EUROPEAN PARLIAMENT

Directorate G for Impact Assessment
and European Added Value
Directorate General for Internal Policies

13 June 2013

BRIEFING NOTES – PRE-RELEASE VERSIONS

Detailed appraisal of the impact assessment on rules concerning third countries' reciprocal access to EU public procurement

SUMMARIES (pre-release)

Prof. Dr. Andrea RENDA from CEPS
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has a vast experience *inter alia* in impact assessments and other regulatory issues and published *inter alia* on public procurement.
His briefing is addressing the questions on the impact assessment, put forward by INTA, from a methodological point of view.

Maté VINCZE, MSc in Economics
has a vast record of experience and publications in the fields of public and corporate finance, public procurement, impact assessment and SME related questions.
His briefing is tackling the questions put forward by INTA in view of finding answers substantiated *inter alia* by data-mining in databases relevant.

Dr. Pedro TELLES from Bangor University, UK,
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is a specialist in public procurement law.
His briefing focuses on SME related impacts, thresholds and national legislation.

Prof. Dr. Nicola DIMITRI from the University of Siena, Italy,
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has also a vast experience in public procurement and published on it.
His briefing is analysing the reciprocity and retaliation questions with a game theory approach.

Briefings elaborated at the request of the Impact Assessment Unit of the Directorate for Impact Assessment and European Added Value, following a request of the Committee on International Trade (INTA)

LINGUISTIC VERSIONS
Original: EN

Manuscripts drafted May/June 2013

ANDREA RENDA

EXECUTIVE SUMMARY

Global trade is currently exhibiting a reduction in the relative weight of developed economies (and in particular the EU27) and a parallel increase in the share of emerging economies. Even if for different reasons, both developed countries and emerging countries have developed an interest in a more protectionist approach to trade. The former, facing an unprecedented economic downturn, fear excessive penetration by cheaper, often state-subsidized competitors from emerging countries; the latter are eager to build domestic capacity (as is the case for China's indigenous innovation policy). Since all countries have already taken multilateral commitments to eliminate barriers to trade within the WTO, the domain in which protectionist measures become easier to implement is public procurement, which accounts for 15-20% of GDP in most countries: many emerging countries do not yet adhere to the plurilateral Government Procurement Agreement (GPA), where the EU has officially committed an unmatched percentage of its procurement, estimated at 85%. The US, for example, has not gone beyond 32%.
Against this background, the European Commission proposal envisages the creation of a new instrument, which would allow national contracting entities to exclude goods or service providers originating from non-EU, subject to an *ex ante* notification to the Commission; and would also allow the Commission to launch investigations on protectionist measures in non-EU countries and ultimately adopt restrictive measures against bids originating in these countries, should they refuse to engage in negotiations.

The Commission proposal rests on two main statements: (i) other countries have not committed the same amount of procurement markets in the GPA, and as such are way less open than the EU, which hampers EU interests in these markets; and (ii) the Commission does not have enough leverage in international negotiations, since – given that it already opened all its markets – there is not much more than the Commission can offer as a "bargaining chip" to other countries to trigger reciprocal concessions. **This briefing note claim that both statements – which are the basis for the hole initiative – are highly questionable**.

More in detail:

- **Concerns about lack of participation and official commitment to openness in the GPA have some merit** in light of the recently reported increase in protectionist measures in both developed and emerging economies. **However, the Commission might be overstating this problem for several reasons**: (i) the EU is not as open *de facto* as it claims to be *de jure*; (ii) countries such as China, Japan and Korea feature a level of *de facto* openness that is very similar to that of the EU27; (iii) the GPA revision in March 2012 has seen a significant expansion of commitments; and (iv) regional and bilateral trade agreements, including the ones that the EU is negotiating or about to start negotiating (e.g. the TTIP) can significantly increase procurement openness in the coming years – this also implies that even if one considers only *de jure* openness as the relevant measure, GPA commitments would be a very imperfect proxy.

- **This problem definition leads the European Commission to mis-measure the potential for market opening in third countries**: in particular, the statement that at least 50% of uncommitted Public Procurement in large trading partners is not open is exaggerated. **As a result, also the estimated impact of the preferred option on job creation appears over-stated.** In the era of "global value chains", banning foreign bids might mean damaging EU SMEs: the recent protests by German SMEs against the EU-proposed tariffs on Chinese solar panels, which are expected to lead to a loss of up to 200,000 German jobs, are a clear demonstration of this fact.
- **Due to the representation of the problem, the Commission Impact Assessment ends up miss-evaluating the risk of retaliation and the potential for leverage creation.** The former is much more likely than the Commission seems to assume; and the latter is lower than the Commission thinks since the EU is not the only – and soon, not anymore the most important – trading partner of these countries.

