



# TRADE AND PROCUREMENT

Effective Public Purchasing and Market Access



Asian Development Bank

# The Need for More Competitive Procurement

Goods, services, employees, customers, investments and intellectual property now cross borders at an ever-increasing rate. Governments sign regional trade agreements (RTAs), bilateral investment treaties, and other economic accords in unprecedented numbers. In the 21st century, open borders have resulted precisely because technological advances have combined with reforms that facilitate many types of commerce.

In contrast, public procurement processes in many jurisdictions remain inward-looking. In some cases, state purchasing regimes were designed long ago to exclude a foreign role. Now that globalization, and related regional economic integration, is the new reality, it is time to revisit whether trade liberalization can be better exploited to enhance procurement outcomes.

The important development priority of promoting inclusive growth is affected by public procurement practices. The young, the old, and the poor in particular are dependent upon the quality of services provided by the state and such provision relies heavily on where inputs are sourced from and on what terms. Companies and their employees

## Public Procurement for Infrastructure and Economic Growth

“...In the future, public procurement and related trade disciplines are likely to be even more important for global economic growth and development than they are at present. Past estimates have indicated that overall government procurement spending accounts for as much as 15–20 per cent of GDP, on average, worldwide though much of this is not covered by current international disciplines. Moreover, infrastructure investment and other public procurement in emerging market economies in Africa, Asia and Latin America is likely to be a major driving force of economic growth in years to come...”

**Pascal Lamy, Director – General, World Trade Organization**

2011. Foreword to *WTO Regime on Government Procurement: Challenge and Reform* (edited by Sue Arrowsmith & Robert D. Anderson). New York, USA: Cambridge University Press

rely on state-funded infrastructure, which in turn relies on state purchasing practices. Whether it is poverty reduction and inclusive growth, jobs, or export promotion, the effectiveness of a nation's procurement regime has in many cases a significant bearing on whether a state attains important social and development goals.

There should be no taboos in reforming procurement processes. The design of state purchasing regimes inevitably involves balancing different socio-political interests. Those that have the most political clout typically tend to get their way—and this often makes for imperfect public policy choices. A review of public procurement processes in light of global and regional developments allows decision-makers to raise their sights above day-to-day administrative matters and consider whether the current balance of interests is the right one. Importantly, it encourages policy makers to assess if there are now better means to attain increased developmental effectiveness.

The unfortunate practical reality for government decision makers, both in developed and developing economies, is that vested interests seek to shape policy outcomes—to the detriment of the rest of society. Increased access to state contracts is no exception. Noble ends and means are hijacked by vested interests opposed to reform—smart policy makers need to keep this in mind.

The purpose of this brochure is to highlight the broader menu of reform options for government policy makers—particularly those responsible for trade growth and more effective public procurement governance—that has arisen as the world economy has become more integrated and regionalized.



# Trade Liberalization Can Improve National Procurement Performance

Twenty-first century globalization has gone well beyond imports crossing borders. However, usually engendering fears of a flood of imports overwhelming local firms and causing job losses—used with effect in the past to scare policy makers and to whip up local resistance—certain political constituencies at the national or local level distort opportunities and benefits that have arisen as governments and technologies have dissolved many impediments to cross-border commerce.

In a world where there are substantial flows of foreign direct investment—including investments by local subsidiaries of foreign firms—and where regional and more far-reaching production networks and supply chains have extended their reach across many sectors and countries, state purchasers in many instances do not realise how much they already benefit from relatively open borders. Figure 1 sets out potential beneficial impacts to national public procurement outcomes from well-sequenced trade liberalization.

**Figure 1: Opening borders improves public procurement outcomes**

|                         |  |   |
|-------------------------|--|---|
| Open borders induce.... | Enhanced competition for state contracts delivering greater value for money  | ...resulting in more transparent, competitive, inclusive, and effective public procurement outcomes |
|                         | Greater competition stimulating product and service innovations as well as process improvements by bidders for state contracts, including public suppliers |   |
|                         | More cost-effective choices available to public buyers   |   |
|                         | More informed price benchmarking for comparable goods and services, deterring collusion among bidders  |   |
|                         | Use of increased transparency facilitating ex-post reviews of procurement outcomes   |   |
|                         | Greater incentives to stick to norms of due process, transparency, and the like to ensure full compliance with trade commitments                           |   |
|                         | Erosion of entitlement among well connected domestic suppliers   |   |
|                         | Greater benchmarking against international best practices in procurement   |   |

