



AGENCY PROBLEMS IN THE PUBLIC CONTRACTING CONTEXT

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Abstract

This survey synthesizes the study of public contracts from an agency perspective, detecting possible inefficiencies in the contracting context between government and firms. In this sense, we offer a clear analysis framework in order to improve efficiency in contracting processes. To do this, we have divided this situation into two conflicts of interest. On the one hand, we have the conflict between citizens and the firm with which the services will be contracted (fundamentally when there is a divergence in the price determination) and, on the other hand, the difference in interests between citizens and public officials. This analysis from a managerial perspective allows us to delve more deeply into a topic scarcely treated in the literature: the relationship of firms to the public sector. It also allows us to reflect on the efficient (or inefficient) behavior which firms are subject to in the contracting process.

Keywords: conflicts of interest, public contracts, enterprise, efficiency

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1. Introduction

The public sector offers remarkable investment opportunities for firms. The enormous volume of public contracts negotiated with the managerial sector reinforces market competitiveness among the firms of an industry. This effect is noticed both by the bidder firms and the non-bidder companies in which the urge to compete for the award of a certain project is bolstered. It should be kept in mind that competition for the awarding of public contracts is a necessary condition to allow economic operators access to the public sector. In this way, minimum efficiency levels in the contracting process can be obtained.

In this context, we should try to detect the potential inefficiencies involved in public contracting, with a view to improving contracting efficiency. Thus, the present analysis synthesizes and clarifies, from an agency focus, the study of public contracts from a new perspective: the consideration of the

necessary efficiency of the relationships existing between the different agents, that is, the public official and the firm to which the contract is given. This novel analysis from a managerial perspective allows us to go deeper into a topic scarcely treated in the literature: the relationship between firms and the public sector. It also allows us to reflect on the efficient (or inefficient) behavior which firms are subject to in the contracting process with the government. For this reason, the remainder of the paper is structured in the following way: the next section describes the potential agency conflict in the contractual sphere, first analyzing the framework involved, and subsequently those aspects in which the divergence of interests between the agents involved is manifested. For a better understanding of the phenomenon, we will refer to two possible conflicts of interest which have in common an increase in agency costs for firms and for society as a whole. The last section offers a brief conclusion.

2. The Conflict

2.1. Analysis Framework

When a construction or service contract is entered into, there are potential conflicts of interest between the agents involved in the contractual relationship. As occurs in the private sector, in public activity the origin of the problem can be located in the differences in interest existing in the contractual relationship. Taking into account the public character of the relationship in this case, the initial problem could increase and could even end up in a problem of corruption. From the theory of the firm, the appropriate context for analyzing the conflicts of interest between economic agents is the agency theory. The literature has tried to specify both the problems and the solutions that can occur when certain conflicts emerge. The agency problem originates in information asymmetry: an agent has information that the principal does not. In this situation the principal delegates a set of functions to the agent. An incentive system should be designed as well so that the agent maximizes his utility and decisions are adopted to minimize the total agency costs and, in this sense, the interests between the principal and the agent will be aligned as closely as possible¹. The principal in this case is the citizen. As tax-payers, citizens are the people most interested in the negotiation of competitive contracts with the government at a low price and in the best conditions. They want to get the best price for the services contracted because with an efficient public administration, fewer public funds need to be collected by the government and this will result in the citizens' paying lower taxes, in an increase in the efficiency of the public administration, in the better competitiveness of firms and, as a consequence, the overall good of society.

Ideally, citizens pursue social objectives. That is why public behavior often seeks the attainment and execution of predetermined plans formalized through different regulation instruments such as price and quality controls, service conditions of goods and products, sector specific mechanisms of industry regulation, industry control with entry and exit barriers, industrial policies of investment and employment, establishment of state reversion clauses, long duration concessions, grants to certain companies or the special tax regimes that some firms possess. And all the previous examples should be fixed at the levels that presumably would exist in a competition situation. We can see how these actions can benefit different agents (citizens, in general): suppliers, employees and especially consumers - fundamentally through the determination of prices- (Cuervo, 1997). The agent, as principal delegate, is the person chosen by citizens to negotiate their interests. In this case, public officials are the citizens'

¹ See how Jensen and Meckling (1976) pose agency in the managerial context.

political agents in society. A priori, they are agents faithful to the interests of the principal, that is to say, their objective is to hire the best quality services and at the lowest price. Also, they are interested in doing their job as well as possible in order to remain in their political position (which has a limited, temporary nature) for the longest possible time.