This briefing note also finds that **some aspects of the Impact Assessment would have deserved a more in-depth analysis**: administrative burdens are only tentatively assessed; the 5 million Euro threshold for public contracts covered by the newly proposed instrument is not discussed at all in the IA document; and the IA document downplays the *de jure* and – even more importantly – *de facto* protectionist measures being taken by some EU Member States.

Finally, the Impact Assessment seems to partly or fully neglect three very important issues:

- **Shifting global trade shares** are changing the landscape of international trade;
- **Subsidiarity** should have been addressed more in-depth in the Impact Assessment, as the preferred option shifts competences and powers from the Member States to the EU level; and
- Notably, **the impact of potential higher procurement costs and reductions of competition in procurement on taxpayers** is not fully addressed in the IA document.

The briefing note concludes by recommending that these aspects are taken into account by the European Parliament when dealing with the Commission proposal, and suggests a more accurate reflection on the merit of creating an instrument which would, at once, generate a significant risk of retaliation by large trading blocs, and perpetuate the lack of leverage in international negotiations. The briefing note also suggests that the current lack of leverage might be approached more as a problem of internal coordination of the EU (and thus, an internal market problem), rather than a problem to be solved outside the EU.

MATÉ VINCZE

SUMMARY ASSESSMENT

Undoubtedly, **much work has gone into the Impact Assessment and the findings and opinions expressed are based on solid knowledge**. Extensive research has been undertaken with regard to the country-specific commitments under World Trade Organisation's Government Procurement Agreement (GPA) and the factual situation of European market access in 22 key sectors in 13 key trading partners (partly "covered", partly "uncovered" by international agreements). Elaborate models were drawn up to structure information on the current situation and to dimension impacts; and available - scarce – statistics were duly interrogated.

The disadvantage from the reader's perspective is that **the models used in the document are complex, difficult to follow**. Several Annexes and "methodological boxes" need to be studied to understand what has been done, and the descriptions of the methods are often too short to comprehend, even some gaps were detected here and there. Although this is not customary in an Impact Assessment exercise, interlinked Excel sheets would have helped to follow up the calculations.

A few impacts were not assessed in detail (on SMEs, working conditions, social and environmental criteria), and the impact of a possible reduction of imports and linked supply chain effects on jobs was apparently left out from the calculations.

Dealing with a very complex topic and lacking detailed and robust data, the Impact Assessment **had to strongly simplify, rely on expert judgement and make assumptions to fill data gaps in the calculations**. The judgements assumptions seem mostly reasonable (although some of them may be contested). However, as the estimated impacts consequently rest to a very high degree on them, a **sensitivity analysis to test the impact of different key assumptions or at least range estimates** would have been warranted**.**

The specific findings in relation to the eight topics – elaborated in detail in subsequent sections - are as follows:

1. Openness of EU public procurement market

The selection of the 22 key sectors for the detailed analysis is reasonable. The method used however cannot be seen as robust as it only allows for a very broad classification of market openness, and many follow-up assumptions and expert judgements were made to estimate the impact of the policy options.

A detailed review of the *de jure* openness of the EU's public procurement market – and a comparison with its key trading partners - under these 22 sectors is missing. While the Impact Assessment states that the EU's market is *de facto* open, also for "uncovered" goods and services, there are in practice many possible hidden market entry barriers that can make it very difficult for third-country suppliers to access European public procurement.

It was not possible within the boundaries of the assignment to undertake case studies on the openness of public procurement in 5 European capitals and 5 global cities. However, a review of contracts above the EU-thresholds awarded to third-country economic operators in 2011 reveals that these companies could access directly – i.e. not through EU subsidiaries or dealers – only a very small number of contracts (0.2% of all). Contracts won by third country economic operators include a high number of relatively low value purchases of medical equipment and pharmaceuticals from (predominantly Swiss) specialised suppliers, but also high-value procurement of, for instance, rolling stock, fuels, or academic journals (EBSCO from the US). In terms of value, the league table of third countries is led by Switzerland by a wide margin; the United States and Turkey follow.

2. Potential benefits of market opening

Further investigation of the method used needs to be undertaken. Comprehensive statistical data on contracts won by EU companies in third countries is not available; only Japan has disclosed figures within the WTO GPA framework. Data on infrastructure deals can possibly be procured from a fee-based service, and some countries have accessible national databases which might be interrogated (by people with the right languages skills).

