

Discussion Paper Series



Supporting MSEs to Access Public Procurement Market in Kenya

Peter Njiraini
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Supporting MSEs to Access Public Procurement Market in Kenya

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Kenya Institute for Public Policy
Research and Analysis

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Abstract

Whereas market access remains a major growth factor, most MSEs in Kenya face formidable market-related constraints. Although the public procurement market is huge, estimated at 9.07 percent of GDP (or Ksh 71 billion), it is dominated by large enterprises at the exclusion of MSEs. It was in view of this fact that Sessional Paper No. 2 of 2005 on Development of Micro and Small Enterprises for Wealth and Employment Creation for Poverty Reduction introduced an affirmative policy of reserving 25 percent of all Government procurement and tenders to the MSE sector. However, this policy proposal is yet to be translated into implementable strategies and guidelines. In addition, it is not supported by an enabling business environment and lacks an accompanying legislation, as is the practice in countries with established affirmative public procurement programmes for MSEs. All these shortfalls make it doubtful that MSEs in Kenya would take due advantage of the provisions in the Sessional Paper. This study picks cue from this shortcoming and attempts to tackle the question: How can MSEs be integrated into the public procurement system? There are significant market and institutional failures that discriminate against MSEs in public procurement. The institutional framework is heavily biased towards attainment of efficiencies, transparency and economy of the process at the expense of mainstreaming MSEs into public procurement market. The legal framework has not significantly changed the barriers to their participation. Specific barriers to MSE participation include technical documentation requirements, slow payment, contract aggregation, costly appeal systems, inaccessibility of procurement information, limited capacity, and tender security, among others. On the basis of the foregoing, the paper recommends interventions such as establishing tender advice centers, using sub-contracting incentives, contract break-out and set aside policy, adopting single-point registration, and instituting a Certificate of Competence program. Other suggested interventions include use of electronic procurement, price preference programmes, preference goaling, micro-privatization, establishment of a national guarantee fund, establishing thresholds for sub-contracting, and awarding tenders in terms of a development objective.

Table of Contents

	Abstract	iii
1.	Introduction	1
	1.1 Research Problem	3
	1.2 Objectives, Approach and Scope	4
2.	Concepts and Theoretical Framework	6
	2.1 Definition of Key Concepts	6
	2.2 Theory	7
3.	Procurement in Kenya	13
	3.1 Procurement Methods	13
	3.2 Public Procurement Cycle	14
	3.3 Institutional Framework	18
	3.4 Policy and Regulatory Framework	18
	3.5 Public Procurement Barriers for MSEs in Kenya	22
4.	Case Studies	30
	4.1 Affirmative Procurement in South Africa	30
	4.2 Micro-Privatization in Tanzania	32
	4.3 Targeted Assistance and Institutional Support in India	33
	4.4 Targeted Technical Assistance in Brazil	35
	4.5 Providing Tender Information On-Line In Peru	36
	4.6 Preferential Policy in the United States of America	37
	4.7 Key Lessons from Case Studies	39
5.	Conclusions and Recommendations	42
	References	47

1. Introduction

It is now widely recognized that Micro and Small Enterprises (MSEs)¹ play an important role in the growth and development of countries through job creation and equitable distribution of the benefits of economic development (CBS, ICEG and K-REP, 1999). The sector can also help boost productivity by increasing competitive pressures within the economy. Despite this, the MSE sector is constrained by numerous market and institutional failures (Hallberg, 2000). In Kenya, some of the factors that have constrained the growth of the MSE sector are lack of markets, inadequate capital, shortage of raw materials, lack of secure worksites, information asymmetry, poor infrastructure, inadequate legal and regulatory policies, and increased competition (McCormick *et al*, 1997; CBS, ICEG and K-REP, 1999; Government of Kenya, 2003; Government of Kenya 2005b).

In Kenya, about 34.1 percent of MSEs cite market constraints and the inability to sell their products and services as one of the most serious obstacles to starting a business and sustaining its growth beyond the subsistence level (McCormick *et al*, 1997; CBS, ICEG and K-REP, 1999). One innovative way in which countries are dealing with the MSE market access constraint is by enhancing participation of MSEs in public procurement. Public procurement provides an important market for MSEs and offers them an opportunity to overcome the market constraint. In Kenya, the public procurement market is huge—averaged 9.07 percent of GDP or Ksh 71 billion between 1995 and 2004 (Table 1). Unfortunately, most MSEs are excluded from this potentially large public sector market for reasons attributed to the mistaken perception that small enterprises are unlikely to deliver (McGrath, 2003). This perception partly explains the huge regulatory barriers imposed on MSEs before they can even get a sniff of public procurement contracts. Evidence shows that over 75 percent of MSEs do not participate in public procurement (Ngugi, 2005). This arises out of the simple fact that transactions costs for both the government (buyer) and the seller are higher if the seller is smaller.

Kenya's public sector purchasing procedures and practices tend to lock out MSEs through high volume standards, need for proof of large financial base and other pre-qualification standards (Government of Kenya, 2005a). Other practices such as limited publication of contract opportunities and overly onerous pre-qualification requirements, costly tender submission procedures, and excessive contract aggregation makes it hard for MSEs to participate in the public procurement markets. Narrow pre-qualification

¹MSEs are defined as enterprises employing 1 to 50 people, whether formal or informal. It is important to point out at the onset that this definition is limiting in a study of this nature. This is because the MSE sector describes a diverse range of activities, differing in terms of size, sector, ownership structure and formality.

Table 1: Public procurement size for Kenya (million Ksh)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Total Gov't Expenditure (TGE)*	135,160	152,187	168,403	194,965	197,341	175,120	232,921	226,915	282,365	277,204
Wages & Salaries (QBR)	44,358	47,029	55,159	62,700	64,557	67,048	73,180	81,606	90,469	99,988
Less Interest Payments	31,823	37,245	34,786	37,971	40,055	29,387	31,035	30,384	36,026	29,700
Less Transfers	5,072	5,076	5,659	35,903	35,197	31,630	29,823	33,206	52,772	53,250
Less Net Lending	1,592	2,848	2,476	2,622	3,336	1,880	3,957	1,862	1,799	1,368
Central Gov't Procurement (CGP)	52,315	59,990	70,324	55,770	54,196	45,176	94,927	79,857	101,300	92,898
GDP at Market	465,272	528,740	623,235	694,029	743,479	799,245	878,731	962,686	1,091,640	1,238,970
CGP as % of GDP	11.2	11.3	11.3	8.0	7.3	5.7	10.8	8.3	9.3	7.5
CGP as % of TGE	38.7	39.4	41.8	28.6	27.5	25.8	40.8	35.2	35.9	33.5
TGE as % GDP	29.0	28.8	27.0	28.1	26.5	21.9	26.5	23.6	25.9	22.4

*Total gov't expenditure is net of public debt redemption and is inclusive of military expenditures.

Source: Owegi et al (forthcoming)

criteria that places too much emphasis on past experience of supplying public sector reflect a belief that contracting with larger enterprises is less risky than relying on smaller ones. Such public procurement practices tend to favour the existing, well-established and mostly large enterprises at the expense of MSEs.

1.1 Research Problem

Market access remains one of the most serious constraints to the growth and competitiveness of MSEs (McGrath, 2003; McCormick, 1997; CBS *et al*, 1999; Beyene, 2002). Evidence shows that the problem of lack of markets and increased competition for markets continues to worsen. The 1993 and 1999 baseline surveys show that MSEs citing market constraints were 30.1 and 34.1 percent, respectively. MSEs are unable to sell their products and services due to over production and low aggregate demand within the economy (Government of Kenya, 2005b). Lack of access to appropriate and relevant market information has also meant incurring high transaction costs as MSEs search for alternative markets. With increased globalization and liberalization of the economy, MSEs are facing even stiffer competition from products coming from other countries. This further squeezes the market space for MSEs in the narrow local market, which is characterized by intense competition and low profit margins.

Many countries have responded to the challenge of enhancing market access for MSEs through affirmative policies that increase MSEs participation in government procurement market (Holden, 1998; Letchmiah, 1998). In Kenya, this market is estimated at 9.07 percent of GDP or Ksh 71 billion between 1995 and 2004 (Table 1). However, this market has been dominated by large enterprises while the participation of smaller enterprises has been marginal (Government of Kenya, 2005b). The most recent deliberate Government intervention came through Sessional Paper No. 2 of 2005 on Development of Micro and Small Enterprises for Wealth and Employment Creation for Poverty Reduction, which proposed an affirmative policy of reserving 25 percent of all the Government procurement and tenders to the MSE sector (Government of Kenya, 2005b). However, this policy proposal is yet to be translated into implementable strategies and guidelines. In addition, it is not supported by an enabling business environment and lacks an accompanying legislation, as is the case in countries with established affirmative public procurement programmes for MSEs. All these shortfalls make it doubtful that MSEs in Kenya would take due advantage of the provisions in the Sessional Paper. This study picks cue from this shortcoming and tackles the question: How can micro and small enterprises be integrated

into the public procurement system? Currently, literature on how public procurement can be used to assist MSEs growth in Kenya is nascent. Like other developing countries, public procurement literature in Kenya dwells on efforts to make the process more efficient and transparent (Ikiara, 2001; Odhiambo and Kamau, 2003; Aketch, 2005; and Ngugi, 2005). However, an analysis of how MSEs can be integrated into the public procurement process would benefit the on-going reforms in Kenya's public procurement process and in the MSE sector.²

1.2 Objectives, Approach and Scope

The main objective of this paper is to analyze how MSEs in Kenya can be integrated into the public procurement process. The paper analyses public procurement policies, laws, institutions, procedures and practices with a view to identifying inherent barriers to participation by micro and small enterprises. More specifically, the paper:

- Identifies and analyses potential barriers to MSE participation in Kenya's public procurement process;
- Analyses different countries' approaches to enhancing MSEs participation in their public procurement; and
- Makes recommendations on how MSEs can be integrated into Kenya's public procurement process.

To achieve these objectives, the paper uses descriptive analysis. The study reviews public procurement theories, Kenya's regulatory and institutional framework as well as case study evidence. In particular, the paper reviews various policy documents, public procurement regulations and the Public Procurement and Disposal Act (2005), supplies manuals, Treasury circulars, Public Procurement Guide, and tender documents that relate to Kenya's public procurement process. The paper documents best practices from other countries with a view to understanding how those countries have eased the market constraint among their MSEs through their public procurement system.

Countries studied include South Africa, Tanzania, India, Peru, Brazil and United States of America. South Africa is selected due to its comprehensive approach in assisting MSEs to access public contracts. All else equal,

² The country has just enacted a Public Procurement and Disposal Act, 2005 (Government of Kenya, 2005a). Preparation of a comprehensive public procurement policy is underway (consultations with Director of Public Procurements). Similarly, a comprehensive Micro and Small Enterprises Policy has been formulated (Government of Kenya, 2005b) while an MSE Act is envisaged in the near future.

Tanzania's MSEs are likely to face almost similar conditions as their Kenyan counterparts. Similarly, Tanzania provides a unique case of micro-privatization. The selection of India and United States is based on the fact that the two countries have some of the oldest public procurement policies and practices that have successfully facilitated small business sector growth. The Brazilian and Peruvian case studies are important to balance the sample of countries. It is presupposed that these few case studies will provide general lessons on best practices for MSEs' participation in public procurement.

