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#### NOTE FOR THE ATTENTION OF THE TRADE POLICY COMMITTEE

**SUBJECT:** Presentation of the paper on TTIP and Public Procurement:  
"Going beyond the tip of the iceberg".

**ORIGIN:** European Commission, DG Trade Unit G.2

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**OBJECTIVE:** *For information*

**REMARKS:**

Please find enclosed a copy of the paper written by DG TRADE Chief Economist, Lucian Cernat, and Zornitsa Kutlina-Dimitrova on TTIP and Public Procurement: "Going beyond the tip of the iceberg".

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# TTIP and Public Procurement: Going beyond the tip of the iceberg

Lucian Cernat and Zornitsa Kutlina-Dimitrova

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## Key Points

*Trade negotiations involving international public procurement rules are on the rise, stimulating a growing interest in having a clear picture of the economic stakes involved, including the current level of international openness. A recent paper published by the European Centre for International Political Economy (Messerlin, 2016) made an attempt to provide a range of estimates for the EU and the US and found relatively low rates of import penetration. This analytical approach, however, looked only at the 'tip of the procurement iceberg', as the data used covered primarily only one modality of international procurement (direct cross-border), which is not the main avenue for international government procurement. Other modalities, such as procurement from foreign subsidiaries established in Europe, account for much more. Such an approach therefore ignores the main modalities through which foreign firms win EU contracts. Once these other main procurement modalities are taken into account, EU openness in procurement is much higher. Comparable data across all modalities do not yet exist for the US, but we do have clear evidence that the US has introduced the largest number of protectionist procurement measures since 2008 affecting all modalities for international procurement.*

*Against this background, this Policy Brief makes four basic points:*

- i. Public procurement is a key area of trade negotiations, and TTIP is no exception to this rule.*
- ii. The existing levels of openness in procurement markets need to be assessed across all three main procurement modalities and not based only on direct cross-border procurement, which is not the main procurement avenue. According to this comprehensive metric, the EU market already has a high foreign participation rate, including by US companies.*
- iii. Unfortunately, similar data do not exist for the US market. But there is growing evidence of discriminatory measures introduced in recent years, which impede the ability of EU firms to compete on a level-playing field in US procurement markets.*
- iv. The importance of procurement as a key negotiating area requires better data and a greater analytical engagement.*

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## Public procurement: A key policy area in international negotiations

Public procurement is a negotiating area that is gaining in importance at multilateral and bilateral level, as evidenced by the growing number of procurement provisions in existing and future trade agreements. The importance of negotiations over public procurement stems from the size of procurement spending, which in most developed economies is in double-digit percentage points of GDP, and the fact that procurement has traditionally been subject to discriminatory policies in many jurisdictions. TTIP is no exception to this trend as public procurement is considered an important negotiating priority by both parties, given the considerable potential for economic gains and greater efficiency that can be achieved by further liberalising public procurement.

Despite the size and importance of this agreement, however, the factual information available to trade negotiators remains scarce. Although public procurement patterns (e.g. size of procurement markets, composition of procurement spending and level of government procurement) can be derived from traditional national accounts statistics, these figures fall short of capturing the international dimension of public procurement. Therefore, there is a clear need to provide further analytical evidence on the structure of international public procurement in the EU and the US.

A recent paper by Messerlin (2016) tried to shed light on some critical issues in the TTIP negotiations on public procurement. One important yardstick used in the paper is an indicator aimed at measuring the current level of openness in public procurement in the EU and the US, by comparing the share of imports in total demand for public goods and services in the EU and the US, based on WIOD input-output data. Starting from this proposed de facto openness metric, Messerlin (2016) argues that, the United States and the EU (on average across its member states) have similar levels of foreign penetration ratios in total public procurement markets, somewhere around 4%. This indicator is then seen as clear evidence that there is little, if any, imbalance in the current level of openness.

While this assessment offers some interesting insights, it suffers from a number of serious shortcomings that could misguide current policy debates, if misinterpreted. Simply put, these import penetration rates overlook a number of important elements and as such represent only the 'tip of the procurement iceberg'.