Even for restrictive national procurement regimes, when foreign firms cannot bid for state contracts, foreign parts, services, and labor have often contributed to the quality of the items purchased or to the variety of the items from which a local buyer can choose. When governments ban sourcing from abroad, local subsidiaries or affiliates may still win state contracts. In such cases, these firms will likely have benefited from managerial practices, technology, and intellectual property transferred from abroad. To the extent that those cross-border transfers result in better and cheaper goods and services, state buyers and the populations they serve gain as well.



# Industrial Policy Preferences are not Inconsistent with Liberalized Trade and Procurement Regimes

Trade liberalization is much more than letting in imports. Policy makers and public procurement officials alike must be made aware of the potential to use trade pacts to upgrade the quality of governance in national procurement markets in different ways. If negotiated wisely, progressive trade agreements can incrementally increase transparency and bid contestability, deepen collaborative efforts between foreign and local firms, and improve accountability through more robust bid protest and dispute resolution mechanisms. This is an incremental process and there is typically no 'big bang'.

In both bilateral agreements and RTAs that address procurement issues, as well as in cases involving countries that have joined the World Trade Organization's (WTO) Government Procurement Agreement (GPA), there is scope to retain negotiated offsets or local price preference schemes or set asides mandated by national industry policy or other overriding socio-political or economic considerations. It is simply not true that every option for trade reform implies abandoning national industrial policies; in reality, the tension between open borders and industrial policy goals is more apparent than real.

In particular circumstances, some RTA and GPA provisions permit for transparent application and, ideally, phase-out of such schemes when underlying conditions that originally justified such differential treatment no longer exist. For example, many such trade agreements have specific provisions that protect or promote small and medium sized enterprises (SMEs).

These considerations highlight that a government needs to think strategically about how to best exploit trade liberalization in designing its public procurement regime. This is not to say that every state purchasing regime must be reformed in the same way, but rather that key design choices take account of the wider menu of options created by deepening trade liberalization to address procurement issues, in addition to focusing on first order outcomes of minimizing or eliminating tariff and similar financial restraints on trade.

Undeniably, many of those options intensify the competition for state contracts. Enhanced rivalry puts downward pressure on prices received by suppliers and some of

## Does Strategic Market Access Maximize Economic Growth?

The merits of industrial policy and its role in economic development, in both developed and developing countries, has been the subject of considerable discussion and debate. See, for example, Ha-Jong Chang, *Kicking Away the Ladder: Development Strategy in Historical Perspective* (2002) or, more recently, Ian Fletcher, *Free Trade Doesn't Work: What Should Replace it and Why* (2011). Whatever position is taken in this debate, use of preferential public procurement schemes to assist in promotion of industrial policy objectives has to date received little, if any, separate discussion. However, in an era of slower economic growth and increasing fiscal constraint, particularly in Organisation for Economic Co-operation and Development (OECD) countries, focus on the potential advantage (or disadvantage) of using public procurement regimes to reinforce other government policy measures promoting national industrial policy and employment objectives seems increasingly likely. In all events, more considered assessment of preferential domestic procurement regimes will sharpen focus on potential economic costs and benefits, and shorter and longer-term tradeoffs, as well as whether, and the extent to which, such regimes promote or are meaningfully associated with sustained dynamic comparative advantage and trade creation.

them may lose state contracts. This is one of those situations where it is critical to weigh all of the consequences of a policy change. The intensified rivalry also forces all firms—domestic and foreign—to keep cutting costs, raising productivity, and improving their service offerings, all of which benefits state buyers and the many in society who depend upon state-provided services. Policy makers must consider the impact on every relevant social interest, not just on those vested interests with political clout that invariably bemoan the 'creative destruction' brought about by progressive change.

It is important to realize that the medium term effect of greater competition is often quite different from its immediate consequences. As domestic firms raise their game, the more efficient and responsive are better able to withstand foreign competition and, ultimately, to contest meaningfully in foreign markets. At the same time, less competitive firms may be driven out of particular markets. To be sure, governments can secure many of the benefits of open borders—greater choice, better value for money, access to foreign managerial practices and technology—through focusing directly on the need for national reforms undertaken on their own, often making reference to best practices.