As pointed out by Enchautegui et al (1997), barriers to MSE participation in public procurement arise from two main sources. First, are the barriers to firm growth and formation that include lack of access to financial capital, social networks, and low human capital – supply-side constraints. Second, are the barriers that arise out of the government's procurement process. This paper limits its analysis to the second approach – the demand side of the public procurement debate. This is justified on the premise that some research has been done on supply-side constraints (for instance, McCormick et al, 1997) but there is limited information on barriers arising out of public institutional failures. It is also acknowledged that some of the efforts aimed at minimizing barriers to MSEs' participation in public procurement could lead to distortions in trade, especially international trade. These issues are beyond the scope of this paper and are therefore not analyzed.

The rest of the paper is organized as follows. Section two provides the theoretical and conceptual framework of the study and reviews the transaction cost, information asymmetry, and market failure theories. Section three reviews the different methods, practices and the institutional structure of Kenya's public procurement system. It highlights various policies, laws and institutions and how they impact on MSEs' participation in the procurement process. This section also identifies and analyses some of the potential barriers that prevent MSEs from accessing government procurements. The fourth section reviews some selected country case studies with a view to distilling some useful lessons. Conclusion and policy recommendations are the subject of section five.

2. Concepts and Theoretical Framework

2.1 Definition of Key Concepts

Public procurement

Public procurement is the process of acquiring goods, services or works, starting from needs identification to contract management and evaluation in the public sector (Wittig, 1998; Owegi *et al*, forthcoming). This definition of procurement includes acquisition activities and those activities before actual purchasing takes place and those activities that come after a purchase has occurred. In addition, procurement includes all logistical activities relating to the movement and control of goods and services through an organization, developing and evaluating bids, negotiating proposals and presenting findings to elected officials (McCue and Gianakis, 2001). It is considered a business process within a political system, which calls for considerations on integrity, accountability, national interests and effectiveness. Thus, core aspects of public procurement process involve attaining efficiency, economy and fairness while at the same time balancing somewhat conflicting national and international imperatives.

Size of public procurement: Although estimation of public procurement size has proven to be difficult due to lack of data and the secrecy surrounding it, there have been some recent attempts to estimate it. According to OECD/ World Bank (2004), public procurement constitutes about 15 percent of the World's Gross Domestic Product. In developing economies, public procurement offers a large domestic market given that over 70 percent of developing countries budgetary resources are channeled through this system. In Kenya, estimates show that public procurement as a proportion of GDP has averaged 9.07 percent (Ksh 71 billion) over the period 1995-2004 (Table 1). Total government procurement as percentage of total government expenditure has averaged about 26 percent in the last decade.

Micro and Small Enterprises

Definition of MSEs varies by country, and is usually based on the number of employees (paid and unpaid workers), the value of assets and turnover (Letchmiah, 1998; DTI, 2005; Biggs, undated)). In Kenya, a Micro and Small Enterprise is officially defined as an enterprise employing between 1 and 50 employees whether formal or informal (CBS, ICEG and K-REP, 1999; Government of Kenya, 2005b). Micro-enterprises have no more than 10 employees and a small enterprise has 11-50 employees. Thus, this study adopts an MSE definition that encompasses both formal and informal enterprises, classified into on-farm and non-farm categories, employing 1-50 employees (Government of Kenya, 2005). Informal enterprises are mainly jua kali micro-

enterprises, often unregistered and in the informal economy, usually forced to stay informal due to harsh legal and regulatory environment.

In Kenya, MSEs play an important role in the growth and development economy. The sector accounts for 75 percent of all new jobs created, contributes up to 61 percent of all wage employment, contributes 18.4 percent of GDP, and constitutes 98 percent of all businesses in the country (KIPPR, 2005). They possess a significant potential to promote economic growth and alleviate poverty among various groups in society. Increased participation of MSEs in public procurement has various benefits. First, they will experience better sales volumes. Second, they will benefit from knowledge acquisition, market information, experience, technology transfers, and management skills. Third, they will establish linkages with large enterprises. Finally, they will be put on government list and enhance their visibility and image.

Fixed cost effects

By their very nature, MSEs are confronted by a number of challenges in order to compete in government procurement markets. Most of these constraints arise out of the effects of fixed costs on MSEs as compared to larger enterprises. Fixed costs comprise a larger component of the total cost for many MSEs relative to those of the larger enterprises. Further, such costs do not vary with the value of the contract. For instance, the cost of pre-qualification or costs of registering as a government supplier pose a greater cost burden on an MSE. A larger firm may be in a position to employ a skilled person to handle government pre-qualification matters, a fixed cost many MSEs may not afford.

In general, financial institutions associate MSEs with relatively high performance and liquidity risks (Rasheed, 2000). Thus, MSEs, unlike the larger enterprises, usually face a constraint of restricted access to finance and are unable to tie their finances in slow-paying government contracts. Tied to this is the common requirement for performance bonds and guarantees.³ Financial institutions normally have very limited faith in MSEs and are unwilling to offer them guarantees.

2.2 Theory

Theory is important in providing insights into why MSEs fail to participate in public procurement. It explains whether the failure of participation is due

³ A financial institution gives a performance guarantee where it warrants that the contractor will perform all the terms of the contract. Under this arrangement, if the contractor fails to successfully fulfill the contract, the guarantor has an option of either paying the government the guaranteed amounts or looking for another contractor to complete the contract.

to systematic differences in the qualifications of the MSEs as compared to larger enterprises. If differences in participation disappear when firms with equivalent qualifications (such as experience) are compared, this could mean that the failure to get government contract is due to limited size or capitalization, pointing to the market failure theory.

However, it is equally possible that participation does not improve even with the control for qualifications such as size and experience, which could point to, for instance, high transaction costs inherent in public procurement processes. Thus, the theoretical review should help us distinguish private market versus public sector barriers to MSE participation. This would in turn ensure that policies targeted at eliminating private market failures are carefully combined with strategies that eliminate public institutional failures. This section highlights some of the arguments underlying participation of MSEs in public procurement.

Transaction costs theory

Transaction costs theory can be useful in unraveling sources of barriers to MSEs' participation in public procurement. Transaction costs include the cost of obtaining and verifying information about the quantity and quality of goods and services, the partner's transactions and the quality of property rights to be transferred, including legal and contractual framework (Helbling, 2000).

Transaction costs derive from three different failures: (i) bounded rationality in decision-making; (ii) opportunism of agents; and (iii) market uncertainty (Bartle, 2002). Bounded rationality is the result of human limitations on the ability to gather and process information. Opportunism is the result of self-interest while uncertainty is the result of unforeseen difficulties embedded in every transaction. Under these circumstances, prices do not provide sufficient information to make decisions. Therefore, additional information is required to help make decisions that produce desirable outcomes. The implication here is that, where contracts, negotiations, monitoring and enforcement are expensive, exchange will be concentrated within groups that trust each other or the incumbent enterprises. By contrast, when information, measurement and enforcement costs are low, exchange can take place over anonymous agents or markets.

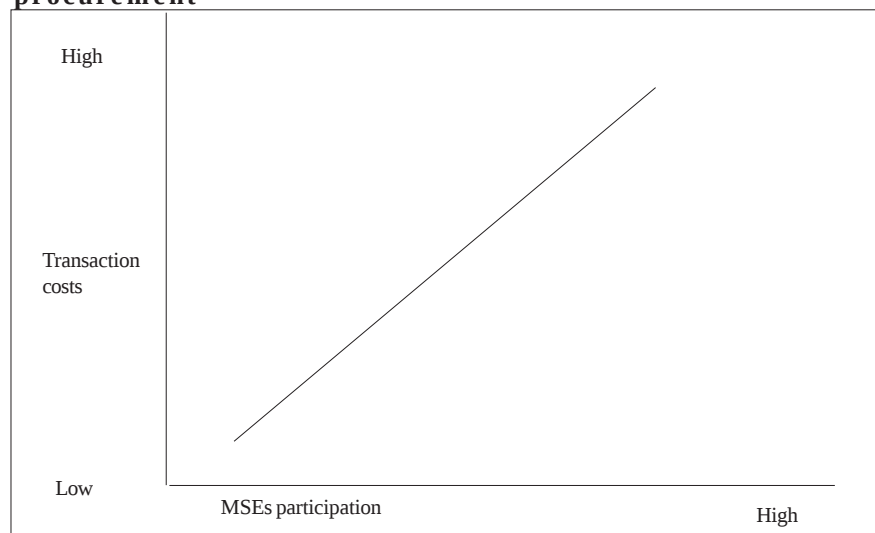
This theory sheds light on institutional and organization efficiency (Bartle, 2002). Cultural, legal, political and institutional factors affect transaction costs by influencing the levels of uncertainty in transactions. An institutional framework conducive to efficient business relations is defined by consensual rules, routines, habits that reduce uncertainty in transactions and that favour business coordination and cooperation. Trust can also be considered a

relational good endogenously created by firms' cooperation and as a by-product of positive interactions between two or more partners. Some institutional frameworks are better than others at reducing transaction costs. Therefore, firms located in areas with institutional frameworks conducive to reducing transactions costs will reap advantages that are not available to firms located in areas lacking such favourable institutional conditions.

In the context of MSEs, transaction costs⁴ relating to public procurement are those costs that the enterprise will incur in trying to access a contract. They are usually unrelated to the actual production costs of the goods or services. Such include the costs of: (i) registration as a government supplier; (ii) preparing a bid; (iii) supplying a performance bond or guarantee; (iv) complying with inspections at various stages; (v) financing goods supplied as governments are notoriously slow payers; and (vi) difficulties of taking legal action against government.

In the context of the government, transaction costs constitute the extra costs that are incurred when dealing with MSEs (Figure 1) that may not be present when dealing with larger enterprises. Such include costs of: (i) evaluating a small bidder; (ii) monitoring many small suppliers rather than one larger firm; (iii) monitoring quality from many small suppliers; (iv) risk of small firm defaults and the associated costs.

Figure 1: Transaction costs and MSE participation in procurement



Source: Holden 1998

⁴ It is noteworthy that not all transaction cost are negative (Helbling, 2000). Certain transactions cost like the cost of registering a business may be useful in enabling an MSE access publicly-provided services. However, if compliance with such regulations and procedures are unnecessarily expensive so as to discourage market oriented economic activities or entrepreneurship then such costs are a negative.

Transactions for both the MSE (seller) and the government (buyer) are lower the larger the size of the seller (Holden, 1998). This implies that smaller firms start at a disadvantage in public procurements. In most cases, these costs systematically exclude MSE from public sector procurement markets.

Information asymmetry theory

The information asymmetry or principal-agent model provides some useful insights into the analysis of the relationship between public procurement agents and MSEs' participation in the process. The principal is the procuring agency (government) while the MSE (the seller) is the agent. New institutional economics, which questions the validity of perfectly competitive markets, assumes that information is usually incomplete, asymmetrical and costly to acquire. Thus, there are risks in undertaking transactions and information can only be acquired at a cost. The theory depicts the problem of procurement as that of ex-ante asymmetric information coupled with moral hazard (Mattoo, 1996; Bajari and Stephen, 1999). This arises out of the fact that public agencies cannot observe the current and expected costs of any firm. This is worsened by the problem of moral hazard on the part of the procurer, who is unable to screen the agent to establish the probability of default (Mattoo, 1996). Important too is the welfare cost of the abuse of discretion by the procurer or the collusion of procurer and the supplier.