3. Impact on job creation of the different options

The impact of the policy options on job creation is directly derived from the expected change in export volumes (new markets and retaliation), and does not account for jobs created in the EU from substituting imports with

domestic production. The exact method used is not clear and could not be reproduced. As for job creation linked to export volumes, the method is likely to overestimate the impacts for the 12 trading partners analysed, but it does not include the impact from exporting to other third countries.

The assumption that the same level of market opening should be calculated for four options (3A, 3B, 3C and 4) is not unreasonable, but it is of course not possible to give a reliable figure on the extent third countries will effectively open up their public procurement markets during negotiations.

Impacts with regard to working conditions, and the respect of social and environmental objectives are only mentioned in the document but they are not properly assessed.

4. Risk of retaliation and leverage creation

This topic is not assessed here. See the three other expert papers.

5. Administrative burden of assessed options

The method is not well described and hence difficult to follow. The Impact Assessment calculates with a much higher number of notifications than the explanatory part of the Commission's proposal (34-45 notices per year expected). The administrative burden on companies only calculates with €5 per certification of origin, probably not taking appropriate account of the time and effort preparing these. No one-off administrative costs (setting up new procedures etc.) have been included in the calculations and the obligation to contracting authorities to indicate a possible waiver in the standard forms should also be considered an administrative burden.

6. Impact on SMEs

The Impact Assessment contains very little discussion of the impact of the policy options on SMEs. Overall, European SMEs are likely to benefit mostly from import replacement – i.e. supplying EU clients directly or as consortium partners or subcontractors – rather than securing (high-value) contracts on new export markets. Hence policy options that are linked with larger import replacement (3A and 3C) are the most beneficial for them.

7. Justification of thresholds

The suggested threshold (€5 million) in Article 6 of the legislative proposal - exceeding GPA-thresholds for supplies and services by a wide margin – or optional thresholds have not been assessed in the document. Lower threshold may result in a larger share of imports rejected but probably more retaliation (hence relatively beneficial for domestic-market-oriented European SMEs but negative for exporters: especially SMEs but also large enterprises).

8. Existing national legislation restricting access to public procurement markets

This has not been explored here; see the briefing by Pedro Telles.

Pedro Telles

Executive summary

European SMEs tend to bid mostly for public procurement contracts within their home Member State and for small contracts. Participation rates of SMEs in cross-border procurement appear lower than their overall participation on the economy. The Regulation proposed by the European Commission will target contracts over 5 Mio Eur with a view of forcing the opening of public procurement markets in third countries. The direct benefits for European SMEs will be limited if any at all. If indeed public procurement markets are opened in the future, the potential benefits for SMEs will mostly be available through sub-contracting and supply chain opportunities, areas that third countries can easily close down with *de facto* protectionist measures.

Some impacts on SMEs of the proposed Regulation do not appear to have been taken into consideration. Any SME participating directly (tenderers) or indirectly (sub-contractors, supply chain) in the procedure will face transaction and opportunity costs due to the four to eight week timeframes for decisions and any possible legal challenge.

All the solutions proposed by the European Commission could potentially lead to retaliation from third countries and it is impossible to map out their entire scope. Furthermore, irrespective of the solution adopted, it is not certain that retaliation would only happen in the same public procurement markets. It is entirely possible that an aggrieved third country could simply decide to retaliate on other trade areas with direct impact on the European SMEs in that market. This may be biggest risk for EU companies as it could impact export led companies and even the operations of companies inside Europe.

From the perspective of SMEs, other than maintaining the *status quo*, all options considered by the European Commission imply transaction and opportunity costs. However, had the European Commission adopted option 3A (legislative approach without supervision) instead of 3B it would have at least reduced the timescales involved and the number of decisions that may be subject to judicial review. The European Commission could have also considered the option adopted in some Member States of targeting the origin of the bidders and not the origin of the goods or services and again some transaction and opportunity costs for SMEs could be avoided as long as it did not imply a supervision procedure.

The proposed 5 Mio Eur threshold for the Regulation is similar to some of the current thresholds applicable to European public procurement. By covering only a small

number of strategic contracts, it will reduce the transaction costs for contracting authorities and the European Commission but may put at risk the effectiveness of the measure. If the threat is not credible because it is seldom used, how will it force any trading partner to negotiate? On the other hand, by reducing the scope of the application of this measure the risks for retaliation are reduced.