Some have taken the above approach in bringing about such reforms, most often relying on a narrow band of NGOs and civil society and social groups interested in transparency and accountability, without the benefit of a broader commercial community of interest. Others, however, have given greater traction to such initiatives by garnering support from local exporters and commercial interests that benefit by regional production networks or local supply chain integration through introducing progressive provisions relating to improvements in public procurement regimes as part of trade agreements.



# Using Regional Trade Agreements to Enhance National Procurement Governance

RTAs are binding agreements between members that are not global in scope. This means a RTA could involve two or more signatories from different continents. WTO reports that there has been a wave of such accords since 1995, so the question of how RTAs can be used to shape government procurement reforms is a live one. This question is particularly relevant for the Asia and Pacific region where, since 1990, over 200 RTAs have been signed or are under negotiation.

One significant misconception of non-trade experts is that RTAs only refer to getting rid of tariffs and quotas on manufactured goods. In fact, given the right opportunities, trade negotiators have also sought to include rules that enhance the transparency and operational integrity of markets and of the regulatory regimes that oversee them. As government spending has grown over time, trade negotiators have sought ways to attain those objectives in state purchasing regimes as well. The result is a rich set of alternative reform options.

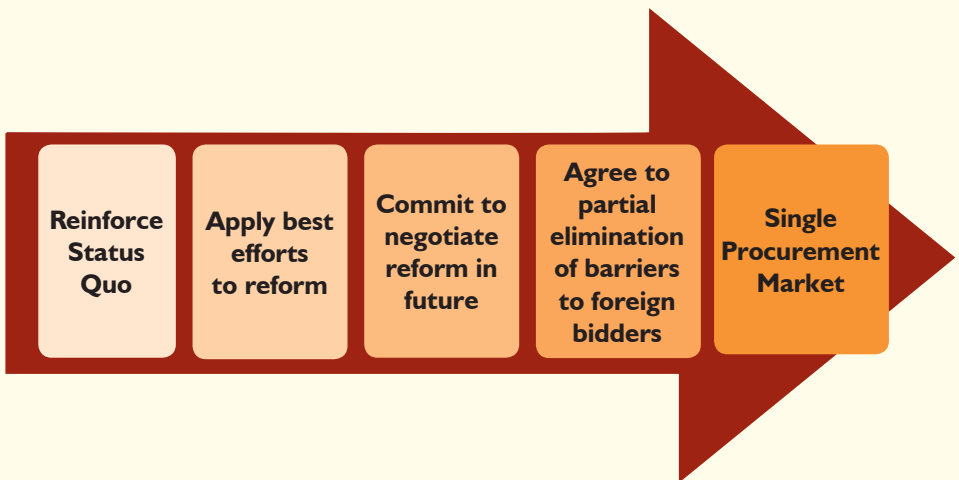


Trade agreements provide two main ways in which governments can exploit open borders when redesigning their state purchasing regimes. First, trade agreements can be used to introduce and strengthen important procedural rights, due process, and transparency into public procurement practices. Institutional innovations—such as improvements to bid challenge procedures and wider dissemination of procurement opportunities and procedures—have been parts of reform packages that have been codified in trade agreements. Smart governments have used the negotiation of RTAs to upgrade a wide range of regulatory institutions.

Second, trade agreements create an important dynamic: they facilitate the alignment of national reform-minded constituents with progressive outward-oriented local firms as well as regional or international concerns interested in deepening production networks and supply chain integration. Such accords combine a range of obligations into one bundle, to the immediate advantage of national firms that want to export and invest more abroad. Those firms have a strong incentive to ensure that their government follows through on implementing reforms that were promised to trading partners, lest those partners too renege on their commitments to the disadvantage of such outward-oriented firms. For a reforming policy maker, these firms are allies that counterbalance the objections of those local firms—not infrequently owned or sponsored by vested interests—that oppose procurement reform. If well managed, the basis of support for procurement reform in the RTA context can be broader and more sustained than under unilateral reforms.