Proponents of these arguments, therefore, argue for increased competition for public tenders through such strategies as increasing the participation of MSEs. Such competition is likely to ensure that the scope of monitoring and enforcement of procurement decision by public agents is shifted from the dispersed taxpayers, who are the main principals, to several competitors (MSEs) bidding for contracts. This would in effect check the discretionary powers of the procurement official.

Obtaining information on public procurement markets is usually a relatively costly undertaking for MSEs than for large enterprises (ITC, 1998). Thus, the problem of asymmetrical information may imply that public agencies can minimize their public procurement costs by choosing large suppliers that are relatively less costly to monitor. In Kenya, informed middlemen have exploited this information asymmetry by taking orders and then sub-contracting different MSEs to produce for them to deliver as producers (Kamau, forthcoming). A likely outcome of this is to cut the profit margins for the sub-contracting MSEs as well as for the public agency. Thus, lowering of costs of information would be expected to enhance participation of MSE in government contracts. Governments can assist in this regard through use of efficient and appropriate information dissemination

mechanism, and lowering of the fees on required procurement documentation.

Market and institutional failure

Markets are institutions that exist to facilitate reduction of costs and risks of carrying out transactions. However, cases of market failure abound in cases where information is asymmetric and where high entry costs act as barriers to entry. In Kenya, public procurement institutions have until recently remained widely dispersed with no unifying legal framework. This has led to disproportionately high costs and risks for MSEs wishing to participate in the public procurement process.

Market failure also abounds in financial markets when the difficulty or high cost of obtaining information on borrowers in the financial markets causes financial institutions to ration borrowers from the markets rather than leave this function to the interest rates (Biggs, undated). MSEs being rather information-intensive are generally the first to be rationed from the credit market. This constitutes a major source of market failure. Thus, MSEs are unable to compete fairly for credit, securities or bonds that are a prerequisite in penetrating public procurement.

Under the market and institutional failure view, it is important to distinguish barriers arising out of the private market and those due to failure of the procurement process itself. As Enchautegui et al (1997) have argued, policies aimed at correcting private market failures only without reforming the government procurement process itself may not efficiently reduce barriers rooted in the government procurement practices and procedures. Policies should, therefore, be targeted as barriers that have the largest impact in assisting MSEs.

A synthesis of the theories

Table 2 provides a theoretical analysis of sources of barriers from the perspectives of the three theories.

From the analysis on Table 2, it is evident that overcoming barriers to MSE participation in public procurement points to the need to correct institutional and market failures that are normally inherent in any public procurement process. Certain institutional frameworks, such as formation of MSE consortia, present a good opportunity to reduce transaction costs for both the government (principal) and the MSEs (agent) and thus facilitate enhanced participation of MSEs.

Table 2: Theoretical analysis of MSE participation barriers

Type of Barrier	Principal-Agent Logic	Market/ Institutional Failure Logic	Transaction Cost Logic	Lessons for Policy
Demand-side barriers	- Principal's intention is to improve transparency in the process. Another intention is to limit possibilities for abusing the discretionary powers conferred to public procurement officers. - The principal does not avail all information that is used for tender adjudication while it is not in the interest of the agent to reveal information about their capability. - Prices fail to reveal the actual costs incurred by the principal/ agent. - Principal's intention is to cut cost by buying in bulk. Due to information asymmetry, the principal becomes risk averse, thus requires tender security.	- Laws and procedures are overly concerned with transparency at the expense of socio-economic goals (poverty alleviation). - Bureaucracy generates loopholes for rent-seeking. - Lack of institutions to assist MSEs overcome some of the legal barriers. - Weak institutional framework to publicize tender information. Size of MSEs and their resources means they are disadvantaged. - Formal financial markets discriminate against MSEs. Delayed payments by government disproportionately affect MSEs' working capital.	- Complex contract forming regulations, pre-qualification requirements and onerous documentation create disadvantages for MSEs. - MSEs incur higher cost relative to larger firms in the search for public tenders' information. - Principal relies on the incumbent to minimize risk and search cost. - Transactions costs are considerably reduced by the public entity when it engages in contract bundling. - Transaction costs for MSEs are high due to information asymmetry, lengthy appeal system and financial market failures.	- MSEs can reduce the transaction costs by organizing themselves into consortia, thereby overcoming the fixed cost effects. - Design interventions that reduce information asymmetry, including information databases, credit reference systems and so on. - Promote sub-contracting arrangements. - Design interventions that reduce transaction costs for government and MSEs. - Public procurement system should create in-built measures to lower corruption. - Preferential policy interventions hold the key to mainstreaming MSEs into public procurement.
Supply-side constraints	- Both the principal and the agent are concerned with the cost of skilled labour needed in public procurement. - MSEs' capacity to supply is weakened by poor information in markets for input markets.	- Inadequate technical skills in public procurement markets and lack of specialized institutions to assist MSEs with procurement tasks. - Involvement of more MSEs raises the transaction costs of evaluating several bids.	Due to fixed cost effects of hiring procurement skills, MSEs are disadvantaged.	Design institutional interventions that strengthen MSEs' access to input and financial markets.

3. Procurement in Kenya

This section traces the nature and sources of barriers to MSEs participation inherent in Kenya's public procurement process. This is done through analysis of methods, procedures, policies, regulations and the institutional framework governing public procurement in Kenya. The section analyzes the procurement system in the context of transaction costs, market or institutional failure and the principal agent logic.

3. Procurement Methods

The method used to procure public goods can have a significant impact on participation of newer or smaller businesses (Eagan, 2005). The type and value of the contract are important factors that determine the method of solicitation. Thus, public procurements are generally carried out using different methods. These range from complex, costly tendering methods like open tender, restricted tender to less complex methods like invitations for quotations and proposal and direct sourcing.

- In Kenya, open tendering is the most used tendering system. It normally happens at two levels: (i) Open national tendering, which is open to participation on equal terms by all providers through advertisement. It mainly targets domestic firms although foreigners are allowed to participate; (ii) Open international tendering is also open to participation on equal terms by all providers but it specifically seeks to attract foreign firms. It is mainly used where national providers may not provide competitive bids (Odhiambo and Kamau, 2003). Open tendering is usually advertised in prescribed national or international newspapers, although media advertising is an expensive undertaking for public entities (such as public schools). The effect is that public tender information is not easily accessible.
- Another method is restricted tendering, whereby bids are obtained directly without open advertisement. The method is used where the value or circumstances cannot justify open tendering process (Odhiambo and Kamau, 2003). In such a case, the procuring entity uses its database of pre-qualified providers who are directly invited to tender. However, the procuring agent must demonstrate that open tendering is neither viable nor prudent. Lack of transparency in this method and the fact that most of MSEs rarely find themselves in the pre-qualified lists means that this method tends to act as a barrier to their participation in public procurement.

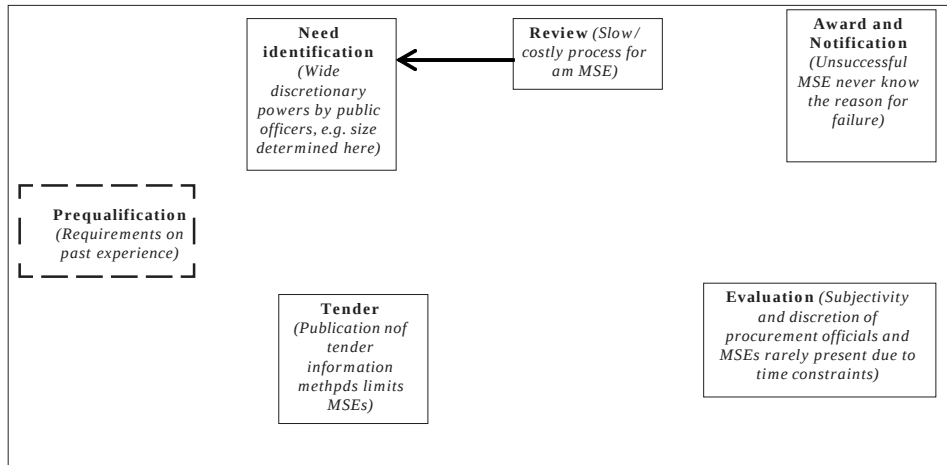
- An invitation of quotation and proposal is another simplified tendering methodology where the procuring entity calls for quotations or proposals. Request for quotations should be addressed to no less than three or more candidates. For MSEs, this raises the problem of incumbency, limiting MSE participation. This happens where the procurement agents seek to limit transactions costs, thus preferring to contact the firms that have a proven track record.
- Finally, direct or single source method is used where circumstance do not allow for competitive bidding. It is used for small quantities in cases where time may not allow for competitive bidding. However, as Eagan (2005) argues, this type of contract is conducted through informal networks. He argues that it is usually more difficult for MSEs, compared to larger enterprises, to have informal access to purchasing agents or departmental heads. Buyers rely on their own lists to solicit vendors in practice, which constitutes a barrier to small businesses, especially the new entrants. This method also makes it difficult to monitor the participation of MSEs as the buyer may not keep records of the purchases.

Restricted and open tendering methods are frequently used in the acquisition of capital goods and complex services. The methods are complex, time consuming and bear big transaction costs. Invitations for quotation/proposals and single sourcing/direct purchase are carried out for goods and services for maintenance and small items. They are simple, price-driven, with simple specifications as well as numerous competing suppliers (Talero, 2001).

In actual practice, government procurements tend to be skewed towards tendering methods. This is due to legal requirements that seek to make the process transparent and less fraud-prone. However, the overall effect is to make the process more complex, contract forming, time consuming and expensive. This way, most MSEs are discouraged from participating in the process.

3.2 Public Procurement Cycle

Procurement of government purchases proceeds in three general distinct stages namely: (i) tendering; (ii) evaluation; (iii) award and notification and review. However, in practice, most procurement processes are characterized by other subsidiary stages that have important implications for MSEs' participation. These include the needs and specification stage and the pre-qualification stage as shown in Figure 2. According to Enchautegui *et al* (1997), this process of public procurement presents barriers to participation of small enterprises.

Figure 2: Procurement cycle and MSE barriers

Needs identification and specifications

→ In this initial stage, the procuring agents exercise substantial discretion in the design of contracts that can promote or inhibit MSE participations. The scale and scope of the public contract is done at this stage. The inability or unwillingness to break contracts down into sub-tasks can have an intentional or un-intentional exclusionary effect for MSEs. In practice, public procurement officials may draft unnecessarily restrictive specifications or designate a contract as restricted tendering type at this stage, which is rarely open for scrutiny (Ngugi, 2005). Specifications are also used at times to unnecessarily increase the costs of participation for MSEs. However, this is important in cases where certain standards such as health and safety need to be adhered to. These tactics are aggravated by the limited access to networks with government officials by MSEs as compared to larger enterprises.

Tendering stage

At the tendering stage, the government makes a decision to purchase certain goods or services. It therefore notifies the supplier(s) of its intention to purchase. It normally specifies the type of goods it wishes to buy and the manner in which they should be produced. Three main procedures, namely open, selective and limited-tendering procedures can be used. As a requirement, dissemination of tender information is usually done through two main daily newspapers. Publishing bid information in newspapers often

does not make it readily accessible to MSEs (Holden, 1998). It is beyond the capacity of many MSEs to undertake time consuming and expensive examination of various sources of information. It is also expensive for government to place this information in the main daily papers. Thus, MSEs are locked out due lack of information on government tenders.

