

# Fighting Against “Dango”: How to reform the Japanese Public Procurement System

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# Today's Talk

1. How has the Japanese view on “Dango” changed over the recent years?
2. How come “Dango” survive so long?
  - Anatomy of Japanese Procurement System
3. How to get rid of “Dango”?
  - Does competitive bidding system help?
  - Some evidence revealed from the case study
4. How to reform the Japanese system?
  - Balance the redistribution versus efficiency
  - Need more “discretion” for government officials

Why is Dango a hot issue today  
in Japan?

# Dango?

- Dango (談合) = Bid Rigging, Price Fixing
  - “談 = Discuss” & “合 = Meet” among many people (to decide something)
  - The word “Dango” itself has good (or at least not bad) connotation in Japanese!
- Bid rigging is categorized as cartel, like many other countries, considered as criminal activity in Japan.
- The Japanese has been ambivalent about Dango:
  - “Good Dango” (for cooperation is good) and “Bad Dango” (for cartel is bad)
- Dango has been known for both the Japanese and Japanese experts for long time:
  - John McMillan, 1991, “Dango: Japan’s Price Fixing Conspiracies”
  - Tom Logan, 1994, “On Dango: The Famous “Yokosuka Navy Base Toilet Job””
  - Haruhito Takeda, 1999, Economics of Dango (in Japanese)

# Recent “Dango” Scandals with Public Procurement

- Three Governors (Fukushima, Miyazaki, and Wakayama Prefectures) and several city mayors were arrested, or resigned because of their involving “Dango” scandals in 2006.
- We all know that Dango has been around for long. Why do we see so many Dango scandals recently?