Another advantage of RTAs is that they can incorporate different levels of reforming ambition as detailed in Figure 2 below. A recent analysis of RTAs in the Asia and Pacific region showed that, in fact, five levels of ambition—ranging from reinforcing and codifying the status quo to the creation of a single market for government procurement contracts in goods and services—have been negotiated. This reinforces

**Figure 2: Five degrees of reforming ambition on procurement matters in RTAs**



the point that reforming state purchasing through trade agreements is not simply a theoretical option but is, in fact, a practical alternative flexibly pursued by many governments to deepen regional (and global) economic integration. Moreover, there is no single, rigid template for trade agreement-based procurement reform, so policy makers can tailor initiatives to their own needs and circumstances.

## **The Multilateral Option: WTO's GPA**

Another option for national policy makers is to join the WTO's GPA. This accord is unlike many others at the WTO. Apart from a few countries that joined this organization since 1995, membership is voluntary. In December 2011, revisions to the GPA were agreed. These revisions include provisions of specific interest to developing countries, namely, allowing retention of price preferences and offsets, higher thresholds before multilateral obligations begin, exceptions to public bodies covered, and longer phase-in times. Provision exists to extend those phase-in times further and, in general, least developed countries are given greater latitude than other developing countries. As many Asia and Pacific countries designate themselves as developing countries at the WTO, these provisions are of considerable potential interest for those governments considering acceding to the GPA.

Members of the GPA have negotiated to open up parts of their state procurement markets to each other's firms. The exact amount of opening is negotiated by parties, indicating that there is flexibility to respond to domestic factors. As Table 1 (see page 12) shows, the total size of state spending by GPA signatories from developed countries on goods already exported by Asian developing countries was nearly \$700 billion in 2008. While construction, computer, and telecommunications services account for the bulk of that sum, these are sectors where Asian firms will continue to have strong competitive advantages and opportunity for deepened regional and wider trade growth with increased GPA membership in the future.

A recent study of the effect of GPA membership on trade between OECD countries (using econometric modeling) found that, for most signatories, the GPA has a positive impact on bilateral trade in goods and services, though the magnitude of impact may vary between trade in goods and services.<sup>1</sup> This study noted that GPA membership seems to play a more important role in promoting bilateral trade in services than in trade for goods, possibly because, for the countries surveyed, services accounted for a majority of the government procurement market for most GPA parties. The results also suggested that exports were influenced considerably more by GPA membership than imports. The GPA, then, can be seen as a positive factor for trade creation and expansion of export markets for OECD countries, particularly in the context of services.

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1 H. Chen and J. Whalley. 2011. *The WTO Government Procurement Agreement and Its Impacts on Trade*. National Bureau of Economic Research Working Paper Series, Working Paper 17365. Cambridge, Massachusetts: National Bureau of Economic Research.

GPA membership, however, involves more than exchange access to national procurement markets. While GPA signatories take on a range of procedural and institutional obligations, those obligations specify outcomes and objectives and not form—allowing for different approaches to state purchasing to coexist. The goal is to encourage the transparent, honest, and unbiased implementation of state purchasing that respects the due process rights of other signatories and their exporters. Unlike other WTO accords, the GPA is unique in giving foreign suppliers rights to challenge government decisions, in this case bid processes. When run properly, these challenge procedures build confidence in the integrity of public procurement processes, reducing the likelihood that public procurement disputes spiral out of control.

