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EXECUTIVE SUMMARY

ACCESS OF SMALL BUSINESS TO GOVERNMENT PROCUREMENT IN ISRAEL

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Access of Small Business to Government Procurement in Israel

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The study recommends:

- **Reduce the amount of procurement exempt from public tenders.**
- **Tenders should be result-based, not technical-requirement based.**
- **Publish tenders on a government website with no charge for downloading.**
- **Lower bank guarantees and eliminate other unnecessary tender requirements.**

Introduction

The government of Israel is the single largest purchaser in the Israeli economy. Excluding military imports, it spent almost seven billion dollars in 2002, or 6.5 percent of GDP. Because of the extreme centralization of state procurement, most Israeli businesses are unable to sell to this purchaser. For the first time data collated and analyzed in this study reveals that in 2003, 70 percent of state purchases were made from just 2 percent of the total number of enterprises that supplied goods and services to the government, and 90 percent were made from less than 7 percent of suppliers. The conclusion is unmistakable - Israeli state procurement helps big businesses grow larger while freezing out small businesses and growth in this major economic sector.

Unlike other western countries, such as the U.S., Israel has not yet found it necessary or beneficial in government procurement to promote the role of local small business, the universally accepted engine of economic growth and job creation.

State Procurement in Israel

In Israel, government purchases of goods and services are made pursuant to a 1992 law, which for the first time mandated that purchases be made through public tenders. However, in 2002, 4,220 government contracts, valued at $1.65 billion, or half of the total $3.33 billion spent that year on civilian procurement (excluding purchases by the Defense Ministry and the Israel Lands Authority), won exemptions from the requirement that they be awarded through public tenders.[1] These exemptions were awarded according to current legal procedure, after being considered by the Exemptions Committees of the various government ministries.

In 2002, purchases by the Israeli government totaled $9.7 billion, a remarkable 9.3 percent of the GDP. Excluding military imports, government purchases totaled $6.8 billion, which was 6.5 percent of the GDP. This number is up from 1995, when purchases were 6.1 percent of GDP. But even these numbers pale when one considers the total purchases made by public institutions in Israel, i.e., not only the government but also municipalities, quasi-government entities such as the Jewish Agency, and state-backed non-profits. In 2002, this total was estimated at 16 percent of GDP; deducting military imports the total was 13.2 percent of GDP.[2]

The more the government purchases from a small pool of large businesses and suppliers, or the smaller the pool of businesses from which it makes purchases, the more negative effects these purchases have on the competitiveness of the economy. Of course, the more competitive the economy and the greater the number of businesses able to participate and increase sales, the more both local consumers and the government itself will benefit from lower prices and higher-quality goods and services, and the more jobs will be created.

To determine the centralization typifying Israeli state procurement, we examined a data base of $2 billion worth of purchases executed through most of the government accounting offices during 2003. For example, the Ministry of Immigrant Absorption spent $64.7 million on procurement from 511 suppliers; however, 70 percent of this sum was paid to just 2 suppliers! And 80 percent was paid to only 4 suppliers; in fact, 94.3 percent of the sum was paid to 26 suppliers, or 5 percent of the 511suppliers from which purchases were made.[3]

Some ministries are less centralized: The Ministries of Interior and Trade, and the Ministry of Industry and Employment made 70 percent of their purchases from about 9 percent of their suppliers. But overall, as noted above, 70 percent of purchases were made from 2 percent of suppliers, 80 percent from 3.3 percent of suppliers and 90 percent from 6.9 percent of suppliers.[4]

It is important to note that while the Israeli economy is known to be centralized, government procurement is far more centralized than the economy as a whole: While 92 percent of the country's financial turnover is centralized in 19.6 percent of local businesses, 92 percent of state procurement is made from just 8.5 percent of the government's actual suppliers.[5]

Tenders

Explanations for the centralized nature of state procurement usually rest with the general centralization of the economy, but in reality, the government chooses to use large businesses that it considers, in principle, more reliable than small ones.[6] Tenders are therefore tailored for large businesses and require that bidders show a certain annual turnover, a high number of employees, a large number of branch offices, many years of experience, high bank guarantees, and so forth.[7] As a result of these obstacles, many small businesses simply choose not to even attempt to make sales to the government.