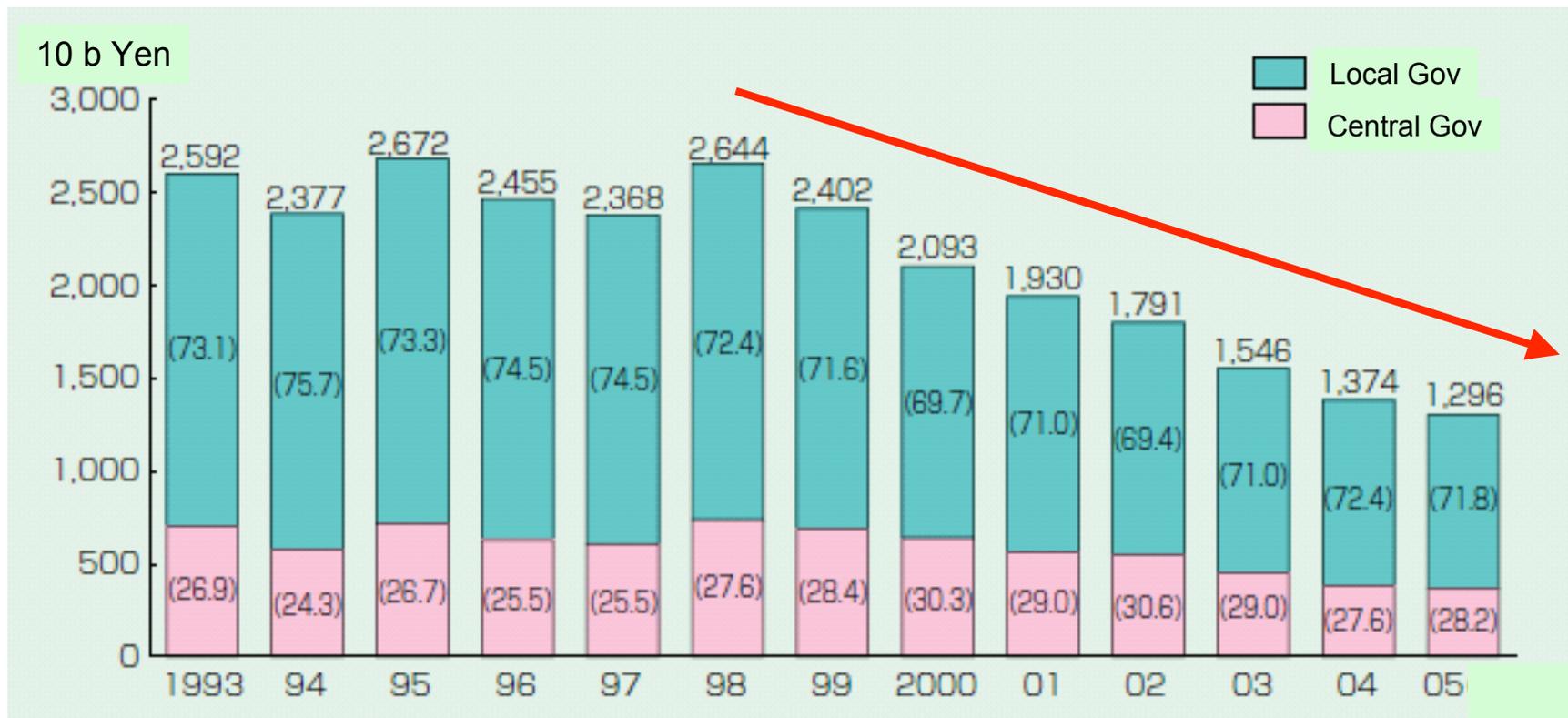


# Why “Dango” becomes a hot issue?

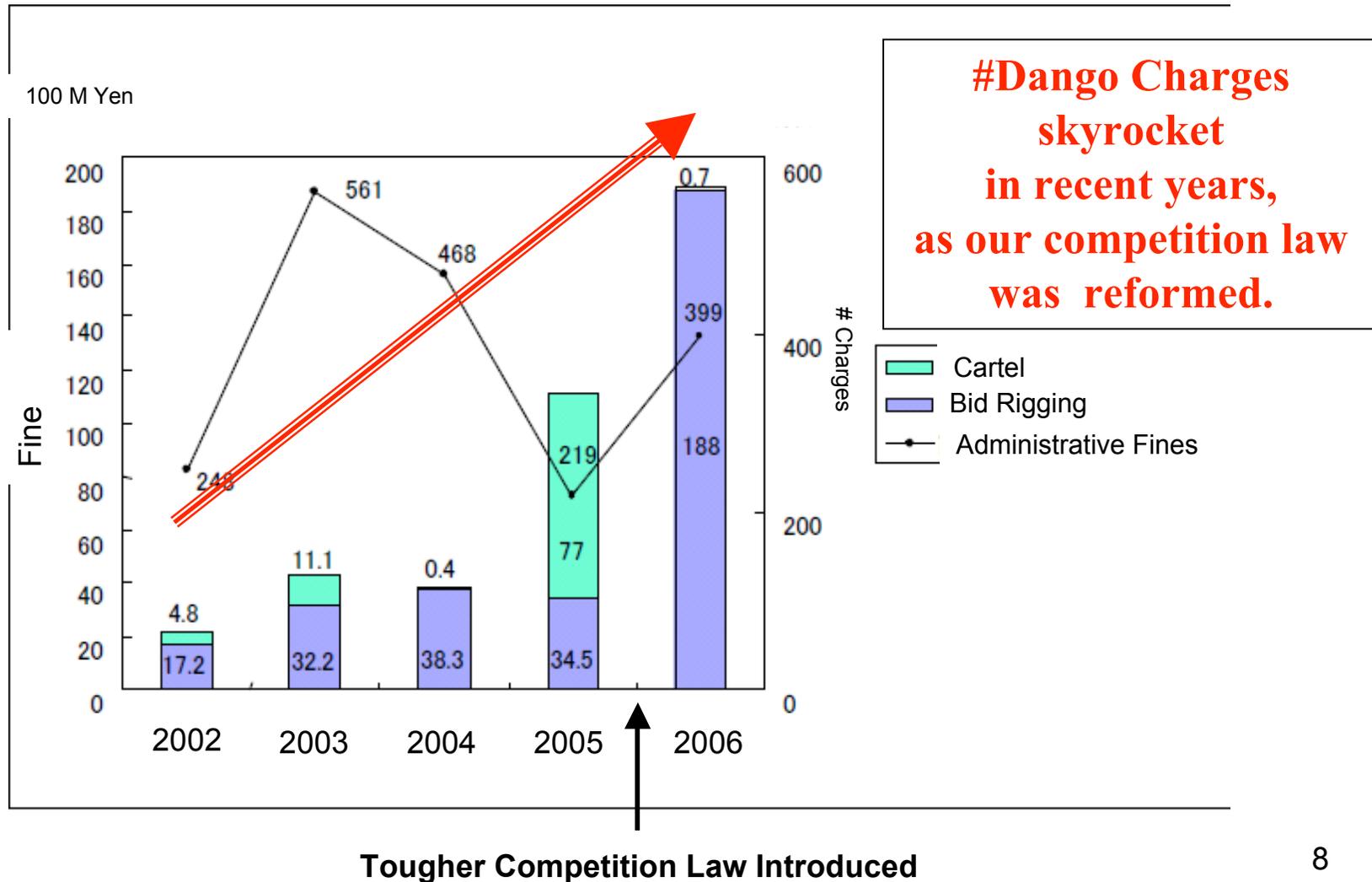
- Koizumi Effects
  - Public becomes more aware of cost and benefit of public service including procurement.
  - People start to recognize VFM on public purchasing (perhaps into the aging society)
- Public scrutiny on companies and demand for social responsibility and compliance
  - Revelation of Fujiya's unsavory operation practices
  - Paloma's defective water heater
  - Matsushita's defective oil heater
- Efforts of the WTO to introduce transparency in procurement (GPA)
- Gov' t budget deficit in Japan
  - at least five million yen per capita
- Stricter Competition Law implemented

# Declining Expenditure for Public Works

The Japanese are more conscious on value for money in public purchasing.



# JFTC looking for Dango



# Why has Dango Survived so long? Economics of Procurement System

# Japanese Accountancy Law

## (Since Meiji Era)

Rule

Exception

### **Competitive Bidding**

As long as they satisfy the minimum criteria (financial responsibility et al),  
Bidders are allowed to participate bidding.

