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ECONOMIC ASPECTS OF PROCUREMENT: A LAW AND ECONOMICS APPROACH

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Introduction

Important topics involving public contracts by the public sector in Brazil spins out of miscomprehension, inadequacy and inefficiency implied by our purchasing legislation regulated by the Procurement Law (ordinary act # 8666/93) and especially, the Public-Private Partnership law (ordinary act # 11074/04). Investigate these problems throughout analytical mechanisms such as transactional costs and information asymmetry seems to be an important task in Brazilian doctrine.

There is a traditional tradeoff between efficiency, legality and how the legal system is ready to deal with this dilemma which is also a theme of great practical repercussion. In this context, themes like Moral Hazard, Adverse Selection and Hold Up gain importance to reveal the incentives of the government and companies in Brazilian great investments, especially when two mega events are at head: the 2014 World Cup and the 2016's Rio Olympic Games.

Additionally, we should observe the particularities of PPP (Public-Private Partnerships) projects that involve permanent negotiations, generating insecurity and elevated transactional costs.

In summary, in section 1, we'll present an general view of Brazilian purchasing system, making a parallel between the Procurement Law(ordinary act # 8666/93) and the Public-Private Partnership's Law (ordinary act # 11074/04).
The basic parameters of Procurement will be assessed at Item 2, as we sequentially discuss themes such as Adverse Selection, Moral Hazard and Hold Up in the following sections. The part 7 will deal with more accuracy about the causes and repercussions of renegotiations of infra-structure contracts throughout the presented framework followed by this paper conclusion.

1 – **Procurement and Public-Private Partnerships on Brazil**

A relevant point at Public-Private Partnerships modeling in Brazil is the private partner's choice throughout Procurement, been up to conceding power to format the Procurement process, making the adequate requirements about the economic and financial qualification in order to choose the private partner that could supply the service better.

It is thus the existence of transactional costs and by considering the aspects involving economic efficiency, that we can get to the conclusion that procurement process is not always the best option, although the Brazilian tradition is very attached to other values like legality and public interest privilege.

Therefore, even though we are supposed to admit some intrinsic inefficiency, the constitutional rule is clear when it obligates all federated entities to elaborate the procurement process. Furthermore, it remains the challenge to adequate the invitation for proposals and administrative contracts to be as efficient as possible. Moreover, the risk spread, information asymmetry, contractual renegotiation and control instruments are extremely important (SALANIÉ, 2005).

The Brazilian Procurements are regulated by the general rules established by the ordinary act 8.666/93 presenting a rite more concerned about the procedure characteristic rather to the results themselves, culminating in a expensive, complex and inflexible process which often choses proposals that do not adequate to the Public Administration necessities.

These facts occur owing to the incapacity of perceiving the intrinsic costs of the procedure itself. For the applicants, namely: the employees, travels, certificated, samples, administrative appeal system, etc. as for the administration: training, equipment, hours expended on tender notes composing and contractual clauses discussions.

The process will be than, more expensive proportionally to its transactional costs. Therefore, these costs will be absorbed somehow and mainly internalized on the company proposals.

The exact costs involved in such process are unknown, but in PPP's construction cases, the values are considerable high. On account of that, as bigger the burocratic procedurals and uncertainty of the process disclosure, the largest will be the transactional costs involved.
How to define and low these costs? That is one of the greatest challenges of those involved on public purchases.

Some authors advocate that, for complex constructions, procurement could be abolished, since experienced enterprises were contracted, throughout transparent negotiations and best price seeking agreements. In this measure, although it could seams more adequate to efficiency terms, - and certainly is – it doesn't fit to the

constitutional procurement obligation, as the risks of corruption and benefits that surrounds this practice.

2 – Procurement: Basic principles

The Procurement Law establishes seven basic principles that should be followed during the procurement in Brazil, namely: legality, impersonality, morality, publicity, objective judgment, administrative compliance and invitation for proposals's commitment. The first four are presented by the Federal Constitution at the article 37 in the public sector principles section.

