive. Directives 2004/18EC and 2004/17 EC are now Old Directives. The New Directives replaced them following a consultative process coupled with a series of legislative proposals. These rules regulate the purchase of goods and services by the member states and their various bodies. The new rules simply contain procedures of public procurement and make them flexible to the advantage of businesses. They pave the way for electronic procurement that is expected to increase the effectiveness of the procurement process. For example, only winning firms submit the papers to show that they qualify. As a result, the new directives will reduce the documentation required (Thai et al., 2016).

Besides, the procurement law includes several specific rules for different sectors. Defense Procurement Directive (Directive 2009/81/EC) focuses on defense and security. Regulation EC1370/2007 focuses on public transport sector by road and rail. Directive 2007/66/EC amended Directive 92/13/89/665/EEC to increase the protection of tenderers against breaches of the law by contracting authorities when they award public contracts (McCrudden, 2007). It sets out the requirements concerning the remedies necessary for the violation of public procurement procedures (OJEC, 2017). European institutions establish directives as the legal instruments to achieve flexibility. The directives provide discretion to the member states regarding the method and form of implementing public procurement rules. They have the ability to harmonize public markets while considering the existing divergences in the legal systems of different states. The directives ensure that legal systems conform to the objectives of the European Community. However, it must be acknowledged that the divergences will remain. Essentially, this attributes to the fact that the EU does not have the power to override existing national legal regimes and impose a different one (Kapteyn & Verloren, 1989).

Although the New Directives address some of the inherent weaknesses in the Old Directives, issues of transparency still arise (Andrecka, 2016). For instance, Directive 2014/24/EU has not yet clarified the uncertainties that involve in the operation of single and multi-supplier frameworks (Andrecka, 2015). Although one can affirm that some level of transparency exists, it is only present at the pre-award stage. Currently, there are inadequate provisions to guarantee transparency, especially during the award stage of the contract. One of the key issues that arise is the lowest price offer that contracting authorities should accept. A transparent or competitive pattern does not guarantee and provides safeguards against underpriced patterns. However, it automatically disqualifies abnormally low offers as in the case of SA Transporoute ET. Travaux v. Minister of Public Works [1982]. Even so, the New Directives allow for the achievement of societal goals, including environmental protection, as well as stimulation of innovation. They improve efficiency in public spending largely by simplifying existing rules as well as introducing flexibility in the procurement process.

2.2. Governing Principles

The contracting authorities in the public sector are subject to the EU General Principles even when the procurement itself is outside the scope of the New Directives (Ebrecht & Werner, 2017). These principles encompass equal treatment, non-discrimination, proportionality, mutual recognition, and transparency. Others include free movement of products and freedom to provide services. For public sector procurements that are outside the scope of the New Directives, the overriding principles are competition, transparency, and equal treatment. These principles require potential bidders to access the suitable information regarding the intention to award certain procurement. Therefore, it means that they should advertise to ensure that the contract is available to all parties to allow fair competition. The European courts have reinforced these principles in different case laws. In Commission vs. Ireland, the Court of Justice of the European Union (CJEU) concluded that the modification of the contract award criteria after reviewing the bids violated the principles of transparency and equal treatment.

2.3. Importance of Public Procurement

Public procurement in the EU is a matter of immense economic value. According to BDI (2017), awarding public contracts to businesses is critical in meeting the public needs and ensuring a cost-effective use of public resources. It also serves as an important factor that allows companies or organizations from different parts of the world to compete fairly. In the EU, member states award public contracts that exceed 2.2 trillion EUR annually (Ebrecht & Werner, 2017). This figure accounts for approximately 12-19% of the GDP. Indeed, these figures show a macroeconomic value of public procurement. Thus, from an economic perspective, public procurement legislation aims to bring competitiveness, increase the penetration of imports, enhance trading of different public contracts, and bring about price convergence (Baldan & Pirvu, 2013). From a legal perspective, public procurement law is essential as it supports the free movement of people, goods, and services, and prohibits discrimination based on the nationality of an individual (Bovis, 2002). Thus, its liberalization reflects the desire of European institutions to end discrimination and preferential purchasing patterns in the public sector. It also shows the wish to create seamless interstate trade links involving both the private and public sector. Due to the importance and value of public procurement, European institutions have developed several rules at a national, regional, and international level. The goal is to create a predictable legislative framework that guides public procurement.