On the Impact Assessment working document the European Commission is forecasting 554 yearly referrals of public procurement procedures. This may prove to be too ambitious, as contracting authorities have no incentive to refer a public procurement procedure to the European Commission. This is due to the fact the costs of doing so are certain, i.e delays in the procedure, risk and cost associated with a judicial review or a weaker field of candidates, wheras there is no obvious benefit for the contracting authority. Therefore it is quite possible the actual number of notifications will be lower than anticipated.

The exception to the previous reservation will probably be strategic or sensitive contracts where the contracting authority may have an interest in having it awarded to a national supplier. In that case, there is a risk the proposed Regulation will be used simply for protectionist purposes and it is as likely that the target of the referral will be either based on another Member State or on a third country.

Some Member States have developed specific "local mechanisms" that led different kinds of national reciprocity clauses: i) excluding suppliers due to their origin (Austria, Italy and Spain); ii) excluding tenders due to the origin of goods (Belgium); iii) exclusion of access to remedies (United Kingdom).

There is no evidence of widespread actual use of reciprocity clauses in the Member States that have them, nor are they a current topic in academic discussions or subject to abundant case law. This lack of evidence of use or interest appears to be the key lesson to be drawn: without incentives contracting authorities will not exclude foreign bidders.

No evidence has been found that the United Kingdom has a reciprocity clause other than an apparent restriction imposed in the access to remedies by suppliers based in third countries. Furthermore, in 2012 the UK Government has spoken against the proposed Regulation in no uncertain terms citing the risk of escalating protectionism.

(Key findings see next pages)

Pedro Telles

Key findings

- European SMEs tend to bid for contracts much lower than the proposed threshold of 5 Mio Eur by the Regulation and they not take part directly in most contracts covered by it. Any SMEs participating in supply chain or sub-contracting roles in tenders subject to the notification procedure would still be affected.
- Cross-border SME procurement participation is limited and Regulation does not address any of the already identified cross-border barriers, as such it is unlikely to have a direct positive impact for SMEs.
- Direct benefits for SMEs from the proposed Regulation other than supply chain opportunities on larger contracts tendered in third countries seem limited and even those are uncertain.
- Inward impact of Regulation has not been thoroughly explored in the Impact Assessment working document and potential impacts not originally forecast can be anticipated.
- Risk of retaliation outside public procurement by third countries has not been taken into consideration. This poses the biggest risk for EU businesses including SMEs
- All solutions proposed by the European Commission could lead to retaliation and other impacts on SMEs, but it is impossible to measure them with precision.
- From a perspective of the transaction costs for SMEs, option 3A (legislative approach without supervision by the Commission) or a system like the one currently in place in Austria, Italy or Spain that targets the origin of the supplier itself would potentially affect less European SMEs. That does not mean that these would be overall better tools to achieve the stated aim of forcing third countries to negotiate access to public procurement.

- The 5 Mio Eur threshold is similar to some of the current thresholds for the application of EU public procurement rules. It will cover a limited number of contracts which may reduce its effect as a credible threat to force third countries to open their procurement markets.
- The proposed threshold seems to be a compromise between having a threat in place and the transaction costs imposed on contracting authorities and the European Commission by being applicable to a small number of strategic contracts.
- A lower threshold would increase the transaction costs for all involved (contracting authorities, direct and indirect suppliers and the European Commission) but at the same time make a more credible threat to third countries. As a consequence, however, retaliation would be more likely.
- The estimated number of 554 notification cases per year seems ambitious. The lack of incentives for contracting authorities to refer a procedure to the

European Commission do not appear to have been tackled. Referring a procedure incurs on costs and downsides that are certain without any visible benefit for the contracting authority.

- There is a danger that this Regulation will be used for protectionist purposes, not only against bidders based in third countries but also bidders based in other Member States, particularly on larger contracts. At a cost, this risk can be minimised by amending the proposed Regulation as to apply the 50% test only to suppliers based in third countries. On the other hand, this would open the door to third country bidders using European companies as "straw men" or complex company structures to sidestep this solution.