### **Discretionary Bidding**

Only qualified bidders chosen  
by officials are allowed  
to participate bidding

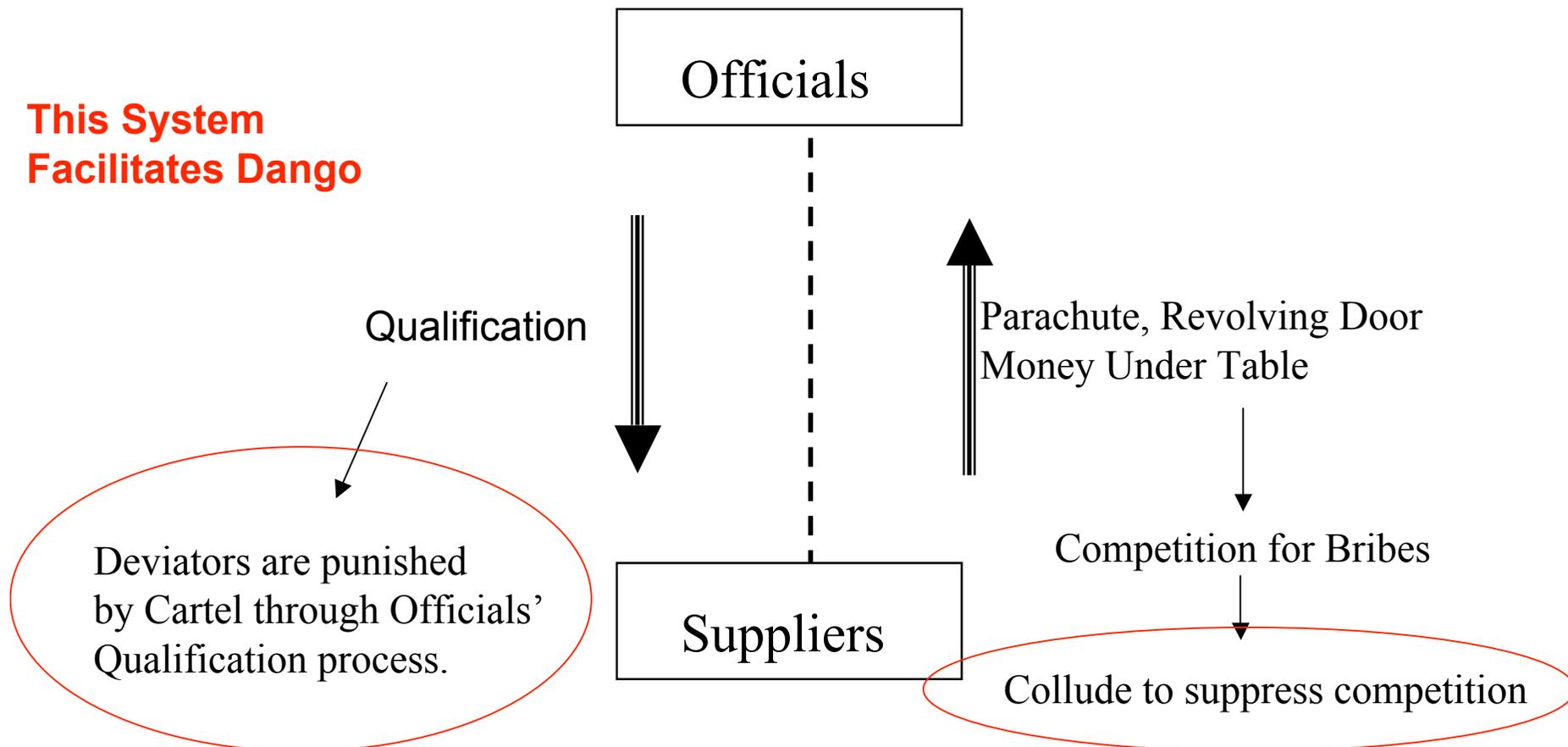
In Meiji era, many cases were observed where suppliers dumped and made inferior products under competitive bidding. The officials needed to use their own subjective information to exclude those bad suppliers by using their discretion.



Discretionary Bidding has prevailed both in central and local governments.