Pre-qualification stage

Under open tender, an interested domestic or international supplier can tender. In selective procedure, only those pre-qualified firms can submit a tender. The pre-qualification procedure is mostly an additional step that requires a firm to demonstrate the potential to deliver goods of required quality in the time specified (thus the dotted lines in Figure 2). This discrimination depends mostly on the discretion of the procuring officials. It is at this stage that many small firms or MSEs are at a disadvantage due to various constraints facing them in terms of limited capital, credit, and qualified personnel, among others. Furthermore, many MSE lack a track record of supplying such goods or services in the past. Because of this, they are hard pressed to show their ability.

Tender evaluation stage

Evaluation of tenders is often a very subjective exercise as many of the factors due for consideration are not quantifiable, such as non-price factors like quality of goods and quality of after sale service. Procurement officials also adjudge reliability of suppliers at this stage. It is at this stage that price preference judgments are made. Procuring officials check for whether firms bidding exceptionally low bids have the capacity to complete contracts if awarded to them. Most MSEs fail to attain most of the required (subjective) factors and are therefore locked out even at this stage.

Tender award, notification and review stage

Once the tender is evaluated, the winner is awarded and notified while those that have failed are also notified. Since the awards can at times be quite subjective and firms not succeeding may require to appeal, the government has established review procedures that enable firms to challenge decisions of procuring officials. The review process for an individual MSE can be a daunting and expensive process in countries like Kenya where the appeal system is quite centralized and slow in dealing with cases. Evidence shows that even though there were 121 appeal cases in 2002 and 2003, only 76 cases were handled (Government of Kenya, 2004).

Table 3: Institutional framework for procurement in Kenya

Institution	Key functions	Issues of MSE participation
Public Procurement Oversight Authority	• Ensure compliance with procurement procedures • Monitor public procurement system functioning and report to the Minister for Finance • Assist in implementation of public procurement system	• This is the technical arm that should guide public procurement throughout all public institutions. However, issues of capacity given the expanse and the shortage of professional skills in public sector could impact adversely on the performance of these functions • Public procurement system in Kenya suffers from limited skilled human capacity (Government of Kenya, 2004). Implementation of complex and technical MSEs participation programmes may not be effectively administered in an environment with limited skilled human capacities
Public Procurement Oversight Advisory Board	• Advise the above authority on the performance of its functions • Approve the authority's revenue and expenditure, and appointment of its Director	• The Act fails to name the organizations from which nine members of the Board will be appointed. For instance, appointment of a member from an umbrella MSE association would be very useful in efforts to lobby government to increase MSEs participation in government tenders
Public Procurement Administrative Review Board	• Reviewing complaints by bidders or by procuring entity against decisions of the Oversight Authority or from persons debarred by Director-General from participating in procurement for breach of procurement rules	• Secretariat of the Board has limited capacity resulting into piling of cases • The fact that the Oversight Authority is expected to provide administrative services to the Review Board could result in institutional conflicts
Ministerial Tender Committees	• Review tender documents and request for proposals] • Approve bids through open tender • Approve variations of contract conditions	• Public officials dominate these committees • Representation from MSEs through their associations or an MSEs public agency like the proposed NCSE could be useful to ensure they influence the proportion of contracts going to MSEs
District Tender CommitteeSchool Tender Committees	• Award tenders • Review tender documents and approve variations	• Most MSEs operate at these regional levels and yet they are not represented in these committees

Source: Public Procurement and Disposal Bill 2005, and own analysis

Given the foregoing, it is quite evident that public procurement cycles involve several different stages. Such numerous stages provide opportunities for rent-seeking as competing MSEs attempt to go round some of the onerous requirements. In countries like India, small-scale industries have been exempted from some of the requirements of the tedious process without any effects of integrity of the process. Thus, there are opportunities in Kenya for waiving some process requirements to enable MSEs participation in public contracts. This is especially so in the pre-qualification stage that normally knocks out most MSEs.

3.3 Institutional Framework

A key determinant of transaction costs in any country is the quality of institutions (Hallberg, 2000). A well-designed institutional framework provides a predictable and conducive business environment at a favourable cost, thereby facilitating compliance. Currently, Kenya's public procurement is guided by regulations contained in the Public Procurement and Disposal Act 2005. The Act provides for the setting up of various institutions that are responsible for handling public procurement as indicated in Table 3.

In general, the public procurement institutional framework is heavily biased towards attainment of efficiency, transparency and economy of the process. There is little evidence of opportunities given to institutions that would assist MSEs to access government tenders. This is unlike South Africa where government institutions like NTSIKA operate Tender Advice Centers (TAC) to advise MSEs on how to access public procurement, and are recognized within the public procurement framework.

Under the current institutional framework, there was an attempt to mainstream the private sector through representation. Unfortunately, private sector representation is not equal to MSE representation. Membership of the above committees is usually drawn from public officials, who may not necessarily appreciate the role of MSEs in the economy and how they can be promoted through participation in public procurement. Institutional capacities in terms of skills and conflicts as noted above are also likely to impact negatively on MSEs' participation.

3.4 Policy and Regulatory Framework

Despite small enterprise support policies, the overall economic policies are still often biased in favour of larger enterprises (ILO, 2002). For instance, the cost of registering and complying with regulations, relative to the enterprise's turnover or profits, is often higher for small enterprises than for larger ones. Even though small enterprises may often lower their costs by

evading tax and labour obligations more easily than larger ones, this may imply constraints on the access to markets, credit and services.

Public procurement policies

Available literature in Kenya indicates that, there is as yet no comprehensible policy on public procurement. Until recently, the Supplies Manuals and Treasury Circulars have provided the guiding principles for the procurement processes. For instance, the 1978 Supplies Manual provided the basic principle of public procurement as “the right item delivered at the right condition and place and at the right price and time”. However, as Wittig (1998) has argued,

Table 4: Selected Treasury circulars impacting on MSE participation

Treasury Circular	Thrust of the Circular	Likely impacts on MSE participation
No. 18 of 6 December, 1961	Provision of Common User Items (non-specialized like stationery, typewriters, duplicators) to be provided by Government Printer ⁵	This limits the size of government procurement market available to MSEs. Most MSEs in Kenya (64%) are involved in trade of such commodities and it is possible that they could provide more innovative and competitive products
No. 2 of 17 February 1970	Directed officers to make use of police aircraft instead of procuring private services	Potential impact is unclear since it is debatable whether a firm offering air transport services would qualify for an MSE
No. 10 of 13 April 1971	Standardization of request for quotation forms	Where there are standardized documents, participation of MSEs is usually enhanced. The form should also have made it possible to monitor MSEs participation
No. 15 of 26 November 1973	Institutionalization of Ministerial Tender Boards	Composition of the boards was dominated by public officials
No. HAS13.011 (24) 13 April 1987	Directed that repairs of government vehicles and mechanical plants should be done at the Ministry of Roads and Public Works workshops	This denies MSEs running motor vehicle garages access to a large public sector market. This is in spite of the unsatisfactory services offered by this government unit (Government of Kenya, 2004)

Source: Government of Kenya (2004) and own analysis

⁵ Government Printer is a government institution that provides printing services to the central government.

interpretation of “right” item/price/time can be very subjective. For instance, should the government pay a premium to assist small enterprises? In Table 4 we highlight some of the Treasury circulars to illustrate how they could have impacted on participation of MSEs in government contracts.

From the above selected circulars, it is clear that there has been no deliberate policy to increase participation of MSEs in public procurement markets. The use of Treasury circulars suffered from the weakness of ad-hoc policy that changed at the discretion of the public official issuing the circular. Procurement policy was for a long time not codified into one coherent document. Evidence from the circulars shows that the government concern lay with the economy, efficiency and transparency of the process.

Evidence elsewhere indicates that public procurement provisions have existed that allowed for 10 percent preferential bias in district tenders to materials and bidders from within the district (Ikiara, 2001). The main objective of this policy was to give local national enterprises a competitive edge as well as to promote use of local materials. As a way of enhancing competitiveness of indigenous firms, a similar and related policy granted indigenous enterprises a 10 percent preferential bias in procurement contracts involving national and international bids and where funding was 100 percent from government. This policy was, however, not applicable for contracts partially or fully funded by development partners. It is important to note that these policies make reference to local, national or indigenous firms as opposed to MSEs. Thus, it is likely that such preferential treatment benefited non-MSE firms who may not have required such benefits, raising questions of equity of such programmes.

Current policy objectives of Kenya’s procurement policy may be inferred from the Public Procurement and Disposal Act 2005. It defines the objectives of public procurement as follows:

- Maximizing economy and efficiency;
- Promoting competition and ensure that competitors are treated fairly;
- Promoting the integrity and fairness of those procedures;
- Increasing transparency and accountability in those procedures;
- Increasing public confidence in those procedures; and
- Facilitating the promotion of local industry and economic development

Thus, the current objectives or principles of public procurement concentrate on attainment of good governance, transparency, and value for money. The last objective is treated rather minimally and with a lot of uncertainty in Section (39) of the Act.

In the current Sessional Paper on MSEs (Government of Kenya, 2005b) the government has committed 25 percent of its procurement budget for the MSE sector. The Ministry of Finance is, therefore, required to adjust public tendering procedures to promote participation of MSEs in the procurement process. For large tenders, the government will encourage the MSEs to form consortia that are capable of registering group bids. Among other efforts, the government intends to use MSE associations to enter into sub-contracting and supply contracts.

Though this policy document has good intentions, it is inadequate.⁶ First, the establishment of 25 the percent goal is not based on any objective analysis, thus putting doubts on how every public institution will contribute towards this goal. Secondly, implementation of such a specific goal also needs to be implemented through a specific legal framework. However, the Public Procurement Act 2005 has not set such a specific goal but rather adopts a preference margins and reservations approach (Government of Kenya, 2005a). This shows a clear disconnect between the policy and the legal framework and hence the possibility of low policy implementation. Strategies on how MSEs can overcome problems of delayed payment and access to government tender information are not tackled by the policy. This would have been important as currently there is no cohesive policy on public procurement.

While Kenya has recognized the importance of small enterprises and formulated small enterprise support policies, the overall economic policies are still often favouring large enterprises over smaller ones. Small enterprises often have to incur unnecessarily high costs to comply with laws and regulations. To create a level playing field for enterprises of different sizes, regulations should be clear and the process of implementation transparent and fair. Lowering the costs to establish and operate a small business and increasing the potential benefits of registration may be an effective strategy for integrating smaller enterprises into the formal economy. This enhances their potential for creating more and better jobs

⁶ Evidence in Europe shows that in spite of government's policies of providing maximum practicable opportunities to MSEs participation in public procurement, the share of public contracts remains low at less than 25 percent (Marechal and Morand, 2004). The participation rates vary by countries. For instance, in Sweden, Italy and Portugal the percent of MSEs trying to participate in government tenders is lower than 10 per cent whereas in France it is 45 percent. In Belgium and Luxembourg, about one third of MSEs attempt to participate. The most cited reason for the failure of MSEs participation in the public procurement contracts is that the projects are usually too large for these small enterprises.

Legal framework

A well-defined legal framework is instrumental in the implementation of public procurement policies as it sets key parameters for government purchasing, including procurement methods, tender information publication, tender security and tender payments (Eagan, 2005). In this section (Table 5), we analyze the existing legal framework and how it would impact on the participation of MSEs in public procurement.