## What lies beyond the tip of the procurement iceberg?

One key element that needs to be borne in mind when looking at international procurement is that foreign firms can win public contracts in a variety of ways. Cernat & Kutlina-Dimitrova (2015) summarised these options into three modalities of international procurement, a concept similar to the terminology employed in the General Agreement for Trade in Services (GATS) for trade in services:

- **Modality 1 - direct cross-border international procurement:** a foreign company submitting a bid and winning a public contract 'from abroad'.
- **Modality 2 - commercial presence procurement:** a domestic subsidiary of a foreign company wins 'locally' the public contract.
- **Modality 3 - Value-added indirect international procurement:** a foreign company participates indirectly with parts and components (goods and services) without necessarily being part of the winning bid. In this case the foreign company may supply goods and services to a domestic company winning the bid or to another foreign company that receives the public contract.

Out of these three modalities of international public procurement, Messerlin (2016) captures only modality 1. However, previous empirical work (notably the Ramboll, 2011, study cited by Messerlin & Miroudot, 2012, as well) provides evidence that in fact the most important vehicle for international procurement is modality 2, followed by modality 3, while modality 1 is a distant third in terms of economic importance.

The intuition behind this finding is clear: for a large number of products and services purchased by public authorities, proximity is key. Hence, the existing data seem to suggest that distance matters in public procurement and very often goods and services are procured from companies (foreign and domestic) that are located in the proximity of the procuring authorities.

Therefore, inferring overall procurement openness from modality 1 data alone puts a serious caveat on the main finding in Messerlin (2016) with regard to the level of 'de facto' openness in both the EU and the US. In addition, this indicator fails to capture the government investment<sup>1</sup> component of public procurement, which is a major element in public procurement spending. The reason for that lies in the structure of the underlying input-output tables. This framework based on supply and use tables reflects commodities demand for intermediate and final uses. The latter consist of private-household consumption, government consumption and investment. The demand for investment goods, however, is not split into government and public investment, and hence, the government investment dimension is missing in the input-output framework. National accounts statistics for the EU and the US, however, reveal that government investment in total procurement is quite important, standing at 17% and 34% in 2012, respectively (Cernat & Kutlina-Dimitrova, 2015). Hence, one should also take into account international procurement related to government investment.

Another important drawback of the Messerlin (2016) indicator is the fact that public procurement as measured in the input-output tables framework based on national accounts includes the so-called *below-threshold procurement* (low-value contracts that are not legally subject to international procurement rules). This is obviously of great significance as there is evidence that the value of a procurement contract has a positive influence on the probability of a foreign company winning a bid (Kutlina-

Dimitrova & Lakatos, 2014). This finding is also linked to the fact that foreign companies are more likely to bid for large-value contracts, as in general they are facing higher foreign-market entry/penetration costs. Accordingly, an asymmetry bias is likely to be present with respect to foreign-penetration shares below and above threshold procurement. In light of this bias, the import penetration ratios used by Messerlin (2016) are not a good metric for assessing the openness of public procurement subject to international treaties. Last but not least, Messerlin's analysis does not capture import-penetration ratios for public utility providers,<sup>2</sup> despite the fact that public procurement of utility services represents a sizable share of public procurement in the EU. In fact, such services have higher import penetration shares for modality 1 compared to other procurement contracts (Kutlina-Dimitrova & Lakatos, 2014). To sum up, an analysis of procurement openness substantiated merely through input-output data as attempted by Messerlin is at best partial and at worst fails to provide a realistic picture of the actual situation.

Instead, more accurate evidence on the size of modality 1 (cross-border public procurement) in the EU and the US is provided by contract award data. The Ramboll (2011) study, for instance, finds modality 1 penetration rates for the EU at 3.5% for the 2007-09 period (with smaller EU member states having higher import shares). These estimates are in line with the results of more recent analysis based on an extended dataset (2008-12) by Kutlina-Dimitrova & Lakatos (2014), where it is found that the direct cross-border share for modality 1 in Europe stood at 3.7% for that period. For the US procurement market, Fronk (2015) finds modality 1 import penetration ratios lower than 2% prior to 2006 and between 3.6-4.1% for subsequent years (2006-10) (based on detailed US federal contract award data).