The following principles are sectorial and therefore established by the Procurement Law (ordinary act # 8666/93), article 3rd. The administrative probity is an open concept that demonstrates the necessity of the administration to act with ethic and justice.

In addition, we'll see that inefficiencies and incoherence's of our purchasing system creates unwelcome incentives that contribute to unethical behavioral. The objective judgment principal reveal the necessity of clear rules that diminishes the decision making subjectivity, implying that the technically viable proposal prevails.

As for that matter, unfortunately it is not always the procurement leads to a 100% technical judgment, what would unavoidably create space for subjective rules appliance. Such thing occurs mostly in procurements taking both technic and price as criteria.

In conclusion, the procurement attachment to the invitation for proposals signalizes the necessity to commit strictly to the further rues stipulated *ex ante* by the administration. In these cases, the deficiency and blanks presents on the invitation for proposalss can contribute to bad public contracts that could cause severe problems to the proper disclosure of the procurement.

Adding to these sectorial principles, we can name the public advantage principle present at the Brazilian Constitution, article 37, XXI which determines that the administration should find the most adequate proposal.

But it is also truth that in the search for the most suitable proposal, we cannot look only for the best price or just any combination with technic. Factors such as organizational aspects of the supplier company, structural costs, control mechanisms and the enterprise internal procedures quality should also be observed.

Therefore, the legal requirements such as technical and economic qualification presented by the Procurement Law (ordinary act # 8666/93) are not sufficient to reveal the true capacity of the enterprise at stake to best serve or supply the object contracted.

It is revealed than the great problem of the information asymmetry *ex ante* which could certainly culminate in a bad contractual execution.

The basic public contracts model, therefore, does not show relevant transactional costs based on: a) limited rationality, b) uncertainty and complexity; c) opportunism and value specifics (KUPFER e HASENCLEVER, 2002: 269)

The limited rationality defines that there are limits to human information processing capacity such as languages limitation to transmit them. It is an alternative approach to the unlimited rationality of neoclassic economic theory. It is also true that if all parts could predict the actions of the adverse counterpart, it would be not any preoccupation about the rationality variable. Nevertheless, in real life we deal with complex environments in which the described situation does not occur and decision making process is actually extremely hard. Moreover, it is also hard to make a correct evaluation of the economic scenario to estimate the odds the events occurrences.

Aside the rationality, the opportunism and the specifics involving the values are fundamental components to define the dimension of the transactional costs. The opportunism leads to the distortion of the transmitted information (KUPFER e HASENCLEVER, 2002: 270) and promises that the parts knows ahead that will not be accomplished. In which case, according to the neoclassical model, the parts are provoked by their own self-interests and use their informational advantages to approach their own payoffs that could even lead to the contractual cancelling.

That kind of opportunism emerges throughout the informational asymmetry between the contracting and the contracted. In Procurement cases, for example, the contracting has no adequate information about the operational capacity or even, the structural costs of the procedure winner company. The only information at its disposal is a signal given by the minimum requirements of the Procurement Law for economic and technical qualifications.

Occurs, in fact, that the administration don't have the proper conditions to evaluate these requirements, which is the same to say that these criteria are not enough to signalize to the administration the capacity of the company to execute the procurement object or even to deliberate about its operational capacity. In construction procurements, it's not uncommon the described situation to occur. The winner enterprise usually get the prices to a level under the price offered by a concurrent capable to execute the object and so the problems starts, where the winner company force situations to review the contract based on financial-economic equilibrium criteria based on situations such as "case of accident" or "act of god", which configures the "table game" examined further on this paper

These characteristics implied on procurement process will be analyzed on the sequence along with the adverse selection, moral hazard and hold up concepts.

3 – Adverse selection

Before examine the adverse selection itself, it is important to define the concept of overestimation. It can be conceptualized as a public founds damage by:

a) Super estimation of values incompatible with the effective service or supply;

b) Under-compliance on construction execution or engineering services that result on quality decreasing, duration or security of the product;

c) Incompatibility on payments in comparison with Market established prices or official organs, as well as the to require unitary prices above the market tendencies;

d) Financial-economic disequilibrium of the contract against the administration throughout quantitative alterations (table game) or prices (alteration on financial clauses) during the construction execution;

e) Alteration on financial clauses that generates anticipated contractual payments, chronogram physical-financial distortions, unjustified contractual deadline prorogation or irregular adjustments.