- The local mechanisms developed by EU Member States lead to three different kinds of reciprocity clauses: i) excluding suppliers due to their origin (Austria, Italy and Spain); ii) excluding tenders due to the origin of goods (Belgium); iii) exclusion of access to remedies (United Kingdom).
- There is no evidence of widespread use of reciprocity clauses in Member States such as Austria, Italy or Spain. In the first two cases the use seems limited and in the third non-existent.
- The lack of evidence of the use of reciprocity clauses appears to be the key lesson to be drawn from this legislation: without incentives contracting authorities will not be excluding foreign bidders.
- No evidence that the United Kingdom has a reciprocity clause other than apparent restriction imposed in the access to remedies by suppliers based in third countries. Furthermore, the Government has spoken against the proposed Regulation in no uncertain terms.
- National reciprocity clauses (Austria, Italy and Spain) appear to target the origin of the supplier and not the origin of the goods being supplied as it is the case with the proposed Regulation. This approach avoids the risk of being used for protectionist purposes against bidders based on other Member States but can easily be avoided by the creation of subsidiaries or similar strategies.

Nicola Dimitri

Executive summary

This paper aims to contribute to the discussion on the reasons for the possible difficulties in reciprocating open PPM, between the EU and third countries (TCs), and related policy measures the EU could adopt to enhance it. It does so focusing on some main strategic themes underlying the EU and TCs interaction in PPM. Within a very stylised game theory framework, a main message of the paper suggests that, under appropriate conditions, open PPM may be more likely when, in the parties' negotiations, the perspective of contracting authorities prevails on that of the business firms. Indeed, the framework seems to point out that when a business firms-related perspective prevails there may be an intrinsic strategic difficulty in opening PPM, that could lead to their closure, or protection. We then discuss that from a business firms' perspective open PPM could be enhanced when complete reciprocation has value *per se*, for both parties. Such value may originate from mutual economic, relational, advantages coming from other areas of collaborations.
Moreover, we argue that reciprocated open PPM can be the case when both the EU and a TC entertain different, favourable, views on the associated advantages.

Then we discuss how a dynamic perspective can enhance reciprocated open PPM. As an illustration we consider two examples where advantages are cyclical over time, and parties exhibit different attitudes towards future benefits and losses.

The final chapter focuses on the possibility of retaliation by TCs. Indeed TC retaliation could be a possible reaction to the new legal framework enacted by EU to strengthen its position in negotiations and, possibly, enhance reciprocated open PPM. Retaliation may take place also in areas other than public procurement, and could be a risk if the new EU legal framework would restrict access to non-EU companies in non-committed PPM. In particular, as for the question posed by the European Parliament

"Taking into account game-theory - what assumptions can be made about the risk of retaliation for each of the proposed options and possibilities to create leverage for negotiations through this instrument? "

if in negotiations parties would privilege their own business firms' interests, rather than the contracting authorities', the game theory analysis of the paper seems to suggest the following general observation, contained also in the EC impact assessment. Considering the risk of retaliation by TCs only in terms of further protection of their PPM, this is higher the lower the leverage of EU. Such leverage may vary depending upon the current payoff of TC and its final payoff, after the EU regulated access to its PPM is enacted and TC retaliates. More specifically, if the latter is sufficiently low as compared to what TC firms could obtain by reciprocating open markets, then retaliation may be less likely. Moreover the analysis appears to suggest that if the new EU legal framework would restrict access by non-EU firms it is plausible that TC would indeed react, either by opening its non-committed PPM or retaliating and further protecting it.

Therefore, among the policy options considered in the impact assessment by the EC those which, at least in principle, could have a higher potential to exclude non-EU firms may increase EU leverage and induce a lower risk of TC further protecting its domestic PPM.
However, since TC reactions may take place in areas other than public procurement, proper estimates of the overall risk of retaliation should consider broader scenarios than just PPM.

Key findings

- Strategic considerations, based on a stylised game theory approach, can illustrate a fundamental difficulty for opening public procurement markets by the EU and third countries. Such difficulty arises when decisions to open the market are based on the monetary value of the available public procurement contracts, a position reflecting more the interest of business firms.
- An analogous position, and conclusions, arise if decisions are based on the estimated monetary sums that business firms effectively receive, from the contracting authorities, for the awarded contracts.
- Taking the point of view of the contracting authorities, aiming to deliver best value for money, as when savings are maximized for given quality level, the strategic scenario might change. The party with the most competitive firms may tend to take advantage of this position to keep its domestic market closed, or more protected, while the other party open. Indeed, the contracting authorities of the party with less efficient firms may find it profitable to allow external firms to enter their own PPM to enhance higher savings.
- Under certain conditions, also within a business firms' perspective a dynamic framework can favor reciprocated open PPM.
- If open trade is considered to be desirable by the EU, then based on the above considerations our findings seem to suggest that EU policy measures, and negotiation efforts, should try to leverage the value of open domestic PPM rather than further restricting entry.