

THE DEVELOPMENT OF CHINA'S PROCUREMENT AGENT INDUSTRY

- FROM THE LEGAL AND ECONOMIC PERSPECTIVE

Yong ZHAO
Institute of Public Market and Government Procurement of
The University of International Relations

【Abstract】

There is a fundamental change of the methods of resource allocation in our way in the transformation from a planned economy to a market economy. When using the fiscal funds, Chinese government uses competitive method for looking for suppliers of works, goods and services from the market and entering into contracts with them. In this context, the special way of entering into a contract by open and transparent tendering and bidding method emerges at the right moment. In the process of economic transformation, the procurement agent experiences rapid development as intermediary organization with Chinese characteristics. However, during the past 30 years since its birth until today, its role, function, and its legal relations with purchaser, as well as its composition and competition situation in the market have undergone tremendous changes. This article tries to analyze the changes from the dual perspective of law and economics, and to put forward for the development direction of the procurement agent industry.

【Keywords】 Procurement Agent Development Entrust Tendering

【Text】

I. The Industry Life Cycle Theory

Charles Robert Darwin in his book *On the Origin of Species* divided the biological evolution process into four phases: the transition breeding, competition for survival, genetic variation, survival of the fittest. This biological concept was later introduced to the economics and management science theory, and it first applied to the product, and later extended to business and industry. Industry life cycle theory comes from the product life cycle theory which proposed by Raymond Vernon in 1966. Based on quantitative research and this theory, Gort and Klepper divided the industry development into four periods: introduction, growth, maturity, and decline or decay period. Through research, the author found that the development stage of the procurement agent industry is in line with the industry life cycle theory as described. Accordingly, it shows different characteristics at different stages.

II. The Introduction Period of the Procurement Agent Industry: 1980 - 1993

1. The Legal Relationship of the Principal and the Agent

The procurement agent was born out of the foreign trade agency company. China's foreign trade agency company is based on the import and export monopoly rights under the administrative examination and approval system. In 1980, the government began to propose the reform which turned the traditional state monopoly for purchase and marketing system to foreign trade agency system in the field of foreign trade, allowing the professional foreign trade companies engaged in foreign trade agent business. In 1984, the State Council approved the Ministry of Foreign Economic and Trade the *Report on the Views of the Foreign Trade System Reform*. Since then, the implementation of the foreign trade agency system has been one of the main contents of the reform of China's foreign trade. At the legal level, the agency system only based on the *General Principles of the Civil Law* in 1986. Article 63 stipulates: Citizens and legal persons may perform civil juristic acts through agents. An agent shall perform civil juristic acts in the principal's name within the scope of the power of agency. The principal shall bear civil liability for the agent's acts of agency. The *General Principles of the Civil Law* recognizes only the named and direct agency relationship, does not empower the agent to perform civil juristic acts in its own name which is unnamed and indirect agency rights. In order to make up the blank of lacking of the legal relationship for the indirect agency on the legal aspects, the former Ministry of Foreign Trade and Economic Cooperation in 1991 promulgated the *Interim Provisions on foreign trade agency system* (hereinafter referred to as the *Interim Provisions*). Article 15 stipulates that the trustee signed import and export contracts with foreign merchant under the entrustment agreement in its own name, and shall promptly send a copy of the contract to the principal. Entrustment agreement shall not be contrary to modify or change the import and export contracts by the trustee and foreign merchant. Trustee shall bear the contractual obligations for foreign merchant, and enjoy contractual rights. The *Interim Provisions* provide a legal basis for the legal relationship of the indirectly agent which widespread practice in the field of foreign trade in the form of departmental normative document.

In the early stages of building the legal system of the market economy, the high-level *General Principles of the Civil Law* and the lower level *Interim Provisions* joint action in foreign trade agency this legal relationship, the result was: the *Interim Provisions* obviously prevailed. With the regulatory provisions of the government act on the foreign trade agent behavior, so that the latter cannot be a voluntary act between equal civil subject as the *General Principles of the Civil Law* described, and become a mandatory statutory agent act. The executive-led solutions have strong representativeness and practical significance in the early stages of economic transition from a planned economy to a market economy. Such mandatory agency relationship was also applicable to the procurement agent which had just established at that time. Precisely, there was no procurement agent as independent legal person. The

procurement agent then existed in the form of one department or branch of the foreign trade agency company. The procurement agent right not formed a formal qualification or legal authorization. In addition to the right to engage in foreign trade, its legal basis mainly comes from the department regulations, normative documents issued by the mechanical and electrical products departments and even conventional practices. This approach has also been recognized by the World Bank and other lenders.