It should be pointed out, however, that these modality 1 import penetration rates of the EU

<sup>1</sup> The government investment component of public procurement, i.e. the aggregate gross fixed capital formation, refers to infrastructure expenditures, for example, building new roads. See also OECD (2015).

<sup>2</sup> Public utility companies provide electricity, natural gas, water or sewage services.

and the US procurement are not directly comparable. The US estimates are based on a dataset that capture only US procurement at the federal level, whereas the EU figures cover both national and sub-national procurement. Knowing that US sub-federal procurement is less subject to international commitments, it is very likely that the overall (federal and sub-federal) modality 1 import-penetration ratio for the US is lower than the federal level estimated by Fronk (2015).

But as indicated, modality 1 is only the tip of the international procurement iceberg. When looking at modality 2 (procurement via foreign affiliates), we get a different picture in terms of levels of openness in EU member states. The Ramboll (2011) study finds that 13.4% of the EU public procurement market is awarded to foreign affiliates from non-EU countries. Strikingly, US foreign affiliates have obtained one-quarter of the extra-EU foreign penetration rate, the largest share of any EU trading partner. Unfortunately, there are no available modality 2 estimates for the share of EU foreign affiliates in the US procurement market.

Under modality 3 (value-added procurement), foreign firms may obtain indirectly a share of public spending even when they are not part of the winning bid (as subcontractors or arms-length suppliers). The Ramboll (2011) study assessed the share of indirect procurement through such contractual relations to be around 12% of the total EU procurement market. Again, there are no estimates for modality 3 foreign penetration rates in the US procurement market, which hampers any comparison in this respect. It is important to note, however, that 'Buy American' provisions limit the possibility of firms winning public contracts to source certain inputs from abroad. Thus, whenever such 'buy-local' provisions induce a costly change in the production patterns of potential foreign bidders, they will not only impose restrictions on modality 3 international procurement but also indirectly on modalities 1 and 2. Therefore, such restrictions may discourage entrance or reduce the ability to win public contracts for both foreign firms and US affiliates, if they have to source intermediate inputs in sub-optimal ways due to 'buy-local' provisions.

Since data on modality 2 and 3 do not exist for the US procurement market, we cannot at this stage make a proper comparison of the overall level of de facto openness of the EU and the US procurement markets. Without speculating about the likely magnitude of de facto US openness in these public procurement modalities, one is left only with evidence on de jure openness, based on protectionist measures found in the US that may negatively affect such international procurement. The scope and discriminatory nature of local content requirements under 'buy-local' provisions is already well-known and documented in Luckey (2012), for instance. Some of these measures have a clear negative impact on modality 3 procurement and one would expect such measures to negatively affect the ability of both US companies and foreign affiliates to source certain inputs from abroad. Overall, such discriminatory measures (with various degrees of domestic preferential treatment) tend to reduce the ability of foreign firms across all three procurement modalities to win public contracts in the United States, notably at the sub-federal level.

### Recent trends in public procurement policies and their discriminatory nature

Clear evidence of the impediments to international procurement in the US market can also be derived from the data provided by the Global Trade Alerts (GTA) project. Coordinated by the Centre for Economic Policy Research, the project tracks newly introduced protectionist measures around the world, including in the field of public procurement.

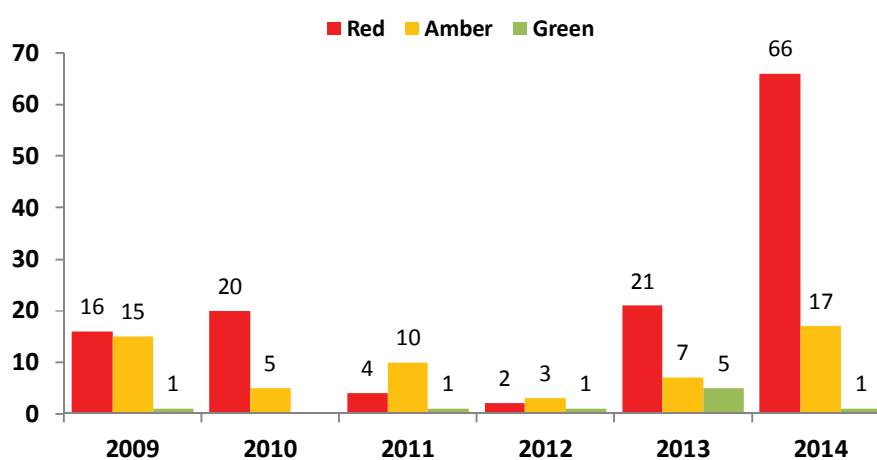
Several GTA reports contain detailed information about new policy measures affecting international procurement introduced by a large number of jurisdictions and their discriminatory level. Figure 1 provides an overview of the annual frequency of newly introduced state measures in the field of public procurement, which would possibly have a discriminatory effect against foreign goods and services or foreign suppliers.