2.2. Two possible conflicts of interest

Once we have identified the principal and the agent, we can intuit the existence of a clear problem of information asymmetry. The agent -politician or public official- has greater access to information than citizens do on prices, on possible candidates to recruit, on the control mechanisms to orchestrate, etc. Also, the environment in which the different contracting projects are reviewed is a closed space to which citizens have limited access. This factor of information asymmetry benefiting the public official can in excess increase the discretionality of the decision-making process and, foreseeably the abandonment of competition as a fundamental premise in contract awarding. In other words, there could be a situation in which somehow the control that the market should exert is replaced with control on the part of the public official or politician.

Delving more deeply into the nature of the problem, we will next proceed to divide this situation into two parts in order to facilitate their analysis and to single out the peculiarities of each conflict. Thus, we can refer to two conflicts of interest in public contracting which, although identified in the literature, have not yet been specifically developed for this context. On the one hand, the conflict between citizens and the firm (or individual) whose services are to be contracted (fundamentally when there is divergence in the price determination) and, on the other hand, the difference in interests between citizens and the public official. Both conflicts have a common point: the increase in agency costs, either for the firms or for society in general.

1 - Difference in Interests Between the Citizen and the Firm (or the Individual)

The main problem to study is the determination of the price of the services. Prices are related to the risk that the firm providing the service takes on and they try to reach the levels that presumably would exist in a competition situation. However, sometimes price determination is not simple, fundamentally because there is a discrepancy between the price expected by the citizen, the one desired by the firm and the one actually established. When the establishment of the service price is negotiated, the public official must face strong controls, both external and internal, because that agreement will be conditioned by political decisions (see the Figure 1). External control is exerted by the range of suppliers offering the service, the competitors, or even by the consumers (who will put pressure on to achieve an appropriate contracting price). And the internal control comes

from government orders, for example, decisions about employment, investments, organizational form, etc.

On the other hand, the firm (or individual) with which the government is going to contract the service also pursues its own interests of a lucrative nature and, consequently, will try to obtain the highest price for the service being provided. The firm must consider the satisfaction and remuneration of its shareholders but, at the same time, should be very competitive. The company must seek, therefore, a difficult balance in the price offer, if it wishes to be chosen as a provider of a social interest service.

In this situation, the public official's role consists of aligning the consumer's interests (citizens) and those of the firm (and its shareholders) in the best possible way. The public official, therefore, must consider, on the one hand, the firm's goal and, on the other hand –and most importantly– the taxpayers' interest. The company wants to maximize the services price offered but the public official is pressured by the consumers who demand reduced prices (Moyer, Rao and Tripathy, 1992). From this perspective, the control exerted by the official through prices will lead to a price reduction—or at least a non-increased price—contrary to the firm's interest in increasing them.

We can thus reflect on the following fact: the official's simple pursuit of a greater benefit for society could lead to a reduction in the desired goal of the firm. The control of this situation leads to a clear costs increment (or a reduction in potential benefits) for the firm, reflected in Figure 1 and, in consequence, a cost increment for its shareholders as citizens. Also,

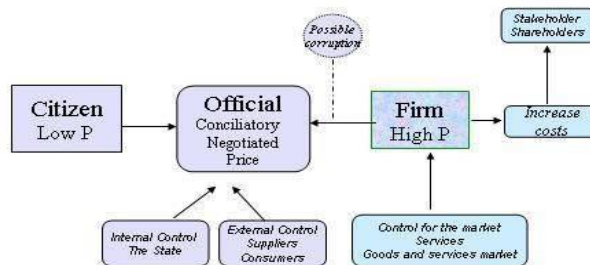
the citizens, their agents and society in general have to orchestrate control mechanisms to oversee the differences in interest between individual agents. Therefore, an interest conflict arises that results in the consequent agency costs that we must try to minimize.