An essential point of discussion to be aboded would be: why is there a overestimation of prices? Who is to blame on: transactional costs, informational asymmetry, project changes, adverse selection? What would be the solution to these problems?

The modern Procurements theory (TIROLE, 1993) uses mechanisms to design models throughout the premise that there is informational asymmetry *ex ante*, the companies have more information about an possible contract than the Government itself. In general lines, the winner has information about production costs (governance as well) that the purchaser don't have access to.

That opportunistic behavior can either occur before or after the contract. If it occurs before, it configures an adverse selection situation in which the agent has information privileges before the contraction and the contracting knows that. Moreover he has not the conditions to evaluate this informational asymmetry, and therefore offers a "contract menu" so the party reveal them.

It is the insurance contract situation, for example. It is expensive (and possibly impossible) to the insurance company to know the characteristics of any consumer. In this case, the company offers a few contract options in which case the consumer will, according to rationality theory, chose the contract that maximize its utility.

This phenomenon occurs in many Procurement procedures, mainly when the object is complex. As shown before, the administration has not conditions do establish the real possibilities to have the contractual object executed. The technical and economic qualification criteria are insufficient to reveal secure information of the real capacity or interests of the executor to properly fulfill the contractual object. In procurement, the situation is even more complex, given that the "contract menu" is not an option, thus it has a contracts on "take or leave " basis in which the contract is usually designed on the invitation for proposals instrument. Therefore, there is not an option to bargain but just an "take or leave" situation built up.

In this case, thus the adverse selection many problems emerge during procurements. In constructions, for example, is not uncommon that the winner signs a contract that it

already knows it will not comply, mostly, it will execute it partly and interrupt the service under allegations of financial-economic disequilibrium by "case of accident" and "act of god" situations.

The administration gets caught in a delicate dilemma, which in many cases can even paralyze the construction. If that occurs, the administration can contract the second placed company on the bid process according to the art. 24 of the ordinary act 8666/93, without another procurement to end the construction.

The problem on that case is that the second place will attend the calling under the same conditions that the first which could incentive the same opportunistic behavior.

It seems clear than that many contracts involving PPPs have the adverse selection problem and contractual information distribution mechanisms should be established.

A quite common issue regarding informational asymmetry *ex ante* is called the "table game" which is defined by proposals based in tables of apparently low costs. In spite of that, the company is able to achieve the sub-estimated result by omitting input costs. Later on the execution phase than, based upon the Procurement Law's prediction "exceptional situations" results to appear, creating obstacles to the perfect execution of the contract established and thus enforcing the contract rearrangement throughout the financial-economic re-equilibrium.

Even though the Procurement Law tries to de-incentive these opportunistic behaviors, it is still considered a common practice in Brazil. Therefore the previously definition of executive projects, utilization of global prices with unitary prices as subsidiary measures are important tools (Procurement Law, art. 40). By unitary prices concept, the law establishes that these prices cannot exceed the product market's currency. Moreover, the costs table of companies should contain all unitary costs in both basic and executive projects (Procurement Law, II, § 2º e o § 4º of art 7º). Though it is not uncommon difficulties *ex ante* that comes from the own administration by lack of definition on the object or service to be contracted.

The prices definition under the market currency is part of the strategy of the companies to achieve further results throughout renegotiation, in the execution phase. It is a "game" where the company bets on the odds to achieve profit *ex post*.

If the government give in easily, or even has the fame to do so, the prices obtained by the procurement process will surely be distorted during the contract execution. Data extracted by concessions contracts in Latin America can appoint to a massive renegotiation rate by 73% in the first two years of contract (GUASCH, 2004:12).