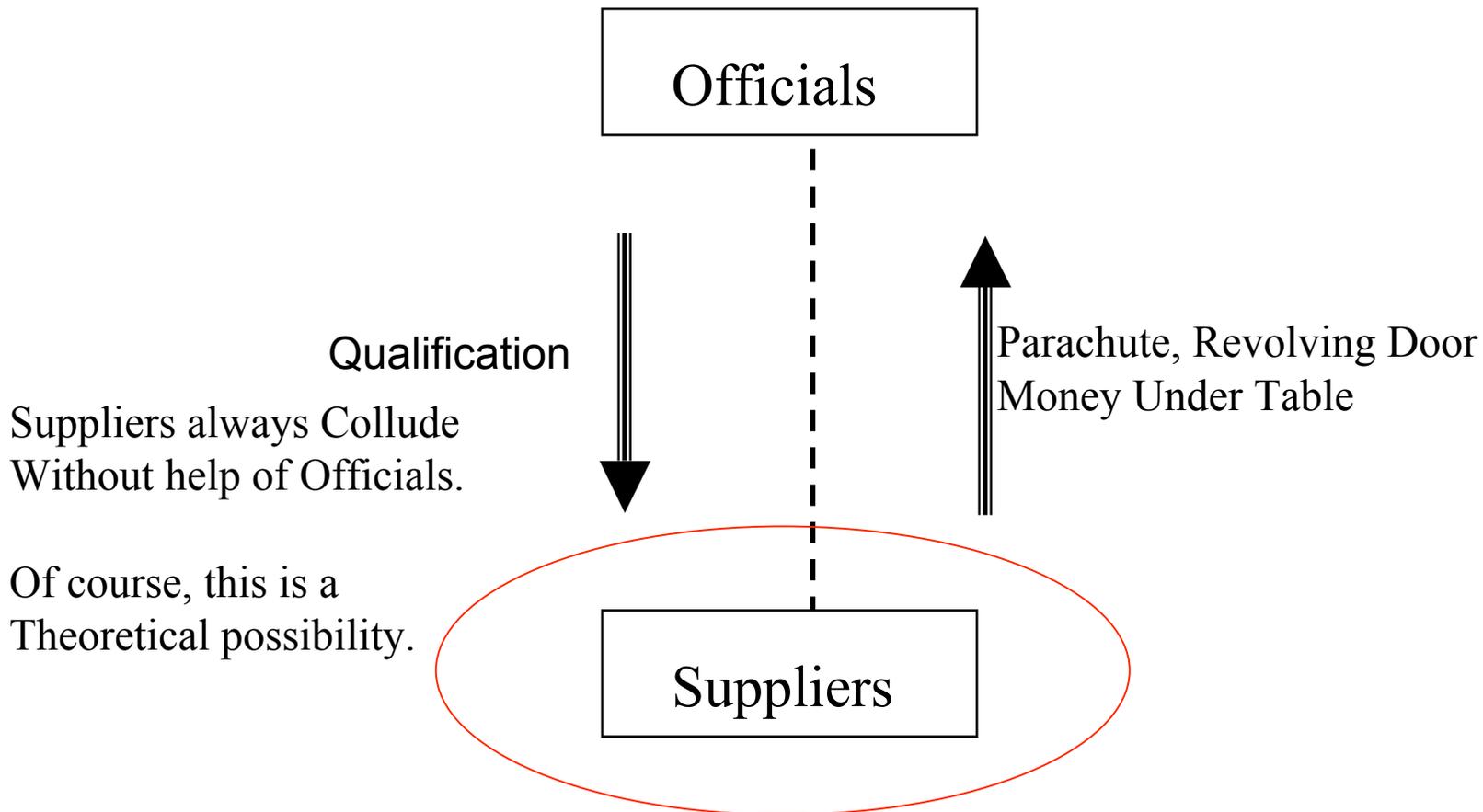
# Dark Side of Discretion

Discretionary bidding came into being for good motives.  
However, this system has root for nurturing corruption and Dango.



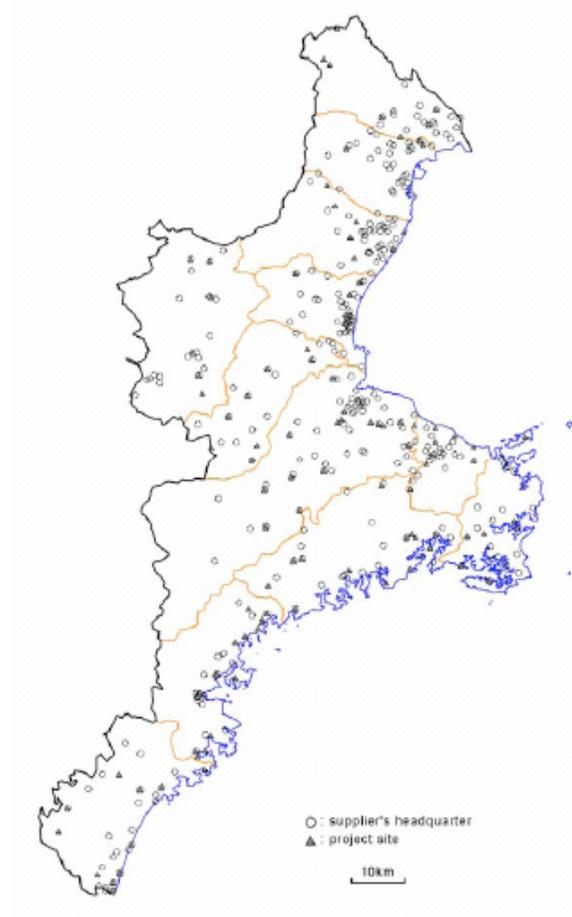
# No Discretion Leads to No Dango?

In view of the fact that discretionary bidding nurtures Dango, gov't started introducing Competitive Bidding (i.e., No discretion).