In summary, the above law on public procurement fails to mainstream MSEs into the public procurement market. Most of the barriers that arise out of contract aggregation, past experience, qualifications, bidding fees, and slow payments, among others, almost remain intact. What the law has achieved is to provide a comprehensive legal framework for the larger enterprises to continue doing business with the government.

3.5 Public Procurement Barriers for MSEs in Kenya

As noted in the previous sections, MSEs by their very nature are confronted by a number of constraints, inhibiting their ability to compete in government procurement markets. Most of these constraints arise out of the effects of fixed costs on MSEs as compared to larger enterprises. In the next sub-section, we identify key barriers facing MSEs in the public procurement in Kenya.

Technical documentation

In Kenya, the barriers to entry for MSEs into the public procurement are quite evident from the standard tender documentation by the Directorate of Public Procurement (Government of Kenya, 2002). For instance, tenders involved in procurement of “small works”⁷ are expected to provide:

- A certificate of registration,
- Monetary value of construction work for the past five years,
- Five year past experience of works of similar nature and references, equipment owned,
- Experience and qualifications of technical personnel, and
- Five year audited financial reports.

⁷ This includes buildings, roads, bridges, repairs and maintenance whose value does not exceed Ksh 5 million.

Table 5: Public procurement legal framework

Act	Provision	Observations
Public Procurement and Disposal Act 2005	In Section 39 the government seeks to provide opportunities for MSEs to participate in public procurement through preference and or reservations	- Preferences and/or reservations are to be prescribed by the Minister responsible for financial matters. As Ngugi (2005) argues, it would be more effective for the participation of MSEs to be explicit in the Act and to avoid the wide discretion by the Minister - The provision also provides for MSEs and disadvantaged groups. However, the definitions of these terminologies remain ambiguous – leaving room for abuse - Implementation of this provision is left to public procurement officers and is likely to suffer problems of moral hazard under the principal-agent logic - It is also important to note that preferences almost always result into market inefficiencies
	Section 30 prohibits splitting of contracts to avoid a procurement procedure	This provision is likely to act as an incentive for contracts bundling, which acts as a barrier to MSEs participation
	Section 31 provides the qualifications criteria for an entity to participate in public contracts as: (i) Have necessary qualifications, capability, experience, resources, equipment and facilities (ii) Have legal capacity to enter into a procurement contract	- While these requirements are important in ensuring quality and timely performance, some like past experiences and capability are subjective and have been used in the past as barriers to MSEs participation - Since most MSEs are informal (meaning that they are unregistered), the requirement of legal capacity will keep them out of public contracts
	In Section 48 on delayed payments, the Act provides for payment of interest by the procuring agent. The amount of interest will be in accordance with prevailing bank rates	- This provision introduces some ambiguity. It would have been more feasible to give a rate that is above a given percentage of prevailing banking rate - It would also be important to fix a maximum number of days within which payment must be made for various categories of contracts to ensure fairness across the board
	Section 54 (2) provides for at least two times advertisement in a newspaper of nationwide circulation, on procuring agency's website or on the procuring agency's premises	Newspapers are rarely the main sources of information for MSEs. At the same time, the low internet penetration makes internet a less effective as an instrument to access public tender information
	Section 56 (2) allows procuring entities to charge fees for the tender documents	Such fees tend to act as barriers to MSEs participation
	Section 57 allows procuring entity to require tender security. It allows the agency to decide form of security	MSEs are rarely able to obtain such securities from financial markets. This locks them out of government contracts

Source: *Public Procurement and Disposal Act 2005, and own analysis*

In addition to the above requirements, the tender documents comprise additional documents including: (i) instructions to tender, (ii) form of tender, (iii) conditions of contract and appendix to conditions of contract, (iv) specifications, (v) drawings, (vi) bills of quantities/schedules of rate and so on. The firms have also to reveal information about themselves that they would not otherwise reveal when dealing with private sector. All this implies varied costs for varied firms. Requirements like experience and qualification of technical staff are likely to act as a constraint to MSEs as they face impediments to accessing high level skills. The search for such skills is a fixed cost that is comparatively more expensive for MSEs (ITC, 1998).

Slow payment cycles

As Letchmiah (1998) points out, cash flow is a critical issue for smaller enterprises' survival. Such enterprises are unable to obtain sufficient credit or surety to finance a procurement contract for more than just a few weeks. They are unable to pursue debt collection beyond the usual delivery of an invoice and are not in a position to pursue delayed payment in formal proceedings. At times, the complexity of some procurement contracts, especially the ones requiring consideration of the cost of performance in determining the price may result into a slow payment process.

Empirical evidence on slow payment cycles is only emerging. For instance, Kamau (forthcoming) has shown that 31 percent of suppliers to public institutions did not receive prompt payment for their supplies. Another 26 percent of respondents in the study indicated that they would only be encouraged to participate in the procurement process if payments are prompt and corruption is eliminated. Despite the government's move in the 1980s to award government contracts to MSEs (Government of Kenya, 1986), MSEs could not cope due to a lengthy payment process.⁸ MSEs require a fast enough payment system to sustain their working capital and sales. The 1999 Baseline Survey shows that 18.4 percent of MSEs experience a serious constraint of shortfall of working capital. For such enterprises, the slow process of payment is a major hindrance to participation in public contracts.

Public procurement regulations in Kenya require that clear provisions for payment should be included in the tender documents and interest should accrue on overdue payment (Government of Kenya, 2002). The Procurement Act (Government of Kenya, 2005a) Section 48 also requires procuring entities to pay interest on overdue amounts. The interest payable will be in accordance with the prevailing bank rates. This is unlike in other countries like India

⁸ KIPPRA MSE training workshop discussions, Embu, 1st March 2005.

and United States where the interest charged is explicitly specified in the legislative Acts⁹ as a given percentage above the banking rates. The Act also fails to recognize delayed payment that arises from the sub-contracting agreements whereby prime contractors delay paying the sub-contractors.

Contract aggregation

One of the key objectives of any public procurement is to achieve value for money. However, how procuring entities go about achieving this objective may impact negatively on MSEs. A major practice arising out of this objective is contract aggregation or contract bundling in order to achieve economies of scale. The procuring entity may opt to deal with one prime contractor. Public entities tend to bundle the quantities being sought through public procurement as they seek to minimize the transactions cost. Dealing with a few contracts and fewer contractors enables government entities to take advantage of quantity-discounting strategies. Though the law in Kenya prohibits splitting of procurements with an intention of avoiding use of a certain procurement procedure (Government of Kenya, 2005a), it is silent on the common practice of government in aggregating public tenders.

In Kenya, most government ministries invite tenders for pre-qualifications of numerous goods and services at the same time, especially at the end and beginning of the financial year. Obviously, this constitutes a barrier to MSEs' participation since they are not able to meet the costs in terms of time and finances. Advertising several items at once (see Box 2 where 128 items were advertised) is justifiable in the context of the principal – via low transaction costs. However, from the viewpoint of MSEs, they cannot apply for most of the advertised tenders due to time and resources constraints. The fact that the tender items are advertised once limits the items that an MSE can apply for.

Costly government procedures

The bureaucratic and lengthy process of transacting businesses with government departments affects the operations of MSEs through high transaction costs (Government of Kenya, 2005b). The requirement in the Procurement Act that bidders aspiring for a government contract must have legal capacity to enter into contract for procurement locks out many MSEs that are not legally registered. For instance, tender documents for a Ministry of Planning and National Development (Ministry of Planning and National

⁹ In India, the procuring entity is liable to pay interest for delayed payment to MSE at a rate of 5 percent higher than the prevailing bank rate if payment is delayed for more than 90 days.

Box 1: Ministry of Gender Sports, Culture and Social Services pre-qualification for supplies, 2006

The above tender invited firms for the pre-qualification of supply of 21 tender items. Features of the tenders are:

- Payment of non-refundable fee of Ksh 2,000 per tender item
- Pre-qualification documents available in Nairobi head office

Mandatory documents from all applicants include:

- Kenya Revenue Authority Registration Certificate
- Valid Trade or Business License
- Valid Kenya Revenue Authority Tax Compliance Certificate
- Certificate of Registration or Incorporation

Source: Daily Nation 13 July, 2005, p.26

development, 2005, Box 1) puts a mandatory requirement that “a firm seeking pre-qualification must be a registered firm in Kenya with a certificate of registration”. This is in addition to requirements for trade licenses, VAT registration and Personal Identification Number (PIN). There are substantial nominal costs for MSEs in registering and qualifying for government tenders. In Kenya, registering a business is a long and costly process. Evidence shows that over 16 percent of Kenyan small enterprises find obtaining business licenses and operating permits to be a major or very severe constraint (KIPPRA, 2003). If a firm cannot produce a legal business registration, it cannot be included in the list of procuring entities.

From Box 1, it evident that government procurement contracts may remain beyond the reach of MSEs as many of them are not registered, do not have trade or business licenses, and may not comply with tax requirements. The requirements summarized above by the procuring entity are in addition to various other requirements. These include the requirement to purchase the pre-qualification documents from one central place in Nairobi, which means additional costs to firms that are located far from Nairobi. This is only at the pre-qualification stage, meaning that there is no guarantee that a firm will even be allowed to tender.

Costly appeal system

The cost of seeking legal recourse against the government and dispute resolution or litigation are relatively high. According to KIPPRA (2005), the cost of enforcing contracts for businesses takes on average 25 procedures and 360 days. Many MSEs constrained by human and financial constraints cannot afford such costs. Unlike large enterprises, MSEs are unable to hire

legal experts due to the fixed cost effects. Such high costs prevent MSEs from seeking legal redress, in cases of slow payments.

Inaccessibility to procurement information

The various stages in a procurement process illustrate locations of particular barriers to MSEs accessing government contracts. For instance, MSEs find it difficult to get information on contract opportunities that are below the prescribed threshold for national advertising. The law requires procuring entities to advertise their tender requirements in at least two daily newspapers of nation-wide circulation or in their websites, where they have a website (Government of Kenya, 2005a). This requirement is, however, for tenders that are equal to or more than the prescribed threshold for national advertising. This means that access to procurement information of lower value contracts is not available to most MSEs. For most MSEs with limited resources and capacity, the lower value contracts are more important than the larger contracts. Secondly, important sources of information for most MSEs are not from newspapers but from other informal networks. As Eagan, (2005) argues, new small firms find it relatively difficult to get access to purchasing department heads through informal interactions.

Even though the items are required for different locations across the country, the tender documents are only available in Nairobi. For an MSE in Mombasa or Moyale, the participation cost is increased by the excessive transport cost they have to incur to come to Nairobi to purchase the tender documents.

Box 2: Department of Defense tender notice

Tenders were invited for supply /repair and delivery of various items to Kenya Armed Forces for the period ending 30th June 2006. Key features of interest in the tender notice are:

- Over 128 tenders items needed at various consumption units across the country (Mombasa, Eldoret, Moyale, Wajir, Isiolo, Kacheliba, Nairobi, Nakuru, Nanyuki, Hakati, etc) were advertised.
- Each item tender document to be obtained at a non-refundable fee of Ksh 4,000.
- For each tender, banks guarantee from reputable banks a must.
- Tender documents obtainable in Nairobi.
- The Department of Defense does not bind itself to accept the lowest price or give reasons for rejection.