Though if there are efficient control actions, for instance, the Counts Union Court (Tribunal de Contas/TCU) which runs against the "table game", the incentives to the company deter this conduct will surge, obligating the company to change their strategy avoiding omitting their costs table.

The incomplete contracts concept can be checked in different cases revealed by the execution phase of the infra-structure contract. Most commonly, during the operational phase, even though it is not also uncommon during the very object construction. That occurs due the "bad" elaboration of basic and execution projects

with open concepts and even contradictions. Based on that, we can define two most common species of contractual blanks: “extrinsic” and “intrinsic”.

In the first case, it is evidenced the incapacity of Government to define better the contractual object thus extrinsic blanks are related to classic limited rationality problems such to cognitive costs and even contractual manufacture costs.
As for the intrinsic problems, the control mechanisms are not effective, thus, even though the administration should analyze the invitation for proposals, much of the content of the instrument comes out of the free will that has been given to the administration by Brazilian Constitution and therefore a subjective issue to be dealt with. In addition, the control action *ex ante*, criticized by doctrinaires’ as burocratic, it is an efficient instrument to be utilized during the contractual execution.

The mentioned inefficiencies are mostly common in expensive contracts, especially during the construction phase and mostly in contracts “Built Operate Transfer” where the risks are greater. That’s why an failed combination it’s revealed in this phase such as intrinsic blanks, elevated risks and transactional costs. Concerning the last variable, there are even greater costs when the disputes comes to the Judiciary Courts. Which could be considered as a fundamental difference between the Civil Law Brazilian system and North American Common Law system, namely, in Brazil, the majority of conflicts go to the Courts, thereafter, the inefficiency and corruption at Brazilian judiciary creates elevated transactional costs to contracts.

There is a rational expectation on contract actors that the problem at stake will occur and the transactional costs will lead to a bad contractual execution by trading good quality inputs to bad quality ones.

It is also important to notice that current doctrine appoints to *ex post* contractual asymmetries (Moral Hazard) too be also an important problem to be considered, as for *ex ante* problems basically characterized by the contractual blank issues.

That equivocated analysis comes out of the partial comprehension of the institutional environment in which procurement process occurs. For the neoclassic point of view, that environment is an *ad hoc* variable. In spite of that, Government, companies and judiciary control are fundamental to diminish the distortions on that system.

4 – Moral Hazard

Other problem to be concerned on government construction contracts is the Moral Hazard. In this case, the information advantage emerges after the contract. It would be, for example, the case of an enterprise which executes the contract and low the quality of the input utilized to reduce costs. Very alike the adverse selection problem, the moral hazard is an information asymmetry problem in procurement process.

Concerning the Moral Hazard problem, it is important to centralize attentions to eventual changes on the original project during the execution phase and the costs brought by that situation, which is an important object of investigation to the modern

doctrine. In such case, the main problem is about quality as the company lows quality of the product or even the don't execute the contract.

That situation reflects a great problem that rounds the public services concessions in Latin America, which is the constant renegotiation on public contracts. If that occurs in the beginning of the execution, the advantages achieved by administration during the procurement process are mitigated. The Moral Hazard can also occur by the transactional costs present on the pre-contractual period that can be "relieved" by the unsatisfactory object execution.

A possible solution to solve these costs could be alternative dispute resolutions such as arbitration. Even though that has been predicted by the in Brazilian PPP's Law there is still a great concern about using that instrument by argument that it would "offend the indispensability of the public interest principle". Moreover, the parts tend to not utilize arbitrational alternatives by the elevated costs concerning that method even though they usually ignore the public judiciary costs.

As for the contractual species, the greater cost contracts in Brazil are usually made in "Standard Cost" (PF) of Cost Plus (C+). In the first case, the price is defined before the contract. In C+ method, the payments should compensate eventual costs. In Brazilian tradition, the Standard Costs are usually applied which gives incentives to reduce costs during the contractual execution. Therefore, as incomplete the contract becomes, the greater will be the renegotiation costs. If we change the criteria to C+ in specific kinds of objects the renegotiation probability tends to diminishes. Even though it would be necessary a more efficient control mechanism to dissipate all these problems.

