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NPRU Policy Briefing

Driving innovation through public procurement

The government can and should use the £125bn 'power of the public purse' to drive innovation

Innovation has a role to play in efficient procurement – and efficient procurement has a role to play in stimulating innovation.

Innovation in procurement is crucial if the government is to meet its objectives of reducing costs and improving public services. However, this can be achieved whilst also supporting UK businesses to be more innovative – thereby boosting the UK economy.

Innovation in procurement can make the public sector more efficient

The public sector currently spends £125bn per year¹

Public procurement plays a central role in delivering public services, such as health and education, and involves all government departments, local authorities, agencies and other public bodies.

Innovation can help reduce costs...

In the 2004 Comprehensive Spending Review (CSR), the government set itself a target of £3bn of value for money savings from procurement by 2008, which it argued could be delivered by giving businesses the opportunity to innovate. It is on track to meet this target.² Further targets on cutting costs are expected in the 2007 CSR.

... and drive up the quality and effectiveness of public services

While the procurement of innovative products and services has a role to play in reducing costs, it can also help drive up the quality and effectiveness of public services.

Procurement can stimulate innovation and boost the economy

Innovation policy must use the demand-side as well as the supply-side

Current policy focuses on boosting innovation through supply side interventions such as knowledge transfer programmes and the R&D tax credit.

However, very little consideration is given to the demand-side of the innovation equation. With a budget of £125bn, the government is the biggest customer in the UK economy, and consequently has the power to demand the production of innovative products and services.

The government should act as an 'early user' for small, innovative firms and manage the consequent risk

'Early users' play a critical role for innovative firms, providing the initial revenue and customer feedback they need to survive and refine their products and services so that they can later compete effectively in the global marketplace.³

However, many businesses, particularly smaller ones, are unable to find willing customers for their innovations in the early stages of development.

Because of the scale of public procurement, the government is frequently well-positioned to serve as this 'early user', demonstrating the value of innovative products and services to the wider market while providing revenue to the supplier and meeting public needs.

Although doing this would involve the government bearing a proportion of the risk inherent in all innovation, effective mechanisms exist for managing that risk, particularly

The government spends £4bn each year on direct support to small businesses, but £125bn on public procurement

given the scale of public procurement activity.

Public procurement has the power to create new markets for innovation

The sheer scale of government procurement can also serve to establish entirely new markets for innovations. For example, if the government decided that all new schools should be carbon neutral, the scale of the subsequent procurement would immediately stimulate firms to develop and supply environmentally-friendly construction techniques.

The government has taken steps to improve procurement

OGC established to improve procurement practices across government

In 2000, the Office of Government Commerce (OGC) was established to support initiatives across government to encourage better supplier relations and sustainable procurement.

Recognising the importance of innovation, the OGC has produced guidance for public procurers to "provide organisations with a valuable springboard for innovation and to encourage a sound approach to risk."⁴

Initiatives introduced to boost procurement from SMEs

In 2000, the UK launched the Small Business Research Initiative (SBRI) to encourage the allocation of R&D expenditures to small firms.

Originally a voluntary guideline, since the 2005 Budget the SBRI has mandated that every government department contract a minimum of 2.5% of external R&D from small businesses.

In 2006, the government also launched the supply2gov website which targets small businesses by advertising lower-value public sector procurement opportunities.

Co-ordinating public procurement to stimulate business R&D

The DTI's 'Innovation Platforms' aim to direct more business and publicly-funded R&D towards major policy challenges such as network security and intelligent transport systems. Supported by the Technology Strategy Board (TSB), the 'Innovation Platforms' align funding streams from separate sources and link business and the research community through procurement opportunities.

However, many problems remain

Innovation and risk taking are not encouraged in public procurement

By the OGC's own admission, public procurement still has a "tendency to opt for low-risk solutions, low-margin players and mature technology," and "innovation is not routinely welcomed or rewarded."⁵

In part, this is due to the competing objectives and bureaucratic barriers that public procurers face, which discourage risk taking.