In examining state tenders as the source of obstacles to small business, a good place to start is the Central Tenders Department at the Finance Ministry. In order to utilize advantages of scale and to cut bureaucracy, this department issues tenders for goods that will be used on an ongoing basis by all government ministries. The suppliers chosen by these tenders are then added to a list of approved suppliers from which the various ministries can later go comparison shopping. But the Tenders Committee chairman says the person issuing the tender "suffers from a lack of information. He does not know who will be buying or how much of something will be purchased, and therefore he does not know which goods to issue a tender for, and operates on his gut feeling"; since suppliers applying via the tender themselves have no idea how many purchases are expected to be made, they raise their prices as a form of protection.[8] Since the Tenders Committee does not know the extent of expected purchases, it often finds itself setting irrelevant annual-turnover or minimum-number-of-employee requirements. Moreover, businesses are sometimes required to maintain reserve supplies of items not likely ever to be ordered. Worse, a 2001 tender for paper states that "in the absence of Israeli standards for most of the desired goods, it has been decided that paper produced by Hadera Paper will be the basis for the technical aspects of all items in this tender."[9] Needless to say, Hadera Paper's competitors are automatically at a distinct disadvantage. Actually, government tenders often set technical requirements for goods, specifying the type of goods that must be supplied, rather than functional requirements that simply ensure the goods supplied can accomplish the purpose for which they are needed.[10]

Furthermore the deputy director of the Central Tenders Department says that the "quality" of a firm competing for the tender is often determined based on its turnover, number of employees, number of cars in its fleet and other such parameters that favor large businesses, which presumably are at lower risk of going bankrupt than smaller ones. These large businesses are thus sometimes chosen even though their prices are higher than those of smaller enterprises.[11]

Since over 80 percent of Israeli businesses have an annual turnover of under NIS 1 million, and 95 percent, under NIS 5 million,[12] the demands to demonstrate high annual turnover, high bank guarantees, or a large fleet of delivery vehicles means that most of these businesses are unable to even consider offering their goods or services to the country's largest single purchaser.

Ironically, sometimes a large enterprise wins a tender to supply a product to the government and then orders the product from a smaller enterprise that was unable to compete in the tender. The result is that the government pays a higher price for the goods, and the large enterprise, which is acting purely as a middleman, reaps unreasonable profits at the taxpayer's expense.[13]

State Debts and Late Payments

A further disincentive for business, especially small business, to sell to the government is the frequent delay in payments for goods. In August 2003,

public institutions were estimated to have owed NIS 3 billion to some 4-5,000 local businesses. In November 2003, the Association of Craft and Industry in Israel estimated that while payments in the economy as a whole were delayed by an average of 36 days beyond whatever credit terms were agreed upon between buyer and seller, government institutions delayed their payments by 127 days.[14]

In October 2003, Dr.Yaron Zelikha assumed the position of Finance Ministry Accountant General, and with Finance Minister Benjamin Netanyahu's support forced the payment of NIS 1.5 billion of government debt to suppliers and ordered a permanent solution to the problem; as of May 2004, only state hospitals and Israel Military Industries had not made their required payments and continued to owe NIS 250-300 million each to local suppliers.[15]

An International Comparison

In the United States, Federal procurement is approximately 2.35 percent of GDP, compared to 9.3 percent in Israel.[16] State procurement in the U.S. (and in the European Union) is also centralized, and small business faces obstacles there, as in Israel. However, in the U.S. and EU, steps are being taken to remedy these problems.