In addition, the companies respond strategically to contractual blanks, expecting "adaptive costs" of renegotiation of legal disputes. Thus the classic model of procurement can work for goods and standard services (such as Auctions, for example), in spite, for specific goods it is hardly a model that could work efficiently by the specificity of the good and the contractual blanks issues.

The bid procedure is complex and by that, it goals cannot be always achieved. When company's proposals are sent, there should be a method to clarify them without changed on execution phases. It is also important that the administration can keep contacts with companies without possibility of revealing this information to other participants, the "participative dialogue" which is the European Union model, which in Brazilian case should have an efficient transparency method and accountability. Some legislation allows the companies to modify their proposals which could be acceptable if it can bring the best final result.

The Latin America examples show a big problem on PPP's contracts during the execution phase. The contracts tend to fail to fulfill their objects due a high tendency of renegotiation or even the abandon of the execution by the company. As an example of problems that can cause these situations we can name the search for the "lowest price" and the difficulties involving the *enforcement* of rules by the government and the weak control of results achieved by the contracts.

These problems can be aggravated by lack of rule of law that comes out of these countries of the debilities in their legal systems and their difficulties to understand the nature and particularities of the infra-structure contracts and the fragile regulatory stability. These governments require also that the private partner informs about the *performance* of the program that mostly cannot be understood by the government personal due internal structure problems. A good contract should deliberately appoint to the renegotiations and changes possible during the execution period. Our Procurement Law's mechanism by the financial-economic re-equilibrium should be evaluated as an anomaly and not as a general rule to be applied broadly. It is, therefore, a necessity to establish which contract could be re-negotiated. Finally, a control capable to utilize *Performance Audit* systems would be the key to maximize these contracts results and bring out economic efficiency to procurement process.

5 - Hold Up

Other important topic to be discussed is the actives specificities. As complex if the specificity of the active applied, it is also bigger the "improper gain", the difference between the active application on that activity or any other alternative activity. That also applies to the exclusive or "quasi exclusive" relationship between the contracting and contracted. There are many kinds of specificities that should be concerned of (WILLIANSON, 1986: 43). The first is the *site specificity*; some actives should be allocated in pre-established areas, considering the transportation, communication inputs costs. A second would be the time characterizing the synchrony of the productive process for costs economy. In addition, other specifications would be the fixed actives and dedicate (complementary) actives. The first case happens under specific transactional characteristics when the actives cannot be used in alternative ways as the dedicated actives represent all inputs (not necessarily fixed) utilized to that specific contractual relationship that has a few or even none alternative use. Finally, we have the cognition costs or *human-asset specificity*.

That is the great costs contracts case, especially at public concessions and PPPs. That specificity of great constructions leads to what doctrine calls the "hold up" making possible to a part to exploit the fragility of the other on renegotiations after the contract. That is clear in infra-structure contracts by the sunk costs involved (there are many specific costs without alternatives for them). This applies on dependent relations that open the door to opportunistic behavior. Creating, therefore, incentives to parts exploit renegotiations to extract extra benefits.

The great challenge on that matter would be to find an alternative use for the active at stake (*second Best*) in order to diminish the profitability on the holdup relationship or *salvage value.* The solution proposed is mainly not possible, which would lead to an second proposal to accurate the contractual instrument as best as possible. If the contract is extremely complex or incomplete the problem could result over compliance or under compliance problems, what would suggest for an optimal contract study in each case. We would suggest in this particular case, to impose effective control mechanisms such as the utilized by the TCU in public constructions.

Therefore, as effective the control is, it raises the possibility of diminishing the holdup effects and therefore, the inefficiency possibilities. By that aspect, analyzing the public constructions performance by the TCU in 2005 (ANGELO, 2005) got the conclusion that the probability of a low performance is related to the control and enforcement which could diminish the holdup effects as well as the control can also maximize the efficiency of public inputs (NÓBREGA, 2008).