The OGC website itself contains dozens of sets of guidelines, toolkits and criteria for procurement officers to absorb. This complexity is exacerbated by the need for public procurement to address other issues, including environmental concerns and local economic development.⁶

Small businesses only receive a small proportion of procurement

Only one fifth of central government contracts are awarded to small businesses,⁷ with 14% of SMEs citing the "effort involved in bidding or pre-qualifying" as a barrier to selling to the public sector.⁸

The SBRI programme has contributed to a rise in the number of smaller businesses who obtain contracts from government bodies to conduct R&D. However, despite this rise, only £55m worth of contracts go to small businesses.

Reflecting this, 40% of small firms "strongly disagree" that the

“There are major opportunities to make public sector procurement more effective in stimulating innovation while achieving spending objectives and value for money”
– DTI, *Innovation Report 2003*

government supports innovation by acting as an early adopter of ideas.⁹

The OGC should be given greater powers to direct procurement practices

The OGC must be given the authority to direct central government activity...

In January 2007, it was announced that the OGC will undergo a radical overhaul. While it will be reduced in size, it will have a stronger mission to set departmental procurement standards and monitor performance.¹⁰ However, it remains unclear whether the OGC will have the capacity to meet these objectives, as it will have no authority to direct central government departmental activity.

...and a stronger role in coordinating other procurement practices

The OGC has produced procurement guidance which encourages procurers to simplify bidding processes to allow for more small firms to bid for contracts. However, this does not always translate to changes on to the ground.

For example, many local authorities and government agencies still require firms to have three years of audited accounts, even though OGC guidance recommends against it.¹¹ This is a prohibitive barrier for new firms. Different procurers also continue to use different processes. This is particularly detrimental in the case of local government – where most suppliers are small firms.¹²

Procurers must learn to intelligently manage risk

Procurement objectives and incentives must include innovation

Many of the policy objectives that procurers face can best be met by the procurement of innovative solutions. As such, innovation should be seen as an overarching principle behind public procurement decisions. To allow for this innovation, procurers must be given the ‘space’

and knowledge to intelligently manage risk.

Procurement officers should be encouraged to collaborate with innovative suppliers

Innovation is increasingly being recognised as a collaborative process. Risk in procuring innovative products and services can be substantially reduced by allowing procurement officers to work closely with potential suppliers.¹³

Combining early supplier involvement with outcome-based specifications allows suppliers to learn more about the underlying problem the procurement is attempting to address, and gives them greater freedom to develop innovative solutions.¹⁴

Such collaboration has traditionally been limited by EU regulations. However, these have recently been eased by EU directives that specifically enable procurer-supplier dialogue.¹⁵ This now needs to be followed by further training and incentives for procurement officers to manage interactive supplier relationships.

Opening up procurement to small firms

SBRI targets must be backed by programmatic and cultural change

The UK’s SBRI bears little more than superficial resemblance to its successful US counterpart (SBIR).¹⁶ In particular, although the two share similar targets of 2.5% of external R&D being sourced from small businesses, in the US this figure is viewed only as a starting point.¹⁷

The UK SBRI must adopt a similar approach to the US model and introduce a flexible, phased structure and strong programme management processes to enable broader cultural change within government. Furthermore, it must recognise that a mandatory minimum target should represent only the beginning of greater engagement with small innovative firms.