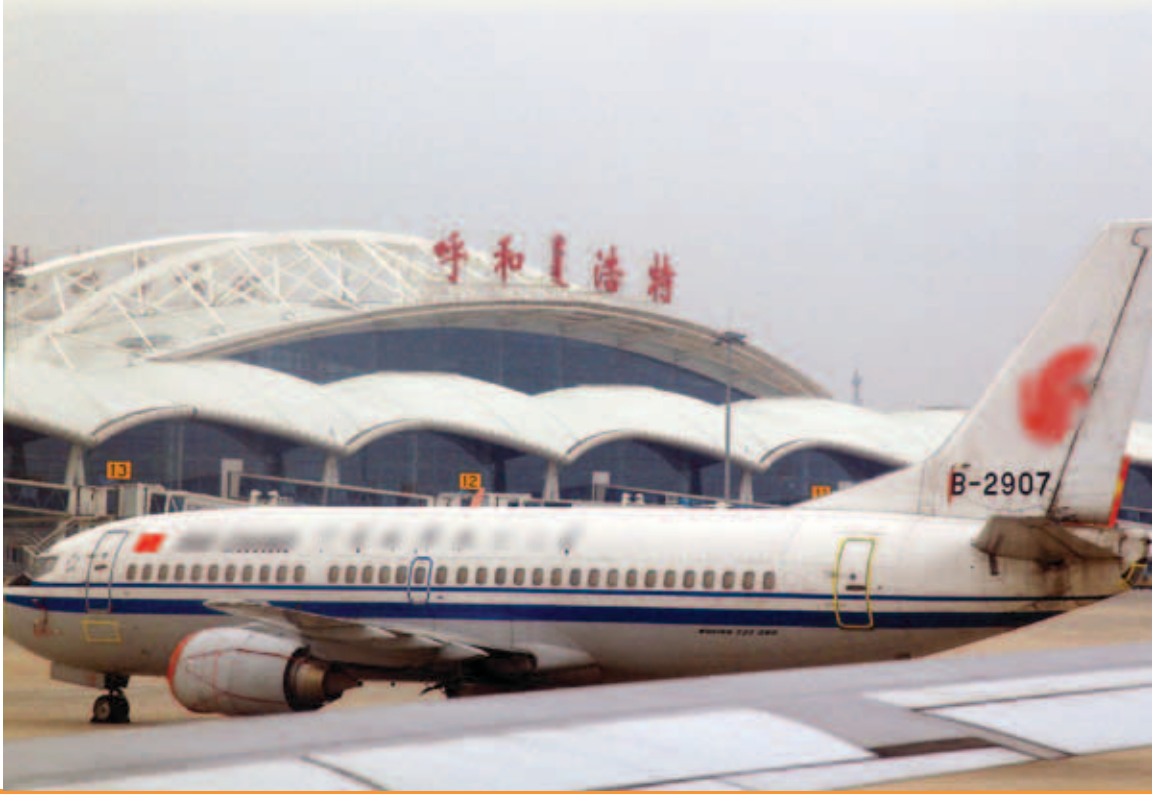
**Table 1: GPA member spending on goods exported from Asia and Pacific countries**

| <b>Parties</b>   | <b>European Union (2007)</b><br><i>(for all covered government entities, € = \$1.3706)</i> | <b>Japan (2008)</b><br><i>(except otherwise specified for central government entities only)</i> | <b>United States (2008)</b><br><i>(except otherwise specified, for the US Department of Defense [DOD] only)</i> | <b>Total</b>            |
|--|--|---|---|-------------------------|
| <b>Construction Services</b>   | \$125.7 billion  | \$11 billion<br><i>(central and subcentral government entities only)</i>                        | \$287 billion<br><i>(central government entities only)</i>  | \$423.7 billion         |
| <b>Pharmaceutical Products, Health Services and Related Entities</b> | \$15.1 billion   | \$1.46 billion  | \$120 billion   | \$136.56 billion        |
| <b>Computer and Related Services</b>                                 | \$46.5 billion   | \$US 2.1 billion  | \$1.6 billion   | \$54.83 billion         |
| <b>Telecommunication Services</b>                                    | \$4.1 billion  | \$531 million   |   |                         |
| <b>Chemical Products</b>   | \$21 billion   | \$7.2 million   | \$2.24 billion  | \$23.25 billion         |
| <b>Fuels and Petroleum Products</b>                                  | \$4.5 billion  | –   | \$12.3 billion  | \$16.8 billion          |
| <b>Machinery and Associated Products</b>                             | \$14 billion   | \$329 million   | \$518 million   | \$14.85 billion         |
| <b>Textile, Clothing and Footwear</b>                                | \$4.4 billion  | \$19 million  | –   | \$4.42 billion          |
| <b>Plastic and Rubber Products</b>                                   | \$903 million  | \$3 million   | \$53 million  | \$959 million           |
| <b>Wood Product</b>  | \$195 million  | \$62 million  | –   | \$257 million           |
| <b>Total</b>   | <b>\$236.4 billion</b>   | <b>\$15.51 billion</b>  | <b>\$423.71 billion</b>   | <b>\$675.63 billion</b> |

Source: Robert Anderson et al. 2011. *Assessing the Value of Future Accessions to the WTO Agreement on Government Procurement (GPA)*. World Trade Organization Staff Working Paper ERSD-2011-15. Geneva, Switzerland: World Trade Organization.