Table 1 Public Procurement Tresholds of the years 2016/2017

PUBLIC	Supply, Services and Design contracts	Works contracts	Social and other specific services
Central Government	135,000 EUR	5,225,000 EUR	750,000 EUR
Other contracting authorities	209,000 EUR	5,225,000 EUR	750,000 EUR
Small lots	84,000 EUR	1,000,000 EUR	n/a
UTILITY	Supply, Services and Design contracts	Works contracts	Social and other specific services
Utility authorities	418,000 EUR	5,225,000 EUR	1,000,000 EUR
DEFENCE AND SECURITY	Supply, Services and Design contracts	Works contracts	Social and other specific services
Defence and Security authorities	418,000 EUR	5,225,000 EUR	1,000,000 EUR

Source: European Commission.

3. Literature Review

3.1. Public Procurement Law

According to the World Bank Group (2018), most countries have enacted public procurement laws which outline the rules and processes that must be followed in public procurement. Most international financial organizations require countries to establish transparent and competitive bidding process in order to receive funding for infrastructural projects. The procurement law requires governments or the procuring authority to publish tenders publicly when the procurement is of a certain threshold (Europa, 2018). According to the European Union (2018) over 250,000 public entities in the EU spend nearly 14% of the GDP on public services. In efforts to establish a level-playing field, the EU law lays out the harmonized procurement rules that stipulate the way public authorities purchase goods and service. According to Fairgrieve and Lichere (2011), public procurement represents over 15% of the EU GDP.

3.2. Public Procurement Law and Crowding-Out Effect and Taxes

Crowding-out arises from expansionary fiscal actions (Sundararajan & Thakur, 1980). Increase in government spending through taxes or debt issuance may curtail investment in the private sector leading to a situation, where the sector feels crowded out (Carlson & Spencer, 1975). Further, Atukeren (2005) indicates that increased government expenditure arising from public procurement laws that requires government to publicly procure goods often leads to excessive borrowing in the capital markets. In turn, the interest rates increase due to the competition for the limited financial resources. As a result, the cost of obtaining capital increases for the private sector, which in turn slows down private investment (Erden & Holcombe, 2005). As Atukeren (2005) indicates, excessive government borrowing to finance public projects often makes the private sector unprofitable. The authors indicate that investment in public infrastructure results to a positive impact on investment in the private sector in the short term. However, some other types of public investment often result in crowding-out (Dash, 2016).

Basar et al. (2011) indicated that the relation between public procurement and private investment is a highly debatable issue. Thus, they investigated the impact of government spending on investments in the private sector within the context of crowding-in and crowding-out hypotheses. Using data from Turkey that had been collected between 1987-2007 combined with Johansen-Juselius cointegration analysis, they observed that total public spending and interest payments by the government resulted in a positive impact on private investments (Basar et al., 2011).

Thus, their findings validated the crowding-in effect hypothesis and rejected the crowding-out effect. Based on their findings, they argued policies that increase public expenditure should be adopted to stimulate investments in the public sector. Similarly, Ahmed and Miller (1999) explored the impact of government expenditure on private investment. The researchers observed that public expenditure on the infrastructural projects increased private sector investment while public sector spending on social security and welfare resulted in a crowding-out effect.