Since the database's creation in the second half of 2008 until the end of 2014, there have been 195

measures in the field of international public procurement worldwide. Out of these, 129 have been described as almost certainly discriminatory (red), 57 as measures that are likely to discriminate (amber) and 9 as non-discriminatory measures. Analysing the data on newly introduced measures depicted in Figure 1 reveals an interesting 'U-shaped' trend: the initial downward trend in newly introduced

protectionist measures in the 2009-12 period is significantly reversed in 2013 and 2014 leading to an expansion of newly introduced protectionist measures. Between 2012 and 2014 the newly introduced protectionist (red) measures increased from 2 to 66. The same trend applies to the 'amber' measures which increased from 2 to 17.

Figure 1. Newly introduced public procurement measures by level of restrictiveness at global level, count of measures, 2009-14



Legend: Red: almost certainly discriminatory measures. Amber: measures likely to discriminate. Green: non-discriminatory measures.

Source: GTA database.

This shows that protectionist measures in the field of international procurement have gained substantially in importance. The trend described above refers to the whole sample of countries included in the database of the GTA report. It is undoubtedly interesting to see that some governments have resorted to protectionist measures in cross-border procurement more often than others, between 2009 and 2014. According to the GTA data collected across all major trading partners, the US has introduced the largest number of new discriminatory measures in the field of public procurement (GTA 2015). The discriminatory measures seem to apply particularly to metal products, construction works but also to foodstuffs and other important intermediate products (textiles, chemicals, etc.).

It is also noteworthy that this protectionist tendency is visible in other key EU trading

partners, with several EU member states being among the most-affected countries by such protectionist measures, in the US and elsewhere. For instance, German and French goods and services were subject to around 50 new discriminatory measures in the field of government procurement around the world. In general, EU firms have frequently been subject to protectionist measures in the field of procurement: out of the top 20 most-affected countries by global protectionist measures in the GTA database, 13 are EU member states.

### Public procurement: What role for new trade negotiations?

The various elements presented above point out three important facts. First, whether measured on a de facto or de jure basis, international openness

in public procurement is a powerful element for economic gains, as part of a globalised economy. Second, in the case of the TTIP negotiations, there is clear evidence that the current level of EU openness is higher than the ‘tip of the iceberg’ when looking at all three procurement modalities. While the overall US openness remains unknown, there is convincing evidence that major gains can be reaped from TTIP negotiations, across all modalities of supply, and in particular in those areas where discriminatory measures have been identified. Third, it would be wrong to think that additional gains cannot be reaped by US firms in the EU market as a result of new procurement rules in the future TTIP agreement.

As Messerlin (2016) pointed out, trade negotiations can go hand-in-hand with domestic regulatory reforms and can mutually reinforce future measures in the EU and the US aimed at more open and efficient procurement markets. There is also clearly the need for better data on the international dimension of public procurement. The absence of a comprehensive, comparable global database on international procurement clearly presents a main challenge for the current and upcoming trade negotiations on procurement, including TTIP. There are encouraging developments from international organisations, however, that new data on international public procurement will soon become available.

In conclusion, against the recent slowdown in global trade and the worrying trend towards protectionist measures, TTIP and other new trade agreements are poised to play a critical role in ensuring a level playing field for all companies in the area of procurement, which accounts for a large share of GDP both in Europe and in the US.

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