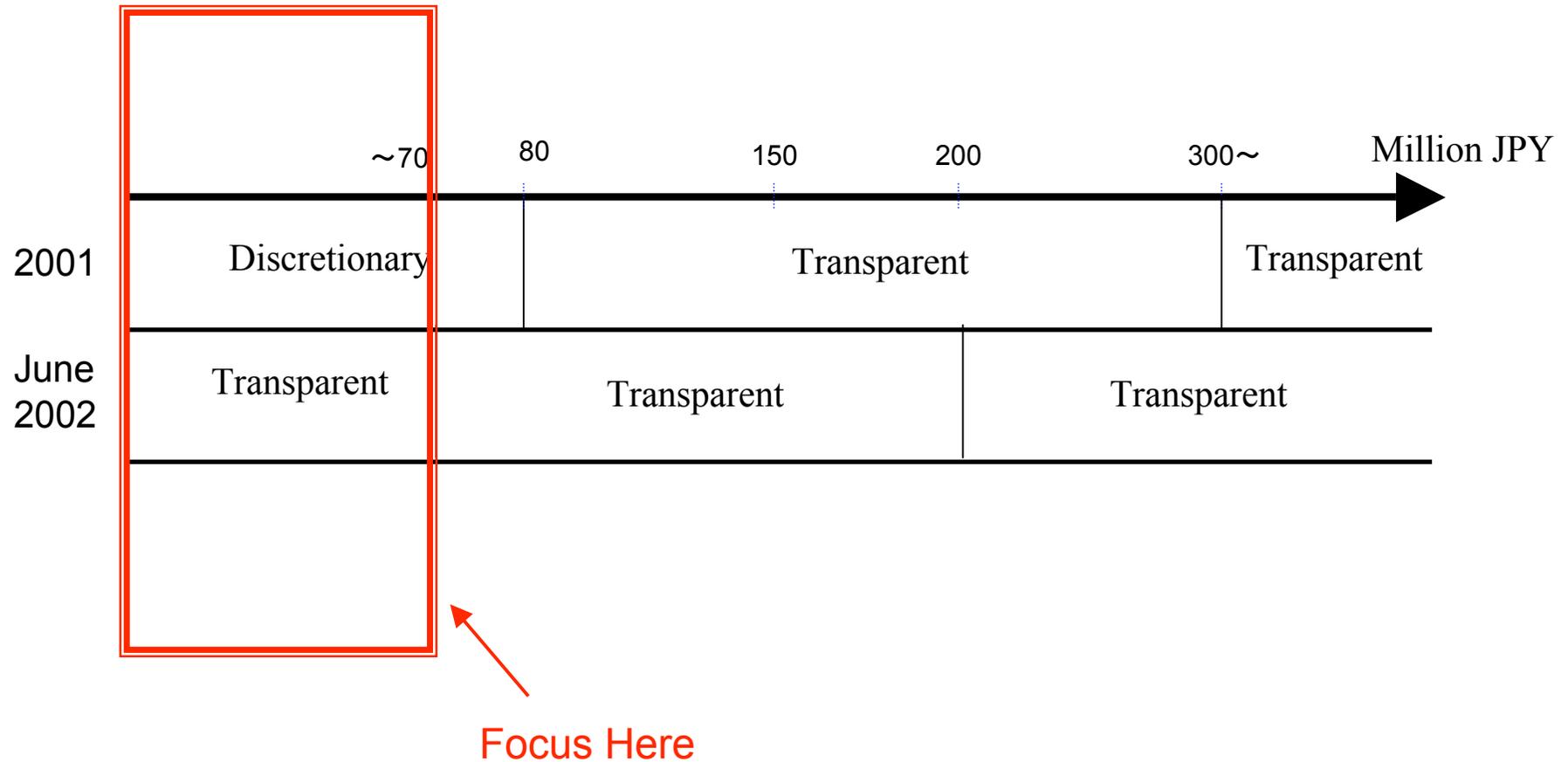
# Dango Remains: Evidence from Mie Prefecture

# Mie Prefecture



11 districts; exclusive territories

# Tendering Format in Mie



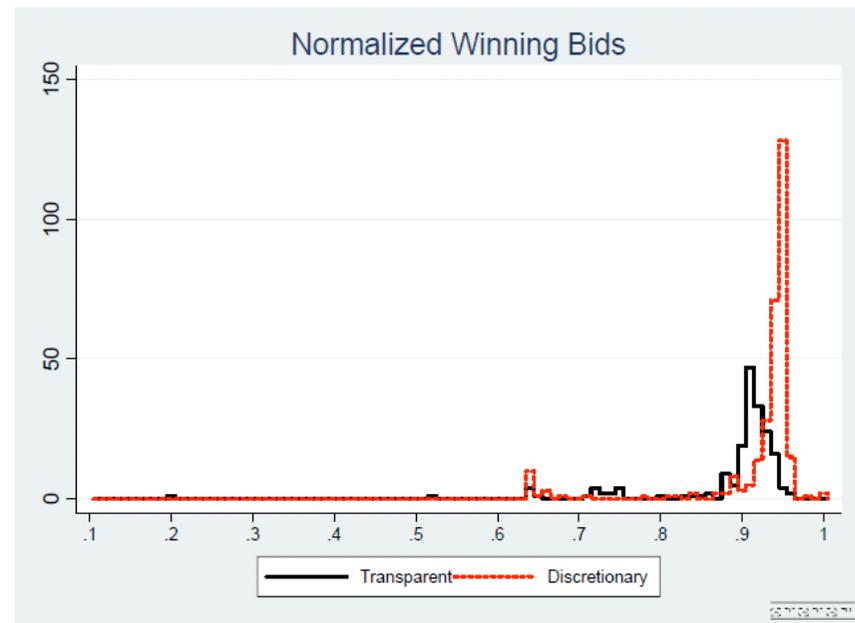
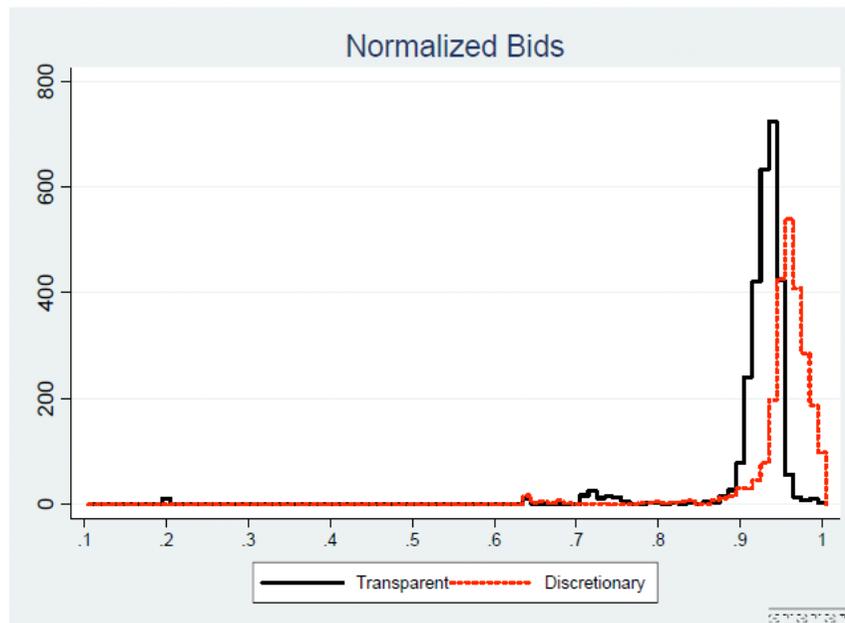
# Data