Simcoe and Toffel (2011) examined the connection between public procurement policies and private sector investment in green buildings. The study was guided by the need to determine whether a preference for public procurement stimulates the private sector to develop innovative products. They observed that public procurement policies motivate professionals to invest in their respective sectors and also fuels the demand for green buildings in the private sector. Thus, government procurement policies serve as a means for increasing investment in the public sector. Similarly, both Bazaumana (2004) and Miguel (1994) observed that public investment leads to a crowding – in effect as opposed to crowding-out effect on investment in the private sector. The latter obtained data using Johansen co-integration analysis while the former gathered findings in Mexico. Similarly, Cruz and Teixeira (1999) examined the effect of government spending on private sector in Brazil. Using data from 1947-1990, they observed a crowding-out effect in the short term, but in the long –term a crowding-in effect occurred.

3.3. Public Procurement Law and Finances

Public procurement law and financial management are correlated. As Sarfo and Baah-Mintah (2003) indicate, financial management is comprised of all activities involved in obtaining and utilizing finances effectively. These activities include financial planning, financial control, and financial decision making. Public financial management lays emphasis on efficiency, effectiveness, and economy. Public procurement is critical towards achieving sound financial management by ensuring that there is value for money spent on public projects. Maithya (2014) conducted a study to determine the impact of public procurement laws on financial management among Kenyan public hospitals. The authors indicated that due to the high volumes of government expenditure on procurement, efforts had to be made to enact a law that would govern public procurement within the public sector. This aimed at ensuring effective management of public finances. Consequently, the Kenyan government created the public procurement & disposal Act of 2006. The regulations aimed to bring fairness and an a just system for effective financial management. Using a sample of 45 employees drawn from the procurement & the finance unit of the respective public hospitals, coupled with an additional 20 percent of the suppliers, the authors issued them with a questionnaire (Maithya, 2014). The researcher observed that public procurement law had improved financial control and planning. However, the regulations had not enhanced financial debt management. According to Abebe (2013), public procurement regulations demand high standards of accountability, transparency, and efficiency to ensure efficient delivery of public services. The law calls on the respective parties to adopt the best practices in the management of public expenditure based on the three principles. Efficiency is critical as it ensures that the public obtains value for money. Transparency is also critical as it encourages fair competition among the suppliers. Both transparency and accountability help in promoting integrity that, in turn, prevents corruption in the procurement process (Lynch & Kobo, 2013). Thus, these principles contribute towards efficient management of public resources and finances.

3.4. Summary and Gaps in the Studies

A close analysis of the literature shows the inconsistencies in the findings. While some studies argue that public procurement and by extension government spending creates the right conditions for private sector investment, other studies affirm the contrary. At the same time, some of the studies argue that public procurement squeezes funds from the public and compels governments to increase taxes in order to meet the costs of public procured services. It is also not clear as whether public procurement laws, improves the overall financial management in terms of planning, controlling, and debt management.

4. Methodology

4.1. Introduction

This section outlines the research method used to answer the study objectives. It describes the research design, the sample, data collection, and instruments for data collection. The chapter also describes the data analysis, validity and reliability of the methodology, and the ethical considerations made.

4.2. Research Design

The paper adopted a quantitative research design. This approach was considered as the most valid one based on the purpose of the study. It would allow the researcher to collect data from a large sample size and make it possible to make generalizations. The quantitative approach was easy to operationalize and analyze the data due to the standardized data collection method (Mugenda & Mugenda, 1999). Over and above, the method was considered as the most appropriate based on the fact that the study aimed to establish relationships between the independent variable of public procurement law and dependent variables of crowding-out effect, taxes, and public finance.

4.3. Sampling

The sample population included public procurement officials, economic experts, the public, and investors in the private sector. The diversity of the sample allowed the researcher to obtain more objective data by drawing responses from across the board. The selection of sample size was guided by Mugenda and Mugenda (2003) who indicates that a sample of between 10-30% of the targeted population is adequate for generalization. A total of 150 participants were recruited where some were from the Ministry of Health and others were investors in the private sector. With the need to ensure diversity in the sample, purposive sampling was used to access information from the right people.