In a world of open borders, GPA influence extends beyond the formal accord. Commentators have noted that many RTAs include obligations taken from the GPA. Many GPA principles are also aligned with leading United Nations instruments on public procurement, such as United Nations Commission on International Trade Law (UNCITRAL). Concerns, then, about a tangled web of international obligations—such as overlapping rules of origin in the context of tariffs—appear less problematic in the area of public procurement than they are in other policies covered by trade agreements.

On joining WTO, the People’s Republic of China (PRC) committed to join the GPA. In December 2007, PRC sought to honor that commitment by formally seeking accession. PRC involvement in the GPA accession process has been associated with an increase in the number of formal GPA “observers” from Asia which now include Indonesia, India and Thailand. No doubt the latter are interested to learn on what terms PRC will join and the negotiation processes associated with that accession. Unlike most WTO accords, the most favored nation principle does not apply to government procurement, so PRC might negotiate access to foreign government procurement markets on a reciprocal basis. Whether other Asian nations can negotiate similar terms remains to be seen.



## Ten Myths associated with Open Borders and Public Procurement

- 1) *Our domestic firms have done a good job supplying the government in the past. We don't need open borders in public procurement.* **No:** If existing government suppliers source parts and raw materials from abroad they're already benefiting from open borders. The same is true if they've hired foreign workers. Moreover, if any suppliers are local subsidiaries of foreign firms, then state buyers are already benefiting from open borders.
- 2) *Favoring local firms through set asides and the like isn't allowed under modern trade accords.* **No:** RTAs and the WTO's GPA allow for both permanent and temporary sectoral exceptions to liberalization.
- 3) *Industrial policy is impossible after trade agreements come into force.* **No:** Trade agreements haven't prevented a massive revival of interest in industrial policy since the global economic crisis started in 2007. Not every industrial policy tool discriminates against foreign commercial interests and those that do can be covered by carve-outs and exceptions in trade agreements.
- 4) *Opening up procurement markets to foreign firms will reduce the share of public contracts filled by domestic firms.* **No:** When the Republic of Korea joined the WTO's GPA, for example, the share of contracts won by foreign firms went down, not up.
- 5) *Opening up state contracts to foreign bidders will put government buyers at the mercy of international cartels and multinational companies.* **No:** While anti-competitive foreign corporate practices certainly exist, there is a growing body of evidence in developing and industrialized countries showing how state buyers are taken advantage of by collusion between domestic suppliers. Policy makers should have no illusions here. Whatever their source, anti-competitive practices are a serious challenge facing state purchasers and the proper laws and regulations should be put in place to tackle them.

- 6) *Developing countries need time to build up institutions and competitiveness before opening their procurement markets to trade.* **Yes and No (depends on circumstances):** Technical assistance provided in conjunction with a trade agreement can be used to build up domestic capacity before imports are allowed to contest local markets on more favorable terms. Trade agreements are flexible enough to allow sequencing of reform.
- 7) *Developing countries don't have the political will to sign free trade agreements that include meaningful public procurement provisions.* **No:** Not every free trade agreement has expansive obligations on state purchasing. Real world experience has shown there are five different approaches to dealing with procurement matters in trade agreements, starting from affirming the status quo to high levels of reforming ambition.
- 8) *Our exporters could never win foreign government procurement contracts.* **No:** When presented with lucrative commercial opportunities, within an encouraging policy framework, properly incentivized managers rise to the challenge. Many developing country exporters of commodities, raw materials, and parts and components benefit indirectly when their corporate buyers win contracts to supply foreign governments. Direct exports to foreign governments are only part of the picture in a world of integrated supply chains.
- 9) *WTO trade rounds take forever.* **No:** As a useful vehicle to frame a reform program, the WTO's GPA operates independently of multi-year WTO trade rounds. Moreover, it's possible to negotiate RTAs independently of the WTO timetable. Not every negotiation has to be a marathon, like the Doha Round.
- 10) *Trade diplomats know nothing about public procurement.* **No:** Many trade diplomats have learned about public procurement matters. Many trade ministries consult widely within government before developing negotiating positions. This is a matter of internal coordination and organization within a government.