Opening up procurement opportunities for small firms

The "drive for greater efficiency in public sector procurement has resulted in a trend to replace many small contracts with fewer larger contracts."¹⁸ In some cases, large contracts can stimulate innovation, as they are more likely to provide the levels of finance and reward necessary for innovation to take place. However, in other cases, unbundling contracts would allow more small firms to bid, and thereby increase the opportunity for innovative solutions to be provided. The OGC should investigate hybrid approaches such as 'second sourcing' that enable small firms to participate in larger contracts.¹⁹

Supporting pre-commercial procurement

Government departments must work together to pull through new technology

The idea of 'pre-commercial procurement' – buying goods and services which require further R&D – has gained momentum in the UK over recent months. One approach, championed by numerous bodies including the CBI and the Conservative Party, is to establish an agency similar to the US Advanced Research Projects Agency (ARPA) that would have sufficient budget (suggested to be £1bn+) to drive the development of new technologies.²⁰

Another approach would be to more effectively apply and align existing procurement budgets from across government. One way of achieving this would be to use the model of coordination currently being adopted by the TSB's 'Innovation Platforms'. However, for this to be effective, government departments must be required to participate, thereby leveraging the full power of the public purse.

NESTA, the National Endowment for Science, Technology and the Arts, is working to transform the UK's capacity for innovation. Our endowed funds of over £300m allow us to be a genuine risk-funder, to take a longer-term view and invest in the most promising new ideas and ventures. Underpinning our work is the fundamental view that successful innovation fuels long-term economic and social progress, and is an essential ingredient to the UK maintaining its competitive edge in the global market place.

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¹ HM Treasury (2007) "Transforming Government Procurement", HM Treasury, London.

² HM Treasury (2006) "Investing in Britain's potential: Building our long-term future", p133, HM Treasury, London.

³ Georghiou L. (2007) "Demanding Innovation: Lead markets, public procurement and innovation" NESTA, London.

⁴ Office of Government Commerce (2007) "Management of Risk (MoR)" available at http://www.ogc.gov.uk/guidance_management_of_risk_4680.asp.

⁵ OGC (2004) "Capturing Innovation: Nurturing Suppliers' Ideas in the Public Sector", p5, OGC, London.

⁶ The Comptroller and Auditor General (2004) "Improving Procurement: Progress by the Office of Government Commerce in improving departments' capability to procure cost-effectively", National Audit Office, London. Sacks, J. (2005) "Public Spending for Public Benefit", A report for the New Economics Foundation.

⁷ SBS (2005) "Access to public procurement for small and medium enterprises: Progress Report", SBS, London.

⁸ SBS (2006) "Annual Small Business Survey 2005", SBS, London.

⁹ CBI / QinetiQ (2006) "Innovation and Public Procurement – A new approach to stimulating innovation", CBI, London. For the purposes of this survey, the CBI defined small businesses as those with less than 500 employees.

¹⁰ HM Treasury (2007) "Transforming Government Procurement", HM Treasury, London.

¹¹ OGC press release available at http://www.ogc.gov.uk/About_OGC_press_office_4212.asp

¹² SBS (2006) "Annual Small Business Survey 2005", SBS, London.

¹³ Edler, Jakob et al (2005) "Innovation and Public Procurement – Review of Issues at Stake", Study for the European Commission ENTR/03/04.

¹⁴ HM Treasury (2007) "Transforming Government Procurement", HM Treasury, London.

¹⁵ European Commission (2004) Directive 2004/18/EC and Directive 2004/18/EC, Brussels.

¹⁶ Connell, D. (2006) "'Secrets' of the World's Largest Seed Capital Fund". Centre for Business Research, University of Cambridge.

¹⁷ 13% of US federal R&D contracts go to small businesses. This is amplified by additional annual "set aside" targets for departmental spend with small US businesses, with a statutory minimum of 23%.

¹⁸ OGC and SBS (2005) "Smaller supplier, Better Value", OGC and SBS, London.

¹⁹ Georghiou L. (2007) "Demanding Innovation: Lead markets, public procurement and innovation" NESTA, London.

²⁰ The CBI has called for a UK-version of ARPA through revamping of the DTI's Technology Strategy Board. It argues that this should be tasked with sponsoring "promising research by universities and businesses". The Conservative Party STEM Taskforce has also called for an 'Innovative Projects Agency' (IPA) to be set up in the UK to "pull through research ideas into viable products and services."