2. The Market Competition Pattern

From the demand side, the procurement agent business limited to World Bank and Asian Development Bank and other foreign investment projects. The market size is relatively stable. From the supply side, a variety of written rules and implicit requirements established high barriers to entry for the procurement agent industry, in addition bidding transactions come into China for a short time and it only play a role in mainly World Bank project and other foreign-funded projects. Thus in more than ten years introduction period of the procurement agent industry, there were only China National Technical Import and Export Corporation and China National Chemical Construction Corporation and two more other state-owned foreign trade companies engaged in procurement agent business (in the industry commonly known as “The Traditional Four Tendering Agents”). The high degree of market concentration, the agency fee pricing using one case one meeting method, there was no uniform standards. Because the Traditional Four Tendering Agents had different industry backgrounds such as technology, chemicals, machinery, instruments etc., there were no substantial competition and conflict for their procurement agent business. Thus it formed the oligopoly structure led by the buyer (in this case refers to the procurement agent) in the procurement agent market. Because the size of the market as a whole is not big, the annual turnover of the procurement agent business of each company (compared with the later) was not high, but stable, which is about hundreds of millions to over a billion dollars a year.

3. The Quality of the Personnel

The practitioners mainly had the knowledge background in foreign language, foreign trade areas. With the development to the peak in the mid-1990s of the foreign trade industry, the Traditional Four Tendering Agents with monopoly rights of procurement agent attracted a large number of top students graduated from prestigious universities. After a period of study and practice, some of them gradually became the backbone of the procurement agent industry.

4. The Services Provided for the Principal by the Procurement Agent

The services provided by the procurement agent mainly reflected in three aspects: First, on behalf of or to assist the purchaser to go through with the project, especially the approval process related to the import of mechanical and electrical equipment,

including for import permits, tax relief or tax refund procedures, import customs formalities and so on. In the administrative system at that time, the relevant approval process must be handled by a company with the right of procurement agent to complete. Second, provide professional services of foreign language, foreign trade, and tender work. In foreign-invested projects, all the procurement documents such as loan agreements, bid documents, tender documents, bid evaluation reports and contract etc. are prepared in English. The bidding contract was not yet known by most Chinese. Because the lack of talents, knowledge of foreign trade and tendering procedures of the purchaser, it's impossible for them to bid by themselves. Also, because the very limited opportunities for most of the purchasers to get foreign investment, it's unrealistic to establish a bidding team by the purchaser themselves. So procurement agent provided translation of documents, bid Opening, bid Evaluation, contract negotiations, contract dispute resolution and other aspects of professional services for the purchaser. Third, the procurement agent using their own expertise and understanding of the international market provided the information of suppliers and international market to the purchaser, and provided information services in the technical program selection, equipment selection for the purchaser.

5. The Role of the Procurement Agent in the Procurement System

Beyond all doubt, due to the above four reasons, namely the legal relationship of forced internal (owners) and external (supplier) indirect agency, oligopoly market position, with high-quality personnel, providing professional and irreplaceable service, the procurement agent occupied a dominant position both in internal agency and external procurement activities organizations during the introduction period. Under the circumstances of the functions of the government and enterprises had not yet completely separated, no very clear definition of property rights, the purchaser's market position had not fully established, the purchaser had not been given full legal responsibility, also had not assigned full procurement right. This right and obligation configuration was comparatively balanced. As the enterprises directly under the former Ministry of Foreign Trade and Economic Cooperation and the former Ministry of Chemical Companies, the procurement agents in the prevailing historical conditions, internally exercised part of the management functions of the government as well as the purchaser's procurement functions. For World and Asian Development Bank, they would also be glad to deal with procurement agents without language barriers and familiar with the procurement process. The procurement agent played an irreplaceable role to let bidding successfully landed in China.

III. The Growth Period of the Procurement Agent Industry: 1994-1999

1. The Legal Relationship of the Principal and the Agent

The *Foreign Trade Law* is the basic law in the field of foreign trade in China which was Promulgated and implemented in 1994, and it plays a commanding role in the

economic and trade fields. Article 13 stipulated: Organizations or individuals without permits for foreign trade business may entrust foreign trade operators within China to conduct foreign trade businesses on their behalf within the business scope of the trustees. The foreign trade operators who are entrusted to conduct foreign trade business shall truthfully provide the trustors with market information, commodity prices, information about clients and other relevant business information. The trustors and trustees shall conclude a trusteeship contract in which the rights and obligations of both parties shall be specified. The *Foreign Trade Law* for the first time in the legal aspects of establishing a foreign trade agency system, emphasized that the control of foreign trade rights. Unfortunately, it's not recognized the unnamed indirect agency in the legal aspects. As to the agency relationship issue, the *Foreign Trade Law* had not only failed to solve the contradiction of the *General Principles of the Civil Law* and the *Interim Provisions*, but rose this conflict to the level of legal conflict of the laws, causing confusion on the law applicable.