# Options for Policy Makers

Public buyers of goods, services, and infrastructure should check whether the institutions are in place to take the greatest advantage of trade integration. This applies to every state purchaser—not just national governments. Regional and wider economic integration represents a clear way to push suppliers to compete, upgrade their offerings and after-sales service, as well as the often overlooked related opportunity to enhance the transparency, predictability, and integrity of public procurement processes.

It is equally clear that forward-looking officials prepared to better take advantage of open borders will face opposition from those who have benefited from the status quo. Opponents to reform will resort to a lot of misleading and false claims—see the “Ten Myths” (at pages 14–15). Reformers should reject sectional interests and pursue the broader national interest instead. In a time of strained public finances, policy makers should be getting the best possible value for money while promoting transparency, economy, efficiency, equal opportunity and fairness.

## National Policy Coherence is Critical

“...In public procurement markets the official de jure discrimination in the shape of declared preferences for national suppliers or price preferences generally represents only the tip of the iceberg of informal de facto discrimination that is made possible thanks to the scope for discretion in interpreting contact award procedures. The fact that some countries make use of de jure ‘buy national’ policies does not change this fact. Past experience with efforts to achieve transparency and competition in public procurement suggests that this can only really be achieved when key interests in government, industry and purchasing entities are persuaded that this is the best policy...international agreements are unlikely to provide early solutions to problems created by national champion policies pursued by other countries based on preferential public procurement...”

**European Union. 2012. *Public Procurement in International Trade*. Belgium (This study was prepared by Dr. Stephen Woolcock for the European Parliament’s Committee on International Trade).**



Governments of all types have started down the reform path and have found trade agreements a useful vehicle to shape in some cases—and to reinforce in others improvements in national public procurement systems. Reforms can be tailored to local circumstances—the record shows there is “no one size fits all” approach.

Equally important, meaningful procurement reform is, more often than not, difficult given the resistance of vested interests to increased transparency and competition. Therefore, in practical terms, approaches to addressing improved market access through trade agreements need to be incremental in nature, through a gradual yet determined effort by progressive trade negotiators, public procurement agencies and reform-minded constituencies, and carefully sequenced to promote sustained momentum.

A rethink of how the ultimate beneficiaries of better state purchasing practices—namely, taxpayers, users of state services (many of whom are poor), and firms that rely on state infrastructure and services—can best benefit from open borders is long overdue. Deeper trade integration can contribute to inclusive growth, enhanced resource allocation and productivity levels, as well as improved governments.

## Possible Next Steps

Governments in the Asia and Pacific region can take the following eight steps to secure the benefits of increased regional and wider economic integration:

- Investigate and identify factors that discourage firms from bidding for public contracts in their jurisdictions;
- Review existing rationales for national public purchasing rules, analyzing alternative policy approaches (and related trade-offs and externalities) with greater or lesser degrees of market access;
- Assess the costs and benefits of existing biases for selected firms against potentially greater opportunities for national exporters and foreign firms, subsidiaries and importers;
- Explore ways in which approaches to public procurement in RTAs can usefully promote national development, trade and growth strategies, with particular attention on:
  - exploiting opportunities to upgrade national procurement institutions and practices; and
  - deepening supply chain and production network integration (through, for example, targeted technical assistance and capacity development collaboration with RTA partners)
- Assess short and longer term market impacts and incremental sequencing of trade and procurement reforms to optimize national policy choices;

- Benchmark national public procurement performance against good practice norms contained in UNCITRAL and other regional and international accords;
- Consider gaining “observer status” for WTO’s GPA with a view to learn the pros and cons of joining the GPA and the experience of other GPA signatories; and
- Deepen the impact of existing and contemplated RTAs through inclusion of new provisions, or making existing commitments relating to public procurement markets stronger.

Development partners can assist governments in such efforts, including through promoting initiatives that focus on quantifying the costs of local “rent seeking” behavior and the potential savings from more robust competition because of increased transparency and market access resulting from trade agreements that include progressive procurement-related provisions.

With significant increases in “South–South” trade over the past 2 decades, and the need to promote global rebalancing in the aftermath of the economic contraction of 2008, national policy coherence in the area of industrial policy, public procurement governance and trade liberalization is long overdue.

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## About the Asian Development Bank

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two-thirds of the world's poor: 1.7 billion people who live on less than \$2 a day, with 828 million struggling on less than \$1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

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