Concluding, it would be necessary to find mechanisms of governance that could deter the possibility of profitability *ex post*. An active control to analyze the quality and compliance of the contracts could be a useful instrument as it could also reveal necessary information during the execution phase to diminish the information asymmetry and minimize the holdup effects. Concluding, the procurement systematic and public contract should take on account the best species of contracts, the complexity of each and incorporate mechanisms of mitigation of "quasi-rent" of the contract and instruments that could lead to efficiency on that matter.

6 – Renegotiation

Adverse Selection, Moral Hazard and Hold Up problems have all in common the need to re-negotiate the contractual relationship (GUASCH, 2010: 43). But we should also add to these factors other variables that should be considered as the institutional and political aspects of the procurement process. Firstly, we usually do not pay enough attention to the structural aspects due the euphoria caused by current virtuous cycle of the country. In addition, the Brazilian institutions debility such as the government, the judiciary, the administrative control, ONG's cannot give the sense of optimal accountability and transparence. There are also tax aspects that should be considered in order to not pressure the country's public accounts. All the mentioned aspects lead to renegotiation right after the contracting.

Another possible reason that can lead to renegotiation is the government tolerance to aggressive company's proposals. These proposals are those that give prices under market predictions with the sole goal to win the procurement and enforce the renegotiation (as in "table game"). The strategic behavior of the company will build on the probability of the Government not accept its offer or to give in the renegotiation appeals. The enterprise should also consider the odds to obtain success by Lawsuit and transactional costs to do so. Adding that as specific is the active; the greater are the chances to obtain best payoffs from the government.

And finally, the difficulties to design the contracts brought by the invitation for proposals attachment and adhesion nature of them that can lead to an decrease of bargain processes and thus can lead as well to renegotiations.

A weak enforcement power of the government itself or its judiciary, are also variables to be taken on account as factors of renegotiation as the government has fewer instruments to fulfill properly the contracts object and do not use them as it should. The proper utilization of contractual warranties as penal clauses can bring out incentives to deter the holdup strategies (depending on the dependability factor). Concluding, the judiciary in Brazil is slow and not much of effective, creating considerable high transactional costs. The control factor, finally, still has the

enforcement issue and as fragile these institutions are, greater is the renegotiation necessity and thus the opportunistic behavior.

7 – Conclusions

In Brazilian bid procedures, there is an intrinsic inefficiency caused by many aspects. Firstly, due the tradeoff existent between efficiency and legality principles. Our legal system, unfriendly to new approaches, requires the procurement process to be fulfilled, which implies in inefficiency and raises difficulties to the best partner's choice to execute a contractual goal.

Throughout that systemic problem, a series of distortions are revealed as the challenge to find a second best situation to minimize inefficiencies. These inefficiencies occur due several aspects such as limited rationality, transactional costs, information asymmetry, adverse selection, moral hazard and hold up issues. The three last issues are consequentially attached to the first ones and vary in intensity according to the degree of intrinsic and extrinsic blanks of the administrative contract celebrated by the Government and the Winner Company.

The Adverse Selection and Moral Hazard are distinguished basically by the fact of the information asymmetry be placed before or after the contractual bound of the parties. The adverse selection in the Brazilian reality can provoke the so called "table game", even though the control organisms raise efforts to deter that practice with relative success. The asymmetry *ex ante* still finds its core on contractual blanks.

It is up to study than the best format to contracts and to establish a better legislation on procurement process in order to give best conditions of competition, searching to really fulfill the principles of public advantage and efficiency.

In Moral Hazard's aspect, the contractual blanks and information asymmetry is still more evident by the production of bad outcomes, execution and contractual renegotiations that imposes absurd transactional costs on construction procurements of Brazil.

These costs are still added with administrative costs when the disputes comes to judiciary, revealing the inefficiency of the system.

It is clear that several information asymmetry can be found in our system of partner selection in infra-structure projects, both by the Procurement Law (8.666/93) anachronism or by the incapacity of the specific legislation (8.987/95 and 11.074/04) to discipline aspects such as transactional costs, information asymmetry and contractual blanks.

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