The development of the practice will not stop due to the hysteresis of legislation. Due to the increasing size and number of the procurement project, all kinds of procurements and contract disputes also increased. In the practice of procurement, the procurement agent charged about 1% of the agency fee on the principal, and enjoyed a 100% contract rights and assumed 100% of the contractual obligations to the suppliers. The rights and obligations configuration were obvious imbalance. This unreasonableness brought distress and losses to the parties, at the same time presented the urgent needs of the legal basis of the indirect agency.

2. The Market Competition Pattern

With the procurement process continues to mature and improve, the uncertainty and risk of the procurement agent market had reduced. Especially the Traditional Four Tendering Agents attracted the attention colleagues since they obtained excess profit by using their monopoly position. More and more new competitors entered into the procurement agent industry by the encouragement and support of the relevant government agencies. There were three comparative representative types of enterprises: First, industry and trade companies expanded their business. These companies were attached to the government department in charge of the industry such as petroleum, petrochemical, aviation, aerospace, electric power etc., and they expanded their procurement agent business. Second, the competent department of the procurement business led the establishment of professional tendering company. The representative case was the establishment of the China CNTC International Tendering Corporation which approved by the former State Economic and Trade Commission in 1993 and established by the China National Tendering Center of Machinery & Electronic Equipment in 1994. Third, some investors with a keen nose for the market began to focus on other procurement agent markets beside the international procurement of mechanical and electrical products since the bidding method was gradually introduced to the domestic construction projects and government

procurement projects. The representative case was the establishment of the Guoxin Tendering Co., Ltd. in 1999. The company was originally co-sponsored by the 6 different state-owned and private investors and established after the approval of the former State Planning Commission. Since its inception, the company put the attention focused on the procurement agent market on the then burgeoning construction projects and government procurement field.

During the growth period of the procurement agent, more and more new enterprises entered into or were trying to enter into this industry. The former Ministry of Foreign Trade which in charge of the imports of mechanical and electrical products and the Economic Cooperation and the former State Economic and Trade Commission which in charge of the approval of technological transformation projects began to use qualification management approach to restrict and regulate the procurement agent industry. In 1996, the State Economic and Trade Commission promulgated the *Interim Measures on Electric Equipment Tendering Institutions Qualifications Management* and the *Mechanical and Electrical Equipment Bidding Regulation*. Later it evolved into the 1999's *Technological Transformation Project Equipment Tendering Agency Qualifications Interim Measures*, which supervised the procurement agent qualifications on innovation projects. The former Ministry of Foreign Trade and Economic Cooperation promulgated the *Regulation on International Tender of Electromechanical Products* and the *International Tendering Institutions Qualifications Examination and Approval Measures* in 1999, which supervised the procurement agent qualifications on international tender of electromechanical products projects. There were over 100 procurement agents obtained the qualifications in technological transformation projects according to the *Technological Transformation Project Bidding Agency Eligible for Annual Review Results in 2000* released by the former State Economic and Trade Commission since then.

Most procurement agents were directly under the local government, competent department of industry and tendering management department, so the same body of supervision and bull management issues began to be revealed. The barriers to entry into the industry had decreased with the normative and transparent of the procurement agent industry management. The number of the procurement agent grew faster than the growth rate of the market demand, so the procurement agent market was encroached on the monopoly market which occupied by the Traditional Four Tendering Agents. It began to have a certain degree of competition between the procurement agents.

3. The Quality of the Personnel

The professional foreign trade agency grew to the peak in the development in the medium-term of 1990s and then gradually moved to steady and decline. And part of its backbone of talents began to drain to other industries. Newly established

procurement agent as a new industry had not been well-known to the public, and did not obtain excess profits in the market. Therefore the procurement agent industry had been unable to be as attractive as in the past to the top talents in schools on the society. A considerable part of the practitioners changed careers from the corresponding industry and local government administration to this industry. In this case, the employees of the procurement agent possessed the educational background, relevant management experience and the necessary level of professional ethics.

4. The Services Provided for the Principal by the Procurement Agent

Overall, the procurement agent still provided services in three parts: tendering business work, project approval, import, tax relief and other project-related procedures work, and also provided the market quotation.