Source: *Daily Nation* 5th April 2005, p.26

Pre-qualification requirements

The volume of information required at the pre-qualification stage is enormous, especially when an enterprise is applying to more than one public department. Yet, there is no guarantee of moving to the invitation to tender stage. Each public sector institution asks for similar information but since it is given in different formats, an MSE has to spend a lot of time. Pre-qualification information would at times run into several pages. MSEs may lack resources to compile such onerous pre-qualification and tendering information. The relevance of some questions such as “Are you an agent of Kenya National Trading Corporation?” is also questionable. In such cases, government policy or procedures requiring pre-qualifications, that apply to all firms equally, generate some fixed cost effects that in turn create a competitive disadvantage for smaller firms.

Past performance and experience requirement

Section 38(1) lists some of the criteria that should be used for one to qualify to be awarded a contract (Government of Kenya, 2005a). One such requirement is “past experience and proven capability requirement”. However, as Snider and Walkner (2001) argues, there is a difference between experience and past performance. For many MSEs, especially the start-ups, they may not have much experience and, therefore, such a requirement has an effect of locking out many MSEs. Experience may not necessarily translate into good performance.

Limited capacity

According to Ahson (2003), accessing procurement opportunities calls for particular skills and experience. Therefore, programmes aimed at involving MSEs in public procurement call for adequate skilled human capacities in public procurement departments. In Kenya, there are about 515 public procurement officers within the central government (Government of Kenya, 2004). The required staff strength is 934, reflecting a deficit of 423 officers. This is likely to affect procurement efforts across the board. This being the case, public officials may opt for incumbent vendors, thus ensuring same deliverables with lower staffing costs (Egan, 2005). The effect is to exclude MSEs, especially the new entrants, from participating in public procurement. A larger firm may be in a position to employ a skilled person to handle government pre-qualification matters, a fixed cost many MSEs may not afford.

Tender security guarantee

In general, financial institutions associate MSEs with high performance and liquidity risks (Rasheed, 2000). Thus MSEs, unlike the larger enterprises, usually face constraints of restricted access to finance and are unable to tie in their finances in slow paying government contracts. This is worsened by the common requirement for performance bonds and guarantee requirements. Securing a performance guarantee implies that financial institutions warrant that the contractor will perform all the terms of the contract. In the event that the contractor fails to successfully fulfill the contract, the guarantor has an option of either paying the government the guaranteed amounts or looking for another contractor to complete the contract. Financial institutions normally have very limited faith in MSEs and are unwilling to offer them guarantees. The requirement for a bank guarantee from a reputable bank (Box 2) effectively excludes many MSEs who cannot obtain bank guarantee. Even those that are able to obtain one are likely to get it from some of the non-reputable or small banks.

4. Case Studies

Different countries have pursued varied approaches to mainstream MSEs into the public procurement. This section highlights some of these approaches with a view to distilling some useful lessons.

4.1 Affirmative Procurement in South Africa

In South Africa,¹⁰ the “Ten Point Plan” public procurement reform was the first reform that sought to provide opportunities for marginalized groups, especially small businesses, to access the public procurement system. The ten points included:

- (i) Improving access to tendering information
- (ii) Developing tender advice centers
- (iii) Broadening the participation base for contracts less than R7,500 (US\$1312)
- (iv) Waiving security/sureties on construction contracts having a value of less than R100,000
- (v) Unbundling large projects into smaller contracts
- (vi) Promoting early payment cycles by government
- (vii) Developing a referencing system for small and medium enterprises owned by historically disadvantaged individuals
- (viii) Simplifying tender submission requirements
- (ix) Appointing a procurement ombudsman
- (x) Classifying building and engineering contracts

The country’s public procurement policy has also adopted attainment of socio-economic agenda as a key principle of the process. Thus, it has instituted a development/price mechanism scoring point (Box 3), which awards points to tenders on account of either their financial offer or for their offer to exceed socio-economic objectives. Such development objectives include use of local resources, use of targeted labour, use of small, medium and micro enterprises, employment generation, equity share holding and affirmative action principles.

Targeted procurement programmes ensure that targeted enterprises, mostly MSEs, have opportunities to participate even when they lack some of

¹⁰ This case study draws from Letchmiah (1998) and Shezi (1998).

Box 3: Direct preference system for minor contracts (less than R2 million or US\$ 350,000)

Tendered Price Points	=	90 points
Affirmable Business Enterprise	=	7 ½ points (fixed)
Women equity Ownership	=	2 ½ points (variable)
Total	=	100 points
Note: Women Equity Ownership is calculated as $No = 0.0333 \times (WEO-25)$		

Source: Letchmiah (1998)

the necessary resources, capacity or expertise to perform public contracts on their own. The approach makes use of various techniques (Box 3) and ensures that such enterprises do not have a guarantee to such contracts.

South Africa's public procurement policy discourages the practice of contract aggregation. This enables contracts to be unbundled by ensuring larger companies procure works in the smallest practicable quantities, obligating prime contractors to engage MSEs in the performance of their contracts in terms of resource specifications, enhancing structured joint venture between smaller and large enterprises, engagement of third party management support to enterprises that are not capable of operating as stand-alone or prime contractors. This method opens a full spectrum of MSEs' opportunities for participation.

The country has set up an elaborate institutional support aimed at assisting MSEs to access public procurement. For instance, NTSIKA runs several Tender Advice Centers with an objective of tender mobilizing, encouraging formalization and capacitating viable, small, medium and micro businesses by facilitating their increased access to government procurement opportunities. The center's work includes information storage and dissemination, facilitating timely availability of tenders, demystifying tender regulations and procedures, and counseling MSEs on government tendering. NTSIKA also proposes to set up a group-purchasing scheme for MSEs that will enable them to purchase raw materials at discounted prices. Another programme is the Emerging Contractor Development Programme that focuses on assisting contractors who have required technical skills but lack the expertise in submitting public sector quotations and tenders.

Standards for MSEs' products are important in assisting MSEs solve problems related to specifications and standards. SABS has started a missing link programme that offers courses on standards and specifications. The training programme aims at improving MSEs' capacity to manufacture high

quality products that conform to acceptable manufacturing practices.

Like elsewhere, South Africa's procurement procedures and policies tend to be very complex. The extensive paper work and procedures dissuade, restrict and preclude willing and able MSEs from participation. They fail to provide MSEs with easy access to public procurement information. Policy in South Africa requires the standardization of contract documentation. Writing of special conditions of contract to change the risks, rights and obligations is being discouraged. The policy states that tender documentation should be easy to comprehend and user-friendly, free of onerous requirements and documentation, ensure wide distribution, and should be standardized.

For small enterprises, delayed payment for successfully completed public contracts affects their operations. This is because small enterprises are usually unable to survive even for short periods without work, obtain sufficient credit or surety to finance their operations. Such enterprises do not have time to devote to debt collection, to pursue late or non-payment in formal proceedings. As MSEs get opportunities to participate in larger public contracts, their ability to finance such contracts diminishes. Existing traditional financing sources are unwilling to extend to them more credit lines even for the performance of a contract. Policy in South Africa has, therefore, proposed streamlining and rationalized pay system, use of electronic payments, revising audit procedures for interim payments, and charging interest rate above the bank overdraft rates in respect of overdue payments. All these are in addition to other strategies aimed at increased access to affordable finance for MSEs.

Due to their weak financial base, most MSEs are unable to obtain necessary performance bonds from financial institutions. This has led to various proposals that aim at minimizing risk by grading of contractors, providing sureties/security instead of performance bonds, establishing a National Guarantee Fund, classifying contracts according to risk exposure, thereby tying bond levels to risks, and underwriting of guarantees by development agencies and contractor associations.

The financial premium incurred by the state in applying the Affirmable Business Enterprises was 0.8 percent and the ABE participation rose from 5 percent to 28 percent between 1996 and 1997 after the application of the affirmative procurement policy.

4.2 Micro-privatization in Tanzania

The City Council of Dar-es-Salaam, with assistance from ILO's SEED programme, has developed a unique public-private partnership or micro-

privatization of municipal services.¹¹ Faced with a problem of poor or non-existent municipal services in solid waste collection and disposal in poor suburban areas of the city, the Council had two options: to give a single franchise to a foreign waste management company that would use highly automated methods, or to franchise multiple smaller groups using labour-intensive methods. The Council chose the latter by making use of the existing system of informal enterprises (MSEs) to provide an organized system of solid waste disposal system. The approach involved a public-private partnership to franchise out different parts of the city to small private enterprises. In this case, the franchise was basically a permit to collect solid waste from households and businesses in the franchised area. The “micro” aspect, in this case of privatization, was critical since MSEs are incapable of competing in the larger public-private partnership privatization projects.

Interested informal enterprises in the business of solid waste disposal submit their bids to be evaluated by committees of residents and government officials. Such an arrangement ensures the government officials provide the needed technical skills in public procurement while the committees of residents ensure transparency of the process. Successful bidders provide the services and are paid directly by households and businesses in that part of the city. Thus, the enterprises do not experience shortage of working capital related to delayed payment cycles associated with public procurement processes. This provides a strong incentive for the micro and small enterprises to be responsive and effective.

ILO through SEED provides support services such as advising the enterprise owners on how to bid for the franchise, and providing training on handling hazardous and non-hazardous waste products. The programme requires that the franchisees adhere to safe and healthy working conditions as well as core labour working standards. Other donors like WHO and UNDP provide handcarts, tools and protective clothing. The impact has been formalization and improvement of working conditions of an informal activity that is now a source of employment for over 1,500 women and youth, among others.

4.3 Targeted Assistance and Institutional Support in India

In India,¹² the Constitution contains specific reference to the principles of equality of opportunity in public procurement. This implies that the state must be fair and cannot discriminate when purchasing its goods.

¹¹ The case study draws from ILO (2003).

¹² This case study draws from Varma (1998) and Kumar (undated).

Entrepreneurs wishing to participate in a tender have the right to be considered without any barriers or discrimination. The Constitution does not make any special provisions for MSEs but the state usually invokes executive powers that enable special preferential treatment in public buying. Such specific provisions have been operative for a long time and have withstood the scrutiny of law.

The thrust of the Indian public procurement policy is to encourage the development of indigenous entrepreneurs. It therefore lays emphasis on local sourcing, use of local raw materials and use of local agents or Indian-based establishments where importation is inevitable. The policy allows for price preferences in respect of wholly or partially locally produced goods and services produced by cottage and small scale industries.

India has one of the oldest institutional frameworks that support the Small Scale Industry (SSI). One such institution is the National Small Industries Corporation (NSIC). The organization, together with the Director of Industries, has the responsibility of certifying an industrial unit as an SSI unit. For SSIs, this is important as it confers to them certain privileges to participate in targeted public procurement programmes. No SSI can benefit from State public procurement programmes without this registration.

Programmes to enhance participation of MSEs have applied two main approaches, namely: (i) set aside programme, and (ii) price preference programmes. The government procurement has since 1952 made provisions for purchases and price preferences for goods produced by cottage and SSIs. Certain government purchases are exclusively for procurement from Khadi and Village Industries Commission, while others are reserved for procurement from small-scale sector. Cottage and small-scale units are entitled to price preferences of up to 15 percent on merit when competing with large enterprises. The price preferences are, however, dependent on the circumstance and the merit of each case. A standing committee at the highest level of government exists for continuously reviewing the reserved list. According to the latest review, 356 items are reserved.