President George Bush addressed this issue on March 19, 2002:

> Government contracting must be more open and fair to small business. But you know as well as I do that there are some large hurdles for small businesses. The main one is that agencies many times only let huge contracts with massive requirements go to the same group of large corporate bidders...[17]

President Bush is not the only person in Washington worried about small business. In 1993, Congress required federal agencies to supply small businesses with 20 percent of their contracts; by 1998, 23 percent.[18] Further, when contracts are "bundled" together to form larger contracts more suitable for larger enterprises, federal agencies are required to justify the procedure; also, they are required to take steps to remove obstacles facing small business.[19]

Moreover, contracts of $2,500-$100,000 are reserved for small businesses, providing at least two competitive offers can be made by small businesses for the contract. Contracts for over $500,000 (or $1 million in the construction industry) require proof that small businesses will be used as subcontractors for some of the work.[20]

All businesses wishing to supply goods or services to the federal government can easily obtain information about how to do so, because most federal agencies publish guides for them. The Small Business Agency advises enterprises how to sell to federal agencies and advises government procurement officials how to exploit the advantages of small business, and it also monitors federal compliance with laws designed to assist small business.

Recommendations

The legal framework for government tenders in Israel does not itself pose problems for small business, but neither does it obligate access for small businesses. Most of the obstacles have arisen from an overly strict interpretation of contracting requirements, such as minimum entry requirements and banking guarantees. In order to open the state procurement market to small business, changes are needed in the interpretation and application of the Tenders Law and its regulations.

The goals of the Tender Law need to be formulated as they are in the U.S. and EU: to create conditions for fair and open competition; to allow public authorities to choose the winning bids from a larger and competitive bidder base; to increase cost-effectiveness and quality; to meet timetables; and to increase competition in the economy. To achieve these goals in practice:

1. Goods should be described functionally and not technically in tenders, such that the purpose for which the goods are being sought is described clearly rather than based on unnecessary technical requirements. In any case, when technical frameworks are listed, they should be kept to the minimum necessary.

2. Data on procurement needs to be collected and analyzed so that accurate tenders can be issued based on real needs.

3. All state tenders should be listed on the website of the Government Publications Bureau, and they should be downloadable from that site. Further, as e-commerce becomes more widespread, as much procurement as possible should be executed through this method, which is easily accessible to businesses of all sizes.

4. Current tender practices should be changed. Forcing potential bidders to pay for the tender should be changed to require them to pay when they actually compete for the tender, rather than when obtaining a copy of the tender itself. The current option the Tenders Committee has to refrain from distributing the tender documents and to display them in only one place should be eliminated. This unnecessary obstacle discriminates against small businesses and potential bidders from the periphery.

5. All thresholds required of businesses should be removed or kept to the minimum necessary to ensure provision of the goods sought. There is also no need for a bidder to conform to the Israeli standard for a particular good, if he conforms to the European or world standard instead, unless in a particular case the Tender Committee specifically finds the Israeli standard is necessary.

6. Tenders should include the expected size of purchases, and also explain how bids will be rated.

7. Since reducing the size of tenders and purchases may entail bureaucratic costs, it should be done only when the expected benefit outweighs these costs as, for instance, when the result will be a large increase in the number of bidders.

8. The government should consider more favorable payment terms; in England, for instance, the public sector is required to pay within 30 days from

invoicing, but also sometimes offers advances based on the progress of the work.[21]

9. The Accountant General's Office can issue a guide on how to do business with the government, emphasizing how small businesses should bid for tenders, and this can include a list of contact people in every government ministry. A separate guide should be published for procurement officials, explaining the main obstacles to small business and how to remove them. The Small and Medium Enterprises Authority should advocate improving the ability of small businesses to bid on tenders and intervene on behalf of small business with procurement authorities.

Adoption of most of the above recommendations would be easy and does not necessarily require any major changes in current legislation, just directives from those responsible at the Finance Ministry. Their adoption would signal that Israel recognizes the importance of small business to economic growth, as does most of the developed world.