The purchaser played an increasing role in the entire project procurement work and scope and depth of services provided by the procurement agent began phasing out, especially in the project approval, began import procedures and contract management services aspects, because the domestic people began to understand and become familiar with the procedures of the procurement and also part of the purchaser had repetitive procurement work. Another change is that based on the needs of different purchasers, each procurement agent provide differentiated services for the purchaser. Both purchaser and procurement agent initially clarified their agency relationship, and generally signed the agreement of agency. The format and content of the agency contract were gradually standardized, and divided the rights and obligations of both parties in details. The purchasers began to bargain on standards for agency fees.

5. The Role of the Procurement Agent in the Procurement System

In the legal aspects, the direct agent relationship of equality, voluntariness established by the *General Principles of the Civil Law* and the primarily regulatory indirect agent relationship stipulated by the *Interim Provisions* common but contradictory acted in the procurement agent industry. The result of these two laws' stalemate was that the strong position of the foreign trade agency established by the *Interim Provisions* was on the decline. In the market economy transition aspect, the purchaser's right as principal had been gradually established, and the functions of government and enterprise had been gradually separated. In the professional ability aspect, the ability of the purchaser was enhanced, and the ability of the procurement agent was weakened. In the market competition aspect, the original minority procurement agent's monopoly pattern on the market was broken. The result of the joint action of the above factors on the allocation of the right of procurement (mainly for the bid evaluation process as well as the preparation of the bid evaluation report), was that the formation of the three pillars situation of the purchaser, procurement agent and design units. The responsibility borne by the purchasers in the project construction and the right to have in the procurement were still not fully in place. The rights and obligations configuration was still comparative balanced. The procurement agent was

able to complete procurement agent work with compare standard in this period, have certain influence in evaluation of bid and award of bid, actively train procurement people, communicate smoothly with world and Asian Development Bank, promote the healthy development of the procurement agent industry, and play an important role in the procurement system.

IV. The Maturity Period of the Procurement Agent Industry: 2000 till the Present

1. The Legal Relationship of the Principal and the Agent

As to the legal relationship of the procurement agent, China promulgated and implemented the "Contract Law" in 1999, which supplement, and improve the agency system. It not only enhances the legal level of the *Interim Provisions*, but also breaks through the limitation of the *General Principles of the Civil Law* which only regulate direct agency. It adds contents about indirect agency. Article 402 of the *Contract Law* stipulated: Where the agent, acting within the scope of authority granted by the principal, entered into a contract in its own name with a third person who was aware of the agency relationship between the principal and agent, the contract is directly binding upon the principal and such third person. This provides a legal guarantee for the agency entrusted tender in its own name in procurement activities. Article 403 balanced the rights and obligations of the parties by the introduction of the right of intervention of the principals and the third person option right system in the common-law system. The *Bidding Law* promulgated in 1999, defined the procurement agent's legal status at the legal level for the first time, and laid a legal foundation for the development of procurement agent industry.

As to the right to engage in foreign trade, China formally joined the WTO at the end of 2001. In order to fulfill the commitments within three years of opening up foreign trade rights, China had gradually changed the examination and approval system to the registration system. In 2001, the former Ministry of Foreign Trade and Economic Cooperation issued the *Import and Export Business Qualification Regulations*; In November 2002, the import and export business management system network began to run on national network; August 2003, the Ministry of Commerce issued the *Notice of the Ministry of Commerce on Adjust the Import and Export Qualification Standards and Procedures for Approving*, further lowering the threshold, standardizing the approval procedures. In April 2004, the National People's Congress amended and approved the *Foreign Trade Law*. In the same year in June, the Commerce Department issued the *Foreign Trade Operators Registration Measures*. It changed the examination and approval system to the registration system for the management of foreign trade rights, and abolished the threshold limit for foreign trade rights, and expanded the range of the foreign trade operators to the individuals. As of the end of April 2009, China has 755,000 foreign trade operators in total which is more than 30 times than the time at the end of 1999.

So far, the legal relationship between the purchaser and procurement agent is an agency relationship between the equal civil subjects. The rights and obligations of both parties under the voluntary negotiation agency agreement, and the agent can use direct agency or indirect agency to perform the procurement activities according to the agreement.

2. The Market Competition Pattern

The promulgation and implementation of the *Bidding Law* declares the beginning of the big development and prosperity of the procurement agent industry in the early 21st century.

The procurement agent increases very fast due to the rapid expansion of the size of the market, the increased tendering agency accreditation departments as well as the reduction of market entry barriers. Insiders estimated that there were millions of the practitioners in the procurement agent industry.