4.4. Data Collection

The respondents were conducted via e-mail or telephone and informed about the purpose of the study. They were contacted to arrange for the convenient time to conduct the survey. They were then issued with the surveys through their respective email where they were required to fill them out and return completed survey forms via e-mail. The researcher used closed ended questions to standardize the respondent's responses and reduce the time they would take to complete the questionnaires.

4.5. Validity and Reliability

Validity entails the degree to which the results reflect the issue or subject under study. It can also be defined as the extent to which a data collection instrument measures what it intends to measure (Ngechu, 2004). In this case, the validity of the findings was guaranteed by the use of the right survey instruments with questions that were tailored to answer the research questions. The reliability describes the degree to which the findings can be replicated by another study at a different point on the same population (Neuman, 2000). Reliability was guaranteed by the choice of a large sample size.

4.6. Data Analysis

In analyzing the data, the researcher checked the questionnaire for completeness to make ensure that the data was consistent. Descriptive and inferential statistics were used where the analyzed data was presented in tables.

5. Results

5.1. Demographic Information

A total of 150 participants were recruited and issued with the questionnaires. Out of this number only 130 of them completed and returned the surveys representing 87% response rate. This percentage implied that the data was significant for data analysis considering that Mugenda and Mugenda (2003) indicate that a 50% response rate and above is valid. Out of the 13 participants, 100 (77%) were men while the rest were women 30 (23%). Nearly 38% of the participants were aged 26-35 followed by 30% above 46 years, 18-25 and 36-45 both at 15% each. A large portion of the respondents were officials in public procurement and finance departments in the Ministry of Health at 46%, followed by those in the private sector at 38%. The remaining were the public at 15.4%. Nearly 70% of the participants had a university education and above with the remaining having a college education and high school certificate in equal percentages. Over and above, 84% of those surveyed were German nationals and the remaining 16% expatriates. Indeed, this demographic information shows the diversity of the participants that collectively helped to improve the accuracy of the findings.

Table 2 Showing Demographic Information

Variable		Number	Percent
Gender	Male	100	77
	Female	30	23
Age	18-25	20	15
	26-35	50	38
	36-45	20	15
	46+	40	30
Occupation	Public procurement officials	60	46
	Private	50	38
	Public	20	15
Higher education	University	90	69
	College	20	15
	High school	20	15
Nationality	German	110	84
	Expatriate	20	15

Source: own processing

5.2. Relationship between Public Procurement Law and Crowding-out Effect

Participants' responses to these questions were examined and summarized in tab 3 below.

Table 3 Participant's responses on public procurement law and crowding-out effect

Question	**Responses Yes**		**Responses No**	
PPL help delivery of public services	Number	Percent	Number	Percent
	110	84	20	15
PPL help infrastruct. facilities	80	62	50	38

PPL support private investors	80	62	50	38
PPL reduce private investors	70	54	60	46

Source: own processing

5.3. Relationship between Public Procurement Law and Taxes

Table 4 Participant's responses on the connection between public procurement law and taxes

Question	Responses Yes		Responses No	
	Number	Percent	Number	Percent
PPL increased taxation	100	77	30	23
PPL increased prices of commodity and projects	80	62	50	38

Source: own processing

5.4. Relationship between Public Procurement Law and Public Finance

Table 5 Participant's responses on the impact of public procurement law on public finance

Question	Responses Yes		Responses No	
	Number	Percent	Number	Percent
PPL increased int. rates	80	62	50	38
PPL reduced money in priv. sect.	100	77	30	23
PPL incr. budget def	90	69	40	31
PPL impr. fin. plan.	100	77	30	23
PPL impr. fin. contr.	90	69	40	31

Source: own processing

6. Discussion

6.1. Public Procurement Law and Taxes

The public procurement law stipulates that government projects above a specified threshold should be awarded to contractors through the laid down processes and procedures. While procurement in the private sector is mainly funded by shareholders and the founders or owners, the funds utilized in public procurement originate from loans and grants as well as taxation (Lynch & Kobo, 2013). When asked whether the amount of taxes on the citizens have increased due to the public procurement law that requires government agencies, departments, and organizations to publicly procure goods and services, an overwhelming 77% of the respondents affirmed with a yes. This confirms that even the public procurement officials were aware of the deleterious impact of increased government spending on projects. In fact, one of the respondents indicated that the government cannot run without taxes from the citizens.