We can see how in this conflict the firm has an important advantage: the fact that if the prices do not stay at certain levels, the capitals markets can negatively value this result and, therefore, firm performance. The basic service being offered could be endangered and this would mean a serious social problem. That is why in these situations a negotiated just price obtained by the firm is assumed and, at the same time, the official's interest will be counteracted by this managerial force. We thus point out in Figure 1 the control exerted by the market, specifically by the goods and services market, on the service offered.

On the other hand, in this price bargaining situation, the firm (or the individual) may want the public official to act corruptly if this were to benefit them in some way, thus making it difficult for the public official to pursue the goal for which he has been chosen by the citizens: to obtain the greatest efficiency in the management of public funds². If this situation finally occurred, we would have a second conflict, which we explain below.

² This behavior would imply a negative external effect that would harm society. In this case, the collective would want public intervention against corruption.

Figure 1 : Difference in Interest between CITIZENS and the FIRM



Source: The author

2 - Differences in interest between citizens and public officials

Although we have referred previously to the controls to which public officials are subjected, it is also important to emphasize the high discretionality they possess in decision-making. This can hinder the usual role of the control mechanisms or simply of competition. When a public official abuses discretionality and goes over certain limits, the previous controls are not effective and the interests of suppliers, employers, consumers and of society in general can be obstructed and harmed.

The problem gets worse when the official acts more as a politician than as a citizens' agent. Under this political focus, the official is clearly incentivated by the short time period that she hopes to remain in the job. In this case, on the one hand a shirking problem appears, in which the agent relaxes and makes less effort at her job than the principal wants her to because the official job is hers forever. On the other hand there is the problem of myopia, in which the agent prefers to undertake projects and make decisions that will benefit the period in which she is acting as a politician instead of those that will be beneficial in the long term (even though the latter will be more beneficial). Also, officials may sometimes

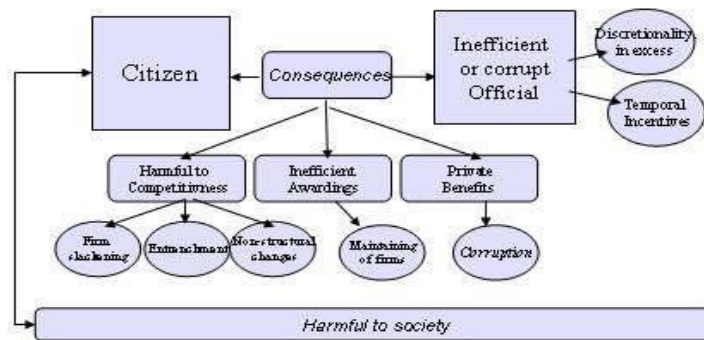
seek their personal satisfaction, pursuing goals different from those corresponding to a citizens' agent, for example, by increasing their remuneration, connecting with certain suppliers, satisfying their close colleagues or friends, etc. In this context, if an official is guided by objectives such as achieving power, he could even overinvest (invest above the possibilities the government possesses). This way of acting could lead to worse results and endanger public accounts (budgetary deficit and failure of the state).

When the process deteriorates, the solution lies in subjecting the official to controls that allow the initial situation to be restored (for example, removing the official from his job). However, this task is difficult because the official possesses a great deal of power in decision-making and control of public resources. This accounts for the fact that, from the purely managerial context, certain mechanisms will not be enough to control the conflicts of interest arising in public contracting. For example, the market for corporate control is not contemplated as a solution

for reducing agency conflicts because the regulator replaces this function to a certain extent. Considering the arguments of Moyer, Rao and Tripathy (1992), Filbeck and Mullineaux (1993) and Lozano, Miguel and Pindado (2002, 2005a), we can see that the same happens when we study the management ownership of regulated firms, as a mechanism for aligning interests in agency conflicts.

Thus, a second conflict emerges when, because of a deteriorated situation, important differences exist between citizens' interests -or the state as supplier of social goods- and the public official -who does not pursue social interests as a faithful citizens' agent (see Figure 2). In this case the agent is inefficient in management: he does not correctly negotiate the price with the firms; he chooses the investments that offer him political utility or private benefits, even though they are not the most economically profitable ones; or, guided by bribes, friendship or, simply, by routine or management inefficiencies, he does not pursue the principal's interests faithfully.