Alternatively, the government has provided incentives to SSIs to reduce their transaction costs embedded in the public procurement process. Such incentives include:

- Bid invitation is supplied free of charge to SSI units. Copies of the bid invitation, drawings and specifications are sent to the NSIC for circulation among its members. In effect, this reduces the transaction cost for individual SSIs as they do not have to lobby or incur marketing costs to obtain the bid invitation.
- Single point registration with NSIC for SSIs guarantees them automatic

registration with all government purchasing agents. No further verifications are needed for such a firm to participate in a government bid contract except for a few safety and defense-related items.

- Registered SSIs are exempted from payment of bid guarantees while submitting their tender offers, and are not required to submit performance guarantees if the contract is awarded. This means that their participation is not influenced by working capital requirements.
- A representative of NSIC is permitted in the bid opening and to record necessary information. Such information is useful to the SSIs for future participation. With this arrangement, they get the information at no cost.
- Khadi and Village Industries Commission units are also exempt from paying penalties for delay in delivering supplies.
- To solve the problem of slow payment, an Act of Parliament makes the purchaser liable to pay interest to the SSI unit at a rate of 5 percent higher than the prevailing bank rates for payment delayed for more than 90 days.

The above targeted support has resulted in an increase of government purchases from the cottage and SSI sector estimated at about US\$ 1.03 billion annually, which is approximately 5 percent of the total public procurement. The estimated extra expenditures arising out of the set asides and price preferences to the government is estimated at US\$ 100 million. However, some of the programmes like set-aside lists have at times been counter-productive. MSEs have had no incentive to reduce costs, improve quality or deliver on time.

4.4 Targeted Technical Assistance in Brazil

In Brazil,¹³ one project illustrates how a government can offer targeted technical assistance to MSEs to enhance their participation in public procurement through a demand-led approach. The project was organized by the Department of Industry and Commerce of the state government together with SEBRAE, which is Brazil's small business service. The central government strategy was to procure wood products from small enterprises located in a drought-hit region as an alternative to public works programme.

The approach was, therefore, a deliberate strategy that sought to improve

¹³ The case study draws from Romjin (2001) and Holden (1998).

accessibility of public procurement markets to local small enterprises. The first step was to reduce the transactions cost associated with procuring school furniture from small enterprises for both the state and the enterprises. Technical assistance was provided to the enterprises through SEBRAE, which was paid commissions on the value of contracts by the State. The result being that the MSE produced high quality products that met quality requirement set by the Department of Industry and Commerce. This was achieved at lower costs than the State's traditional large suppliers. To reduce transactions costs further, the State did not procure directly from individual MSEs but from producer associations of clustered small furniture manufactures. The association was responsible for honoring orders, warranty claims and coordinating the members. Making the association the focal point meant that it was in the interest of members to monitor each other's performance to ensure quality maintenance.

Other benefits arose out of these well-organized institutions. Within the organizations was an inbuilt structure of distributing financial assistance, enforcing obligations, gathering information, and organizing the technical training. Thus, significant administrative burden of providing target assistance to the MSE was transferred from the state to the beneficiaries through their own associations. Since the State was not obliged to accept the association's output, this generated competitive pressures that ensured value for money for the State school furniture purchases.

The success of the project was evident from the upgraded skills and knowledge, improved management skills, substantial investments, expanded production capacities, linkages and employment generation. Five years after the project, 70 percent of the MSEs' output was already going to the private sector. The associations have also initiated other development activities without the initial assistance.

4.5 Providing Tender Information On-line in Peru

In Peru, MSEs rarely participated in government purchases due to lack of information about the market.¹⁴ To promote information flow, the government intensified the usage of on-line services in advertising government tenders. The country has a dense network of cyber cafes numbering over 2000 and with the lowering of the cost of Internet, over 91 percent of low income people use internet services. Thus, intensification of internet services has helped many MSEs to overcome the information barriers that previously prevented them from taking up the advantages of the

¹⁴ The case study was adopted from Kamau (forthcoming).

enormous purchasing power of the state.

In 2001, the government established PROMyme, a Commission of Small and Medium Business to support the involvement of the MSE sector in tender process, especially those involving low value purchases as well as direct purchases. On receipt of a call for tender proposals, PROMyme immediately notifies the MSEs through various means, including: (i) one minute daily radio announcement; (ii) posting it to its own website; (iii) or posting it on its premises. Failure by government agencies to notify PROMyme in time leads to challenge and eventual cancellation of tender awards.

As a result of this programme, in 2002 goods worth US\$ 400 million purchased by the state were supplied by 67,635 small enterprises. In turn, the proportion of central government purchases supplied by small enterprises rose from 23 percent in 2001 to 33 percent in 2002.

4.6 Preferential Policy in the United States of America

In the United States,¹⁵ there are well-defined policies, institutions and programmes for assisting small businesses to participate in the public procurement programmes. The US Federal Acquisition Regulations (FAR) section 19.202-1 is devoted to supporting smaller businesses to participate in the public procurement. It requires states to afford equitable opportunity to small businesses to compete for contracts they can perform to the government's expectations.

Institutions such as the Procurement Policy and Liaison Office maintain contact with all federal departments and agencies to ensure small business concerns receive fair and equitable treatment from each agency. It also plays an important role in the development of federal acquisition policies, legislation and regulations. It is, therefore, able to safeguard the interests of small businesses in public procurement.

The Small Business Agency (SBA) operates a Certificate of Competence (COC) programme. The main objective is to ensure that small businesses entering the public procurement market are given a fair chance to compete. It is an appeal process for small business bids that are considered unqualified by the public contracting officer. The public official is required to refer the rejection to the SBA, which administers the programme. Within 15 days, the SBA determines if the small business can perform in accordance with the requirements of the procurement. With this certificate, the small enterprise does not have to undergo any other pre-qualification stages to verify its

¹⁵ The case study draws from Roussel (1998).

competence. The merit of the programme lies in the fact that its decisions are based on facts and analysis but not on opinion or personal leanings.

In addition, the COC staff provide public procurement, production and quality assurance skills to small businesses. One direct result of the programme has been the expansion of the competitive base for government contract bidders, leading to competitive prices and increased savings to the government.

Other important affirmative programmes include the Preference Goaling Programme. According to the Small Business Act 15, each federal agency is required to have an annual goal representing the maximum opportunity for small business to participate in public procurement. The government-wide goals are established as percentage of annual government expenditures. The statutory goals are:

- (i) 23 percent of prime contracts for small business;
- (ii) 5 percent of prime and sub-contracts for small disadvantaged businesses;
- (iii) 5 percent and sub-contracts for women-owned small businesses;
- (iv) 1.0 percent of prime contracts for Historically Underutilized Business Zones; and
- (v) 3 percent of prime and sub-contracts for service-disabled veteran small businesses.

The introduction of the Federal Acquisition Streamlining Act in 1994 transformed many federal agencies towards streamlining procedures by shortening procurement lead-time, simplifying procurement procedures, and saving money by reducing procurement staff. The effect was a rise in the practice of unnecessary contract bundling. The impact of such practice was to limit the participation of small businesses in public procurement. Through the Prime Contracts Programme, SBA stations Procurement Center Representatives (PCRs) within the government purchase departments. The work of PCRs is to collect data and advocate for contracts break-out into items for full and open competition, thereby enhancing participation of small businesses. In addition to the break-outs, the PCRs initiate small business set-asides that promote the use of small businesses. These initiatives by PCRs resulted in almost US\$ 1 billion in contract awards to small businesses in 1997 while the contracts break-out had saved the federal government in excess of US\$ 2.4 billion between 1985 and 1997.

A Sub-Contracting Assistance Programme is also in place to ensure small businesses receive maximum possible opportunity to participate in federal contracts as sub-contractors and suppliers. Its focus is on large enterprises

that are prime contractors for the government with one or more federal contracts above US\$ 500,000. According to the Small Business Act, such contractors are expected to have separate and distinct goals for small businesses, small disadvantaged businesses and women-owned small business.

SBA through its Commercial Market Representatives monitors performance of prime contractors to ensure they stick to the sub-contracting plans and goals. It also takes a proactive role of matching prime contractors with small businesses. For instance, SBA has works with the six largest providers of Federal Employees Health Benefits programme to develop sub-contracting plans and goals for utilization of small businesses. In addition, SBA has entered into agreements with large enterprises like General Motors, Ford and Chrysler that seek to encourage sub-contract awards to small disadvantaged enterprises. However, since SBA lacks the legal muscle to make a prime contractor use small businesses, it uses an incentive system. This includes the Award of Distinction and Dwight D. Eisenhower Award for Excellence awarded to large enterprises that have best small businesses sub-contracting programmes.

An Internet-based database PRO-Net programme containing profiles of 200,000 small firms, federal prime contractors, and federal and state agencies is another approach to develop a market for public procurement information. It is available to federal and state governments agencies as well as prime and other contractors free of charge. The facility, which is updated weekly, facilitates and expedites procurements from small business at low cost for the seller and the buyer.

4.7 Key Lessons from Case Studies

The case studies reviewed in this section provide relevant lessons on effective approaches for mainstreaming the participation of MSEs in the public procurement process. These lessons are summarized below:

- 1) **Public policy support:** The government needs to support MSE participation through clear and credible public procurement policies supported by a long-term vision for the small enterprise sector. This is evident in South Africa, India and United States. A comprehensive, credible and consensual policy framework is the first indication of government commitment and forms the basis for all other support mechanisms.
- 2) **Institutional and legal support:** Public policies in support of MSE participation in public procurement are important but they need

adequate legislation that institutionalizes the policies. Participation of MSEs should be entrenched in the country's laws, such as in the United States, India and South Africa. The MSE procurement policy is implemented through strong and specialized institutions such as NTSIKA and the Tender Advice Centers in South Africa, Khadi and Village Industries Commission in India, and SBA in United States, which are mandated to help MSEs benefit from public tenders.

- 3) Single-point registration for MSEs: Institutions such as NSIC in India and SBA in the United States have set up mechanisms to assist MSEs to access public tenders. They register and vet bidding MSEs as well as provide information on public tenders at reduced or no costs. Single-point registration with these agencies evokes an automatic registration with other government institutions so that MSEs registered with such institutions need not register with the government to access tenders. These institutions also eliminate the need for performance guarantees or tender securities as well as the need for pre-qualification steps. All this reduces transactions costs for governments and MSEs, thereby increasing their participation.
- 4) Demand and supply capacities: Such approaches appreciate the poor access of MSEs to the public procurement system as well as weak supply capacities within the MSEs. Demand-side but targeted interventions include set-aside, contract break-outs, preferential goaling system, Internet-based procurement databases, free bid information and so on. Notably, demand-side targeted programmes should not guarantee participating enterprises a market, otherwise the latter will have no incentive to reduce costs, improve quality or deliver on time. Supply-side interventions include the provision of business development services to MSEs to enhance their capacity to supply quality products and services.
- 5) Price preferences: India, South Africa and the United States have used price preference margins to increase participation of MSEs in public procurement. Such price preference margins range from 6 percent in the US, 10 percent in South Africa to 15 percent in India. However, price preferences almost always lead to market inefficiencies and should be used cautiously.
- 6) Sub-contracting practices: This requires that a large firm is awarded a contract on the requirement that y% of the contract will be sub-contracted to small enterprises. Alternatively, the contract could require purchases of x% value of the intermediate inputs from MSEs. It is, however, important to guard against stringent requirements being imposed on the sub-contractors by the prime contractors. Where

compulsion is not appropriate, the government can use incentives such as “Awards of Distinction or Award for Excellence” for large enterprises that have established sub-contracting arrangements with small enterprises.