- Public-works contracts worth a maximum of 70 million JPY (70% in number; 50% in value)
  - Study period: May 2001 – March 2004
    - (May 2002) discretionary procedure → transparent procedure
  - Types of Public works
    - rivers (14.9%); ports (10.2%); roads (41.8%)
    - bridges (2.2%); sewage (1.9%); erosion and torrent control (23.8%)
- Data identify the bidder and bid of each participating bidder, the winner, and the characteristics of each project
- Data contain valid bids of solo bidders (no JV bids)

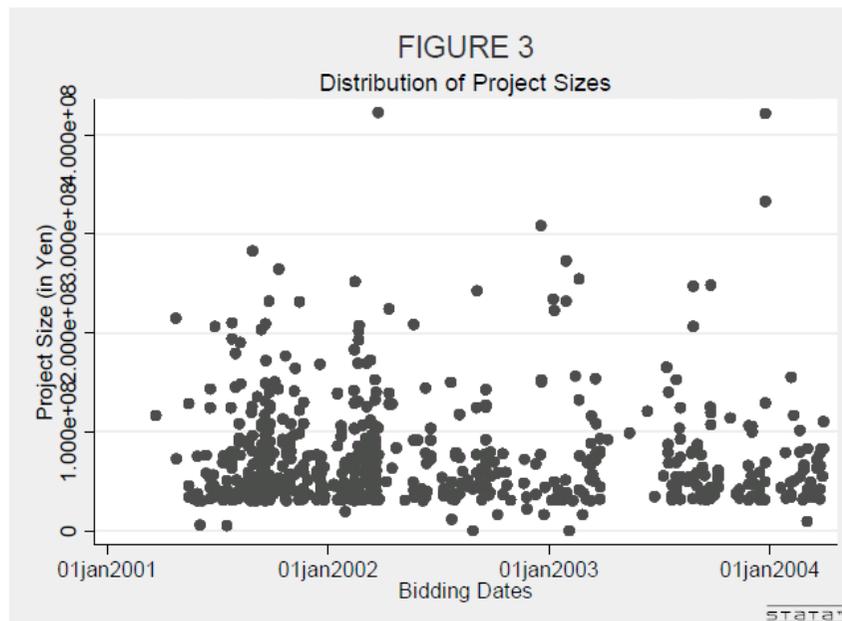
# Auction Outcomes

	Discretionary	Transparent	Difference
# Auctions	136	106	
# Bidders	235	279	
# Bidders Per Auction	8.91 (4-9)	15.71 (4-32)	
Normalized Bids	0.95	0.91	0.03 (0.002)
Normalized Winning Bids	0.91	0.87	0.04 (0.01)

# Effect of Competitive Bidding System



# Do they maximize Bribes?



- To maximize the opportunity of receiving bribes, the officials might have an incentive to divide a large project into small pieces.
  - → bids are likely to be higher under the discretionary regime
  - → downward bias on  $\alpha$ .
- Proportion in number of small projects increased 72 → 76%.
- Thus, the concern in the endogeneity is not severe.
  - Note that this does not necessarily mean the absence of corruption.
  - Officials can be cozy with suppliers over a given set of small projects.

# How to Identify Collusion

- Two ways to identify collusion
  1. Collect hard evidence (wiretap, paper trail, etc)
    - Suppliers will learn how to hide their traces.
  2. Look though bidding data
    - If the bidding is done by competitively, the bids should reflect the bidder's cost. The most efficient (low cost) bidders should win in competitive bidding.
    - Thus, if the bids do not reflect bidder's cost, there is a doubt whether bidding is done competitively.