Notes

1. David Cohen, Accountant General's Office, Finance Ministry, telephone interview with author, 14 July 2004; the data was relayed in the name of Jacob Dinowitz, chairman of the Central Tenders Committee at the Finance Ministry.
2. Central Bureau of Statistics, *Statistical Abstract of Israel 2003* (Jerusalem: CBS, 2003), table 14.2; Amir Davidson, CBS Department of Government Accounting, letter to the author, 26 February, 2004; CBS, *Monthly Statistical Abstract of Israel*, no. 55 (Jerusalem: CBS, April 2004), table 9/13 [Hebrew].
3. Author's calculations, based on "Bochen" data base of the Finance Ministry's Accountant General's Office, 21-28 March 2004 [Hebrew].
4. Ibid.
5. Ibid.; CBS, *Business and Turnover in the Different Sectors of the Economy Based on VAT*, 2002-2003, Summary 19/2003 (Jerusalem: CBS, 2003), pp. 56-59 [Hebrew].
6. Jacob Dinowitz, Economy and Administrative Department head, and chairman of the Central Tenders Committee, at the Finance Ministry, interview with the author, 11 December 2003.
7. Notification of state tenders can be read at http:/michrazim.lapam.gov.il; Gilat Viner-Negev, deputy director of the Central Tenders Committee at the Finance Ministry, interview with author, 11 December 2003.
8. Dinowitz, interview, 5 May 2004.
9. Finance Ministry, *Goods/Services Tender 3/97*, form 3000; *Tender 36/2001*, clause 2.1 [Hebrew].
10. Zvi Lavie, *Actual Procurement Management* (n.p.: Ministry of Defense, 2000), pp. 172-173 [Hebrew].
11. Viner-Negev, interview.
12. CBS, *Business and Turnover*.
13. Lior Mashiach, owner and manager of "Fix Omanuyot," interview with the author, 6 June 2004; Charlie Peretz, owner of "Temunah VeShelet," telephone interview with the author, 23 June 2004.
14. BDI-Business Data Israel, Inc., "Special Examination by BDI-Business Data Israel: Payment Practices of Public and Government Bodies and Companies" (BDI-Business Data Israel, August 2003, Bnai Brak) [Hebrew]; Association of Craft and Industry in Israel, "Payment Practices of Government Ministries and State Companies and Corporations" (Association of Craft and Industry in Israel, 1 January 2004) [Hebrew].

15. Knesset Oversight Committee, *Protocal 62*, pp. 5, 7-9, 27, 30, 32, 34 [Hebrew]; Yossi Itzkovitch, Health Ministry deputy accountant, letter to the author, 18 May 2004 [Hebrew]; Zohar Yinon, IMI accountant, interview with the author, 18 May 2004. State hospitals are themselves owed some NIS 650 million by local Health Funds, and thus short of cash, and IMI has the legal status of a private company in this matter, and thus not under Zelikha's sway.
16. http://devdata.worldbank.org/externalCPProfile.asp?SelectedCountry=USA&CCODE=USA&CNAME=United +States&PTYPE=CP; http://www.govexec.com/top200/03top/top03s3s1.htm
17. House Small Business Committee Democrats, *Federal Contract Watch List, How big contracts hurt small businesses: 10 to watch* (25 April 2002), p. 1.
18. U.S. General Accounting Office, *Small Business, Trends in Federal Procurement in the 1990s* (January 2001), p. 12: www.gao.gov/cgi-bin/getrpt?rptno=gao-01-119
19. OMB, Office of Federal Procurement Policy, *Contract Bundling, A Strategy for Increasing Federal Contracting Opportunities for Small Business* (October 2002), pp. 2-3: www.acqnet.gov/Notes/contractbudnlingreport.pdf
20. GAO, *Small Business*, pp. 8-9; http://www.sba.gov/GC/indexwhatwedo.html
21. Office of Government Commerce & Small Business Service, *Smaller Supplier…Better Value?*, p. 17: www.ogc.gov.uk/embedded_object.asp?docid=2077

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