Figure 2: Difference in Interests between CITIZENS and PUBLIC OFFICIALS



Source: The author

In fact, the official is using the state assets incorrectly. The official can use government assets improperly, for example, by wasting them in perquisites³ and therefore spending more than necessary to cover his functions. In fact, the politician only assumes part of the costs generated in the corruption process (since this affects society as a whole and the costs are borne by the citizens) but nevertheless he alone receives the benefits from the business and the agreements that he undertakes. So, while for the citizen corruption only means costs and negative effects, on the other hand, for the corrupt official, the effects of corruption are a small part of the overall results that he obtains because he also possesses other beneficial sources that he will try to protect and preserve. For this reason it is possible that corrupt officials, besides the mentioned perquisite consumptions, will try to ensure their succession

³ Perquisites are that range of extraordinary consumptions with a discretionary character and not usually pecuniary, in which more resources than necessary are employed.

(with a trusted person) so that their previous management will not be questioned; or they will select from among different alternatives a supplier close to them; or they may even carry out illegal activities such as those related to insider trading.

In our opinion, the problem that we outline can be inserted in a wider framework. Politicians can also have other problems, not directly related to corruption, but which can affect social welfare in the same way (recall the previously mentioned overinvestment problem). Perhaps politicians' problems are very similar to those of firm managers⁴.

The consequences of this process can lead to an inefficient awarding of contracts (severely damaging the competition), and to the achievement of private benefits. In short, it enhances the corruption

⁴ In the attached figure by Lozano, Miguel and Pindado (2004), multiple problems related to the firm are depicted. One of these is precisely the pursuit of "private interests" (as the origin of the corruption problem).

phenomenon and damages not only the principal's interests but also those of society in general.

In this situation, it is absolutely necessary to harness these processes since if they are not radically cut off we will be fostering situations such as those in which a certain company is the one that is always subject to recruiting, or in which these firms illegally finance the political parties in power. Furthermore, if the problem continues, the services could be awarded to the firms that, instead of bidding competitively, limit themselves to subcontracting the service⁵. In this case, the firms have indiscriminate financial government support, thus encouraging inefficiency in both the government and the private sector.

The process becomes even more muddled when the politicians or public officials pursue their permanence in power (by seeking citizens' votes) and insist on maintaining the same contracted firms (and these firms also finance the political parties). The lack of competition among firms impedes the structural changes they need to modernize, the management becomes entrenched and inefficient, and so on. And what is more, firms may think that the State will solve their problems, and so they become slack and lose the incentive required to reduce costs and foment innovation. As Cuervo (1997) points out, any public intervention is subject to the law of diminishing returns, due to regulators' stagnation. All these situations can finally weaken the State in the face of pressure from social groups, making the attainment of efficiency in the process even more difficult.

Regarding the double relationship outlined above, we can see in Figure 3 how the role that the public official carries out can be also double: on the one hand, the official is the citizens' agent and, on the other hand, he is the principal in his relationship with the firm. In the same way, a relationship between the citizen and the firm could be established although to

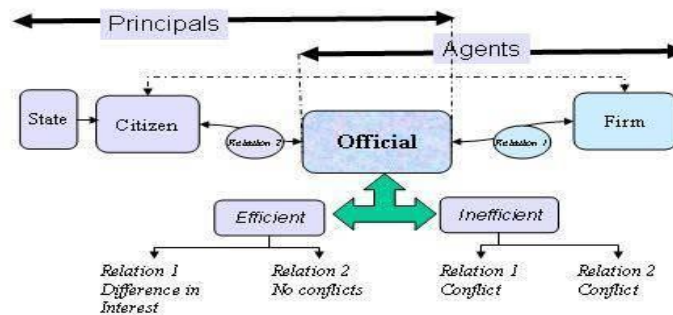
do this it is necessary to suppose that the official's behavior is efficient in any case.

And at this point we should consider a new alternative. A public official can be efficient or not. When a public official acts efficiently, a clear difference in interests exists in the first relationship in which each part defends its own opposing goals. We must take into account at this point the importance of fostering efficient behaviour in officials since it has been observed that although they act in an efficient way, the conflicts and differences in interests are latent. The second relationship (recall that now the official is the citizens' agent) has no conflicts between the citizen and the official (principal-agent) since there is a total correspondence in the pursuit of the goals that the principal delegates.