In the introduction and growth period of the procurement agent industry, although there were certain competitions between agencies, there were very few enterprises to withdraw, but due to the capacity of the market had been growing rapidly, the number of market entrants is far greater than the exit by quantity. Until maturity period, the market has begun to differentiate, industry-leading enterprise gradually dominate. They rely on the advantages of qualifications, personnel, funding, policy, customer base, and continue through internal expansion and external merger to establish branches in various ways to expand the scale and reap super profits rely on economy of scale. On the other hand, there have been new companies to enter the procurement agent industry at this time. Due to the slowdown in the growth rate of the market demand, the competition between the procurement agents is more and more serious, so some of the enterprise exited the industry because it's difficult to adapt to the competitive environment. However, as always the total enter number is greater than the total exit number, so the total scale of the industry is still growing. Since the alternatives (mainly referring to purchaser invites tenders by themselves) begin to appear and grow rapidly, the overall competitiveness of the procurement declines.

3. The Quality of the Personnel

The increasing number and size of the procurement agents show a rapid growth trend, but there are only less than 100 professionals trained in domestic universities annually. The high-quality, specialized human resources in government procurement area are very scarce.

4. The Services Provided for the Principal by the Procurement Agent

Because the domestic fund and government procurement projects share most of the procurement market, the translation of text and language as well as the import customs formalities are no longer the services provided by most procurement agents. Since the introduction of the demonstration effect of the industry leader, as well as all types of standard tender documents, preparation of tender documents no longer is regarded as a work of the technical content. As the former State Planning Commission promulgated the *Interim Measures on the Administration of the Procurement Agent Service Charges* in 2002, procurement agents cannot have substantial price competition. Thus, there are some improper behaviors, and even commercial bribery and other criminal behaviors.

5. The Role of the Procurement Agent in the Procurement System

In the legal aspects, the *Contract law* has made it clear that the agency relationship of equality, voluntariness between the purchaser and the procurement agent. The procurement agent no longer has any monopoly right to operate due to the liberalization of foreign trade rights. In the market economic transformation aspect, after 30 years of development, the right as principal of the purchaser has been established. In market competition aspect, the procurement agent has changed from a seller's market into a complete buyer's market. The procurement agent is absolutely in a weak position due to the above reasons. Due to historical reasons, the *Bidding Law* gives the bid evaluation function to a temporary unincorporated organization which called the bid evaluation committee. The responsibility borne by the purchaser of the project construction has been basically put in place, but it lost the right to the bid evaluation. The bid evaluation committee has sovereign rights, but they almost do not have or cannot bear the corresponding responsibility. This right and obligation configuration is serious imbalanced. In this case, the positive role of procurement agent in the entire procurement system has been getting smaller and smaller. Fragmentation in the management of the procurement agent and the same body oversight problems are more and more prominent. Local protection of the procurement agent industry and regional blockade phenomenon are very serious. Facing the survival pressure, some procurement agent even goes to the opposite of the design of the system. Chinese Academy of Social Sciences published the *Corruption Situation and Countermeasures Research of Social Intermediary Organizations* in 2009. It said the procurement agents often become illegal profiteering helper.

V. The Expectations of Procurement Agent Industry

In accordance with the industry life cycle theory, the procurement agent industry will also enter into the recession or transformation period in the future. This period is likely to occur in the shift of China's economic growth rate and the mode of growth, and the reduction of investment in fixed assets. It may also occur at the time of a change of the way of the conclusion of public contracts. Currently the transformation experience of some procurement agents provided different path choices of

development directions for the procurement agents in the industrial institutions transition period in the future: the first choice is Economy of Scale. It combines the internal processes, strengthen staff training, and provide standardized procurement process services for the purchasers. Through economy of scale to reduce costs, improve efficiency. The second choice is Economy of Scope. It can expand the scope of services. Making the single procurement services extends to project financing, project management services, cost, contract management, supply chain management and other fields by using client resources and its own personnel, and increasing revenue through product differentiation, economy of scope. The third choice is Specialization. It overall joins to a large-scale enterprise group and get the long-term survival and development of space through providing professional procurement services inside the enterprise.

From the point of view of the management and supervision governments to the procurement agent, they should timely change their managerial ideas. Both domestic and foreign lessons tell us that the concentration of power will inevitably lead to the low efficiency of management and corruption breeding. The procurement agent has played an active role in certain historical periods, but the negative effects of the local protection, the blockade of the industry, the authority extends etc. are more and more apparent. The procurement agent industry will sustainable develop in a long time, but of the industry competent department should focus on enhancing the ability and quality of the practitioners. Some departments have made a good attempt in implementing the tenderer vocational qualification system in this regard. This will be the development direction in the future for a long period of time.