# Characteristics Variables

- Distance
  - a great circle distance between project site and bidder's headquarter
- Utilization rate
  - supplier's current job backlog divided by its capacity (linear depreciation; consider jobs from JV)
- Government rating
- Past wins
  - difference in cost efficiency, or difference in skill across bidders)
- We find that these cost variables have little explanatory power in the bids and winning bids.

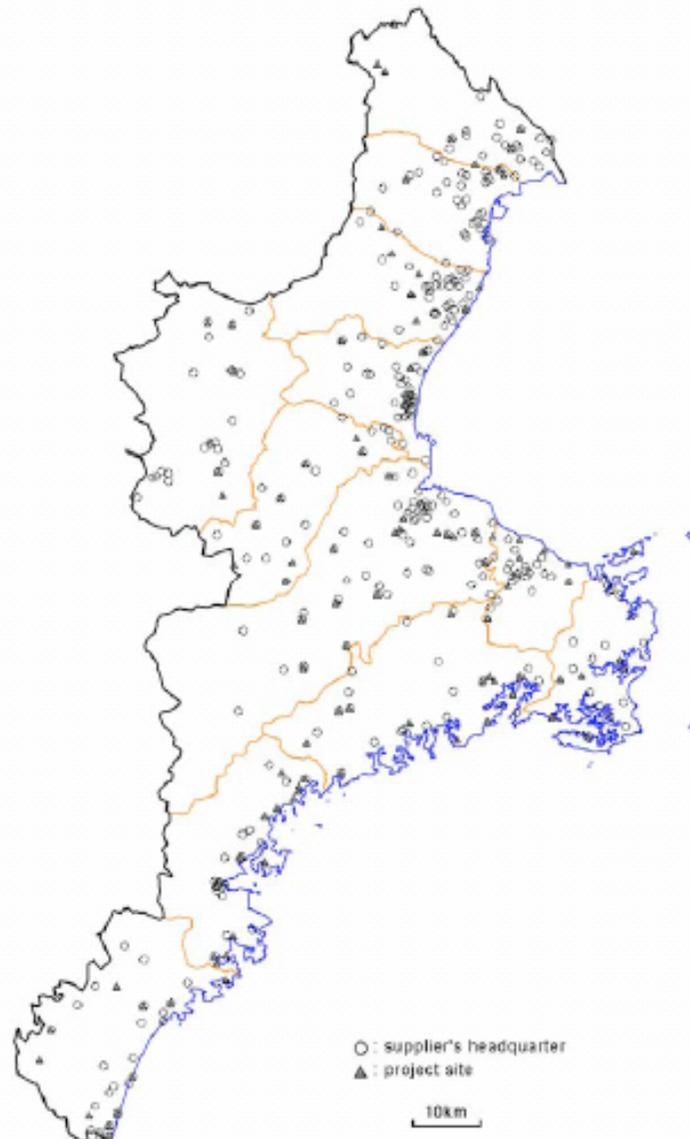
What should we do with Dango?  
How to reform the Japanese System

# Issue 1

## VFM v.s Redistribution

- National procurement policies cover at least two main objectives:
    1. To achieve Value For Money
    2. To favor local suppliers (usually small and medium enterprises) through redistribution
  - Japanese system has placed a substantial emphasis on 2
- Two such elements are: (1) Exclusive territories; (2) Rank System

# (1) Exclusive Territories



Each suppliers are allowed to bid and procure only from the same district in which the supplier's headquarters are located.