However, when the official is not efficient, the conflicts in the contracts are of a different nature. Thus, in the first relationship, the conflict becomes worse since the official can be bribed (or seeks to be bribed) by the firm in order to get the prices that the firm wants. In this situation, the official, abusing his discretionary power, awards the bid to the firm without minimizing the prices. This situation is worse when the remaining mechanisms that the market provides are not efficient either (imagine an inactive market for corporate control, a weak board of directors or a high ownership concentration of the firm) that gives the official great power when the price negotiation is established (Lozano, 2004; Lozano, Miguel and Pindado, 2005b). For its part, conflict 2 in this case is clearly manifested, the main problem to solve being the possible corrupt behavior of the agent. Furthermore, this conflict also negatively affects the other one, being in fact at the origin of conflict 1. As a result of this reasoning we can see in Figure 3 that there is a natural relationship between the citizen and the firm. Also, we should not forget that this relationship also comes from the very concept of "enterprise" as a defender of its stakeholders and especially of its shareholders.

⁵ Observe that a new middleman appears in this new situation that naturally increases the process costs.

Figure 3: Role of the Public Official



Source: The author

3. Conclusions

The contractual relationships that the government undertakes with private enterprise can, as with any

other contract, exhibit differences in interest between the agents involved in the operation. Moreover, the contracts are not only not exempt from these daily conflicts but in an extreme situation, they can result in

a bigger problem, related to corruption. Thus, in the public context, we see a corruption problem whose origin can be located in the delegation of power that occurs among the participants of the contractual relationship and which can be analyzed from the perspective of the agency theory.

In this framework, our goal has been to synthesize and clarify the study of public contracts from an agency perspective, taking into account the necessary efficiency of the relationships between the agents involved (the public official and the firm with which the contract is made). This novel analysis from the point of view of the firm allows us not only to go deeper into a topic scarcely treated in the literature (the relationships between firms and the public sector) but also to detect the inflexion points that public contracting offers in order to contribute to an improvement in the efficiency of the contracting process. Thus, the problem of information asymmetry between the principal and the agent has been split into two conflicts of interest in order to facilitate the analysis and to specify the peculiarities of each conflict. Although these conflicts are identified in the literature, they are not specifically developed for this public contracting context. On the one hand, we have the conflict between citizens and the firm with which the services will be contracted (fundamentally through the determination of the contracting price) and, on the other hand, the difference in interest between the citizens and the public official.

The first relationship derives from the discrepancy between the price expected by the citizen and the one the firm wants. In this situation, the public official should reconcile the citizens' interests (reducing or, at least, not increasing the prices) with those of the firm (which wants to increase the price) in the best possible way, while beset with a series of internal and external pressures. In the second conflict we observe how public officials have an important information advantage over the citizen. For example, in the context where different contracting projects are considered, a situation could arise in which real competition does not exist in the awarding of contracts. In this situation, the control that the market should exert is replaced by the control exerted by the official. This unfailingly leads to a greater risk in public officials' actions and, therefore, favors the indiscriminate use of their discretionality.

The consequences of the processes described will only increase costs, severely damaging both the firms and society in general. In this way, inefficient behavior would be encouraged, deriving from a reduction in competition (consequently making the necessary structural changes more difficult for firms, favoring entrenchment and slackening on the part of the management and/or the public officials), from maintaining firms without efficient criteria for awarding contracts and from the attainment of private benefits which often border on corruption.

From this new perspective, we must reflect and offer rules of behavior in order to correct the inefficiencies to which the firms are subjected in their relationships with the government. Thus, the development of transparency processes would lead, in our opinion, to an improvement in the problems outlined here. Indeed, if we work from the principles of free circulation of goods, freedom of establishment and the free offering of services, such premises will undoubtedly lead us to seek maximum transparency in the contracting process. This process would help us to avoid, or at least to mitigate, the problems related with corruption in the public contracts context. In this sense, we must consider the mechanisms that somehow control this inefficient behavior as well as define, as accurately as possible, the role that management and/or public officials play in the contracting process.

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