6.2. Public Procurement Law and Crowding-out Effect

When asked whether the public procurement law has resulted in crowding-out effect, 62% of the participants indicated that it has reduced the amount of financial resources available to the private sector, while another 54% stated that it has reduced investment in the private sector. The responses confirm the crowding effect that is brought about by increased government spending. The responses correspond with Carlson and Spencer (1975) who found out that increased government spending through taxes or debt issuance, often impedes investment in the private sector by making it feel crowded-out. For instance, massive government spending in the health sector would effectively kick out private investors due to the lack of demand for their service. If the citizens can receive adequate health services at a lower cost, then it would not make any economic sense for a private investor to consider establishing a hospital to provide similar services. Thus, the feeling of being crowded-out arises as the investors perceive the government to have invaded in the sectors that should have been left for private investment. The responses from the participants conflict with those reported by Basar et al. (2011), Simcoe and Toffel (2011), Bazaumana (2004) and Miguel (1994) who observed that government spending increases investment in the private sector through a crowding-in effect.

6.3. Public Procurement Law and Public Finance

Regarding the relationship between the public procurement law and public finance, 69% of the respondents indicated that it had an increased budget deficit. The law has made it mandatory for government agencies, departments, entities, and organizations to publicly procure goods. As a result, there is increased demand for money. When the government cannot secure financing from the taxes, it resorts to loans from international financial organizations and foreign countries. This phenomenon is quite evident in developing countries where governments have resorted to massive borrowing to finance public infrastructural projects. As a result, these countries have huge budget deficits. Similarly, when asked whether the public procurement law has reduced the financial resources available for the private sector, 77% of the respondents agreed. The competition for money increases when the government increases spending on infrastructure. As a result, the lenders prefer lending money to the government as opposed to private entities which in turn means that the private sector has a few resources to fuel investments. Similarly, the cost of capital increases, which is a disincentive to the private sector. When asked about the efficiency that public procurement law brings in the management of finances, an overwhelming majority indicated that it improves financial planning and control. The responses correspond with Maithya (2014) who found out that public procurement law, enhanced financial planning and control in public organizations. However, the present study established that public procurement regulations did not improve financial debt management. The fact that public procurement laws require the respective parties to follow the best practices and embrace the principle of accountability, transparency, fairness, and efficiency explains why the regulations enhance financial planning and control.

7. Conclusion

Public procurement law sets a level playing field for procuring public goods and works. The law requires public entities to embrace the best practices by observing the principles of fairness, accountability, and fairness, and efficiency.

It is for this reason that it is considered as the cornerstone of efficient financial management in the public sector. However, it has unanticipated negative impacts on the private sector and taxation. The provision in the law that requires government entities, departments, or organizations to publicly procure services when they are of a certain threshold often leads to a crowding-out effect.

As observed in this paper, massive government spending must be funded by higher taxes or loans which implies that it increases taxation on the citizens and elevates the budget deficits. Similarly, by publicly procuring key services, governments edge out the private sector as they reduce the opportunities for the investor. Although critics argue that government spending provides a foundation through infrastructural projects that in turn increase the incentives for private investment, the present study found contrary results. Public procurement laws increase government spending where government borrow excessively from the capital market that in turn increases the interest rates that, in turn, increase the overall cost of capital for investors, which eventually lowers private invest.

Over and above, public procurement law improves financial planning and control, but it does not enhance financial debt management in public institutions and entities.

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