- 7) Late payments: Governments have legislated automatic penalties for late payment of an MSE that has successfully performed its contract. Penalties are based on a percentage of prevailing banking rates.
- 8) Information and communication mechanism on public contracts: For MSEs, getting information on contract opportunities can be a costly task. Countries such as India and the United States have responded by building databases for MSEs and the products they can offer. Government’s and MSEs make use of these databases, thereby cutting the transaction costs.
- 9) Procurement procedures: Most public procurement procedures tend to be complex, with onerous requirements most of which are unnecessary for the performance of the contract. Countries such as South Africa have embarked on standardization and simplification of tender documentation.
- 10) Micro-privatization: This approach is based on the principle that the current wave of privatization in developing countries should be designed in ways that create room for competition by being sensitive to the merits of MSEs. Privatization should un-bundle public contracts so that MSEs, especially at the local level, can participate in public procurement. They will be able to bid for small value contracts without having to incur inhibiting transaction costs.

5. Conclusions and Recommendations

The main objective of this paper is to analyze how MSEs in Kenya can be integrated into the public procurement process. It identifies some of the barriers to MSEs participation in Kenya's public procurement process and makes suggestions on how they could be overcome. From the analysis, we have established that the public procurement market is huge – estimated at 9.07 percent of GDP or Ksh 71 billion between 1995 and 2004. The Sessional Paper No. 2 of 2005 proposed an affirmative policy of reserving 25 percent of all government procurement and tenders for the MSE sector. This should translate into an additional market worth Ksh 18 billion for MSEs coming through public procurement. Despite the good intentions of the policy proposal, there are no implementable strategies and guidelines specifying how MSEs would take advantage of the policy proposal. This paper picks cue from this shortcoming and goes further to propose some of the interventions that are required to open up opportunities for MSEs in public procurement. Lessons from case studies indicate that there are many ways through which governments can enhance the involvement of MSEs in public procurement.

Generally, there are two major interventions:

- **Establish the National Council for Small Enterprise (NCSE):** Case studies reviewed in this paper indicate that flexible institutional coalitions involving public, private and MSE organizations are important. Kenya should therefore enact the MSE Bill in order to establish the National Council for Small Enterprise (NCSE).¹⁶ The NCSE would cope with the inefficiencies of poorly functioning public procurement systems by absorbing significant amounts of the transaction costs for both the MSEs and the government. This should institutionalize the standard practice in countries such as India, United States or Brazil where “one-stop-shop” institutions serve as intermediaries between the small enterprises and public entities. It is, however, important to create NCSE at the national level as well as at devolved levels to avoid the pitfalls of over-centralized institutions. The NCSE would remove barriers to MSE participation in public procurement by lowering bureaucratic red tape and by providing procurement-related assistance to MSEs. The NCSE would also establish taskforces to create MSE specific sub-institutions.
- **Harmonize procurement policies and regulations:** From our analysis of the public procurement policies and procedures, it is evident that

¹⁶ NCSE is proposed in the MSE Sessional Paper No. 2 of 2005.

Kenya lacks an explicit public procurement policy. There is need, therefore, to develop a comprehensive procurement policy and harmonize it with the new public procurement law. This would in effect reduce the high fixed and transaction costs associated with conducting business with the government in uncertain and complex environment, noted in the analysis of transactions costs theory.

Specifically, there are several interventions. Table 7 summarizes some of the barriers to MSE participation in public procurement and the requisite policy proposals.

Table 7: Summary of public procurement barriers and policy interventions

1. Onerous technical documentation	
a)	Tender Advice Centers: Establish Tender Advice Centers under the proposed National Council for Small Enterprise. The centers should mobilize tenders, encourage formalization of MSEs and enhance the capacity of MSEs to access government procurement opportunities. The centers should store and disseminate information, facilitate timely availability of tenders, demystify tender regulations and procedures, and counsel MSEs on government tendering. The centers should set up group-purchasing schemes for MSEs that will enable them to purchase raw materials at discounted prices.
b)	Streamline registration procedures and apply standard and simplified procurement documentation to avoid raising the transaction cost for smaller enterprises unnecessarily.
c)	Streamline tender evaluation by involving committees of public as well as MSEs and community representatives. Public officials would provide the needed technical skills in public procurement while MSEs and community representatives would ensure the transparency of the process.
2. Slow payment cycles	
a)	Fix penalty rates and maximum duration: Although the Public Procurement and Disposal Act 2005 makes provision for delayed payment penalties, the provision is inadequate. The provision should be amended to fix the rate above a given percentage of prevailing banking rate (say 5% higher). The amendment should also fix the maximum number of days (say 90 days as is the case in India) within which payment must be made for various categories of contracts to ensure fairness across the board.
b)	Electronic payments: Adopt the use of electronic payments and revise audit procedures for interim payments.
3. Contract aggregation and bundling	
a)	Sub-contracting arrangements: MSEs participate in public procurement either as prime contractors or as sub-contractors, suppliers, manufacturers or service providers to the prime contractors or at some point in the delivery chain. Policy should establish clear benchmarks (or thresholds) of contract amounts that must be subject to sub-contract. It should encourage prime contractors to sub-contract part of the contracts to the MSEs by, for instance, requiring that a large firm is awarded a contract on the requirement that y% of the contract will be sub-contracted to small enterprises. Thus, bidders would score higher points for proposing adequate sub-contracting plans involving MSEs as well as higher points for bidders forming consortia that include MSEs as partners. Alternatively, the

contract could require purchases of x% value of the intermediate inputs from MSEs. Where compulsion is not appropriate, the government can use incentives, such as “Awards of Distinction or Award for Excellence” for large enterprises that have established sub-contracting arrangements with small enterprises. In addition, the government could develop guidelines that ensure contracts are unbundled by ensuring larger companies procure works in the smallest practicable quantities, obligating prime contractors to engage MSEs in the performance of their contracts in terms of resource specifications, enhancing structured joint venture between smaller and large enterprises, engagement of third party management support to enterprises that are not capable of operating as stand-alone or prime contractors.

- b) Contract break-out and set-aside policy: This should be implemented by stationing NCSE Procurement Representatives within the government purchase departments. The work of such representatives would be to collect data and advocate for contracts breakout into items for full and open competition, thereby enhancing participation of MSEs. In addition to the breakouts, the NCSE Procurement Representatives should promote MSE set-asides that encourage reserving some contracts for MSEs.
- c) Prime contractors: Introduce programmes targeting Prime Contracts. The thrust of such programmes is to target large enterprises that are prime contractors for the government with one or more public contracts of above, say Ksh 20 million and enter into lasting agreements for sub-contracting MSEs. These should be designed as matching programmes where prime contractors are matched with MSEs.

4. Costly government procedures

- a) Single-point registration: Adopt a single-point registration with NCSE for MSEs. This should guarantee the MSEs automatic registration with all government purchasing agents. This certification should confer to them certain privileges to participate in targeted public procurement programmes. MSEs registered should be exempted from payment of bid guarantees while submitting their tender offers, and should not be required to submit performance guarantees if the contract is awarded.
- b) A representative of NCSE Procurement should be invited to the bid opening committees to take into account MSE interests.

5. Costly appeal system

- a) Certificate of Competence (COC) Program: Once established, the NCSE should institute a Certificate of Competence (COC) programme. This would provide an appeal system for MSEs' bids that are considered unqualified by the public contracting officer. The public official could be required to refer the rejection to NCSE, which should administer the programme. Within, say 20–30 days, the NCSE should determine if the small business can perform in accordance with the requirements of the procurement and confer a Certificate of Competence if satisfied. With this certificate, the MSE would not have to undergo any other pre-qualification stages to verify its competence. The COC staff should provide public procurement, production and quality assurance skills to MSEs.

6. Inaccessibility to procurement information

- a) Electronic procurement:¹⁷ Establishment of electronic databases for prospective MSE bidders should reduce the government transaction costs. The government, through the NCSE, should advertise public tenders on-line. On receipt of a call for tender proposals from the government, the proposed NCSE should immediately notify the MSEs through various means, including: (i) one minute daily radio announcements, (ii) posting it to its own website, (iii) or posting it on

¹⁷ Although this method is suitable for countries with high Internet penetration (see the case of Peru or US), it should form a long term strategy for public procurement information dissemination.

its premises. Failure by government agencies to notify NCSE in time should lead to challenge and eventual cancellation of tender awards. NCSE should host an Internet-based database containing profiles of registered MSEs, government, quasi-government agencies, and public prime contractors. It should be available to central and local government agencies as well as prime and other contractors free of charge. The database should be updated weekly. It should facilitate and expedite procurements from MSEs at low cost for the seller and the buyer.

- b) Tender Advice Centers: This policy should aim to popularize the one-stop-shop concept by establishing tender advice centers. These centers should enhance structured interaction between procuring government departments and MSEs through meetings, information brochures as well as use of popular and accessible media to disseminate public procurement or tender information.

7. Pre-qualification requirements

- a) Special requirements for MSEs: Develop differentiated pre-qualification requirements and processes to cater for different contract values. While large contracts may require lengthy pre-qualification procedures, it may not necessarily be the case for smaller contract values.
- b) Fee waivers: Waive pre-qualification fees by ensuring that bid invitation is supplied free of charge to MSEs.

8. Past performance and experience requirement

- a) Awarding tenders on the basis of a development objective/price mechanism. In Kenya, where majority of Kenyans are unemployed and live below the poverty line (56%), value for money may not necessarily be measured entirely by monetary cost alone. It could be measured also by the extent to which it provides increased employment opportunities per unit of expenditure provided or a more acceptable technical offer, or an exceptional human resource development offer. Tenders could be awarded on a point scoring system that considers a development objective and a price mechanism in such a manner that tenderers are first awarded points for their financial offer and then for their offer to meet or exceed specified socio-economic objectives, or on the basis of their current enterprise status.

9. Limited capacity

- a) Price preference programmes: Such programmes give preferential treatment in purchases and prices for goods produced by MSEs. Price preferences may target wholly or partially locally produced goods and goods and services produced by MSEs. Under this approach, MSEs could be entitled to, say, price preferences of up to 15 percent on merit when competing with large enterprises. The price preferences are, however, dependent on the circumstance and the merit of each case. A standing committee at the level of the NCSE should be established with the mandate of continuously reviewing the reserved list.
- b) MSE Consortia: Encourage MSEs to reduce transactions costs by organizing themselves into consortia, thereby overcoming the fixed costs effects. This effort should discourage procurement directly from individual MSEs but from producer associations.
- c) Preference goaling: Introduce Preference goaling programmes. Each government ministry and department should be required to have an annual goal representing the maximum opportunity for small business to participate in public procurement.
- d) Micro-privatization: This approach is based on the principle that MSEs widen the base for competition during privatization. Thus, privatization should un-bundle public contracts so that MSEs, especially at the local level, participate in the purchase goods and services.

10. Tender security guarantee

- a) Guarantee Fund: Establish a National Guarantee Fund, classifying contracts according to risk exposure thereby tying bond levels to risks, and underwriting of guarantees by development agencies and contractor associations.

Finally, maximum benefit of increased participation of MSEs in public procurement markets will only be realized once full supply side mechanisms are put in place to complement such measures as public sector procurement opportunities, which target the demand side. Such supply side measures include access to finance, access to inputs and access to specialized forms of managerial and entrepreneurial training for MSEs.

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