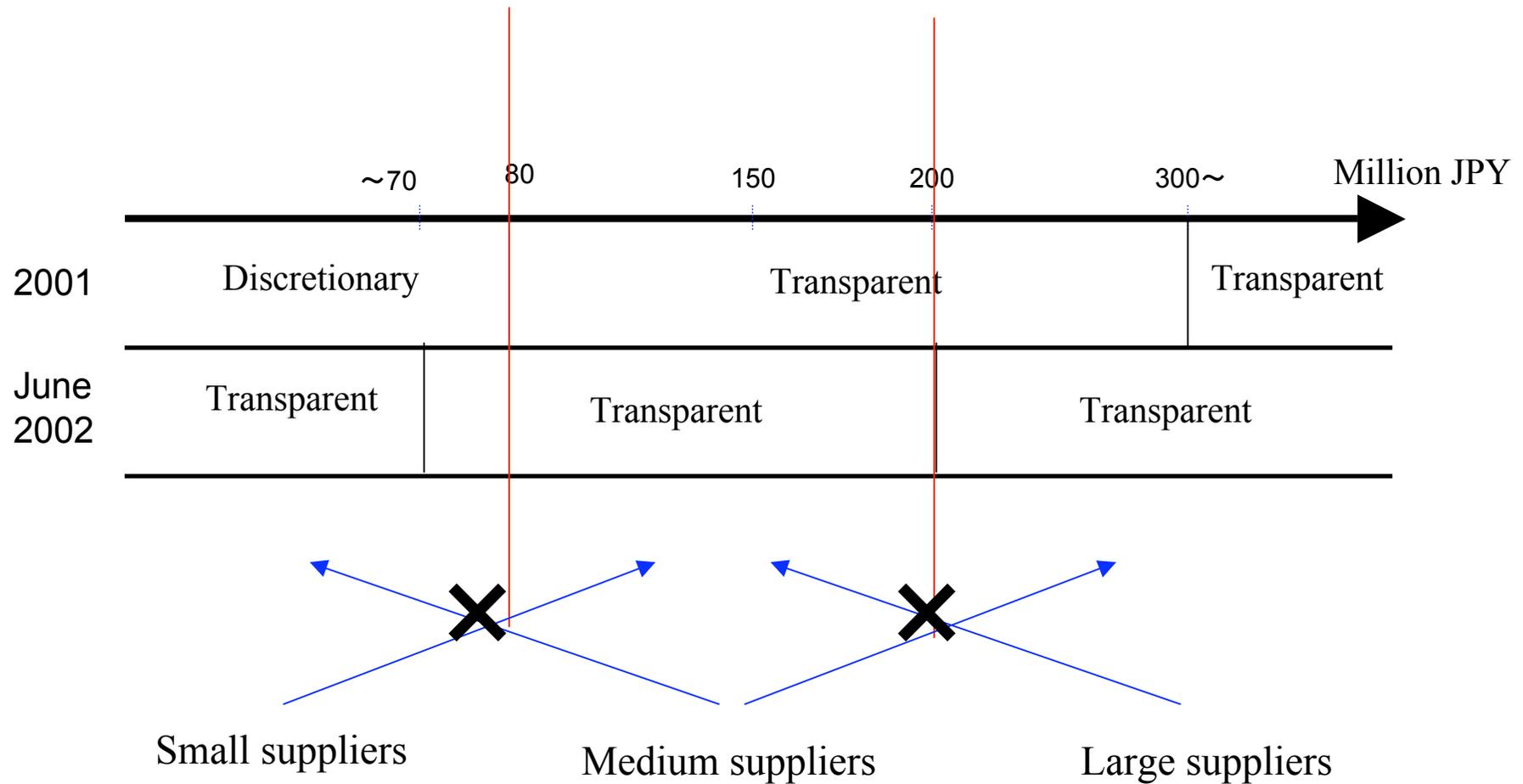


By this way, gov't successfully prevents the entry of suppliers from outside the district, and procures suppliers only from the district.

*“The best of all monopoly profits is a quiet life” (Hicks, 1934)*

# Excluding Qualified Bidders

- (2) Rank System -



# Preferential Bidding

- A common tool to strike a balance between VFM and favoring particular suppliers.
  - Buy American Act (Pref of 6%; 12% for SME)
  - Canada (Pref of 10%)
- It has been shown in academics that preferential bidding promotes competition more effectively than no-preferential bidding.\*

\* McAfee, McMillan, 1989, "Government Procurement and International Trade," *Journal of International Economics*.

# Issue 2

## Problem on Competitive Bidding

- Japanese competitive bidding system is such that:
  - Only price determines the winner, who is the lowest bidder.
  - The winning bid is valid when it is under the government engineering estimate of the project.
- Economics tells us that this bidding system, only based on price competition, works effectively for standardized goods and services (e.g., stationary products); however it does not so for other goods.
- In particular, for non-standardized goods, quality and design concepts are another important consideration.
- For those non-standardized goods, such as construction projects, negotiation and discretion, complemented with price competition, works better.

# Kelman's Experience in the 1990s\*

- Steven Kelman, Kenney School at Harvard, reinvented the American Federal Procurement Policies in 1993 to 1995.
  - Before 1990s, inefficiency exists due to the strict regulation on procuring officers in U.S. Federal procurement.
    - The winner (1) has to be lowest bidder, and (2) provides “objectively” superior quality
  - Even if the officers knew from their past experience that a particular supplier is not suitable for certain auctions, they could not exclude them from bidding.
- Kelman has provided discretionary power for the officers, and allow them to use their subjective opinions in the procurement criteria.
- The Kelman's reform produced outstanding outcomes.

\* Steven Kelman, *Procurement and Public Management*, 1990

# More Incentives for officials

- The current procurement situation in Japan is similar to the years before Kelman arrived.
- We should provide more discretionary power to the officers, and allow them to exercise their expertise and ingenuity in the procurement process.

WAIT! Did we have problems with DISCRETION?

- There are GOOD and BAD discretion.
  - BAD discretion should be severely punished by fines and penalty stipulated by the law.

# Some concerns ahead to the reform

- Many prefectures have begun contemplating or implementing competitive bidding. Bids are dropping for those which introduce competition.

## **GOOD SIGN! HOWEVER,...**

- With the start of the Abe Cabinet: Old guards are returning (who favor local suppliers; probably Dango, too).
- They raise the dumping concern we had in Meiji era.

## **ANY SOLUTION?**

=> Quality problems should be handled by inspection, not by price.

- The “Aneha” problems illustrates how bad our inspection system is.

# Summary

1. Dango will survive through competitive bidding system.
2. The public scrutiny on government expenditure generates more interest on VFM, in contrast to the redistribution to local suppliers.
3. To promote VFM and balance with the interests on local suppliers, preferential bidding system worth the attention. And, we need another *Kelman*.
4. We should be careful in dealing with people who express concerns on dumping. They may be old guards who wish to bring us back to the old days of Dango. What we need is a proper inspection system, not Dango, to take care of dumping.

Thank you for your attention!