



National Audit Office

Report

by the Comptroller
and Auditor General

Cross-government

Government's spending with small and medium-sized enterprises

Key facts

27%

proportion of the government's reported procurement spending that reached small and medium-sized enterprises (SMEs) in 2014-15 (Cabinet Office estimate)

£4.9bn

government's reported procurement spending directly with SMEs in 2014-15

Unknown

number of SMEs working on government contracts

25% aspiration for government's level of procurement spending to reach SMEs by 2015

8 of 17 number of central government departments that reported exceeding the government's aspiration in 2014-15

19% proportion of the Ministry of Defence's procurement spending that reached SMEs in 2014-15 (the Ministry of Defence is currently responsible for 44% of government's procurement spending)

33% government's target for the level of procurement spending to reach SMEs by 2020

4 the number of different methods government has used to estimate its spending with SMEs in the last five years

60% proportion of government's spending with SMEs that was via another, larger, contractor to SMEs in their supply chains (indirect spending)

Summary

1 Each year, the government spends around £45 billion on goods and services supplied by non-public sector organisations. Increasing the proportion of this spending that reaches small and medium-sized enterprises (SMEs) was a key priority within government's procurement policy over the past five years. In 2010, the government announced an aspiration for 25% of the spending to go to SMEs by 2015. In August 2015, the government announced that it would extend this target to 33% by 2020. The target covers both direct contracts with SMEs and spending that reaches SMEs indirectly (where the government's contract is with a larger provider that subcontracts SMEs as part of its supply chain).

2 The Department for Business, Innovation & Skills (BIS) estimates that there are currently 5.4 million SMEs operating in the UK. Most are private sector businesses, but the definition includes many voluntary, community and social enterprise (VCSE) organisations. Government uses the European Commission's definition of an SME, which defines it as an entity engaged in economic activity that:

- employs fewer than 250 people; and
- has annual turnover less than or equal to 50 million euros (£39 million); or
- has a balance sheet total of less than or equal to 43 million euros (£33 million).

3 The Cabinet Office's Crown Commercial Service (CCS) is responsible for the government's commercial policies. This includes leading on government's SME procurement policy. By increasing government's use of SMEs, the CCS aims to increase competition and innovation for public sector contracts. It intends to do this by:

- monitoring government's spending with SMEs, against its target; and
- identifying and removing barriers that SMEs face when bidding for government contracts.

4 Individual contract awards are decided by the government department awarding the contract. By identifying and removing the barriers faced by SMEs across government, the CCS aims to make it easier for SMEs to do business with government. As this becomes easier, the CCS expects more SMEs to bid for government contracts, increasing competition for work and leading to better value for the public sector.

Scope of this report

5 This report looks at what government is doing to make the public sector marketplace more accessible to SMEs. It focuses particularly on the action government took to achieve its aspiration of 25% by 2015 and early plans to achieve the 2020 target. The report sets out:

- central government's progress in increasing the government's use of SMEs;
- efforts to remove the barriers that SMEs face when bidding for government contracts; and
- the challenges for government of realising the benefits of using SMEs.

6 We did not audit the value for money offered by SMEs compared with other providers for individual contracts. Appendix One explains our methodology.

Key findings

The government's use of SMEs

7 **For many years, government has sought to harness the potential benefits of involving SMEs in the public sector marketplace.** The departments we met agreed that SMEs can offer a number of benefits to the public sector, compared with other providers. For example, offering more flexibility, innovative approaches and better value for money due to lower overhead costs. The Cabinet Office told us that SMEs, particularly VCSEs, can offer value in terms of local investment and improved social outcomes. Although government set its first target for spending with SMEs in 2010, the underlying policy is not new. Government has sought to increase its work with SMEs for similar reasons since the 1990s (paragraphs 1.5 to 1.9 and Figure 1).

8 **In order to track performance, the CCS has made improvements to the understanding government has about its spending with SMEs.** The number of bodies involved and different data systems have made it difficult to develop reliable estimates of government's spending with SMEs in the past. The CCS has worked with departments to improve the quality of government's information about SME spending. For example, it introduced a survey of large suppliers in 2011-12, in order to develop an indicative estimate of the amount government spends with SMEs through the supply chain. It has continued to refine the methodology each year up to 2015 (paragraphs 1.18 to 1.20).

9 **In February 2015, government reported that it had met its 2010 SME spending target a year early.** The Cabinet Office estimated that 26% of government spending reached SMEs in 2013-14, surpassing its 2010 aspiration of 25%. It estimates that government further increased its spending with SMEs the next year, to 27% of total procurement spending. The CCS reported that departments spent £4.9 billion directly with SMEs in 2014-15 and that a further £7.3 billion reached SMEs through supply chains (paragraphs 1.10 to 1.15 and Figure 2).

10 However, we cannot be certain that the amount government spends with SMEs has increased over the last Parliament. The reported annual increases in spending with SMEs happened in parallel with the CCS' work to improve government's understanding of its spending with SMEs. As a result, we do not know how much of the reported increase is due to the changes in approach and how much is an actual increase in SME activity. For indirect spending, the Cabinet Office has surveyed a larger group of providers each year since 2011-12 so annual figures are not comparable. The CCS' methodology for direct spending has not changed since 2011-12, but we cannot be certain that numbers are directly comparable due to the structure of the underlying data (paragraphs 1.6, 1.16 and Figure 3).

11 Increasing SME spending further by 2020 will be challenging. The government has set a new target for 33% of spending to reach SMEs by 2020. Whether it reaches this will depend heavily on the Ministry of Defence (MoD), which is currently responsible for 44% of central government procurement. In 2014-15, 19% of the MoD's procurement spend reached SMEs. The other 16 departments collectively reported 33% of spending reaching SMEs. The MoD told us it will be challenging to increase its SME spending further by 2020. It has already committed large proportions of its annual spending and is unlikely to be letting many further large contracts during the current parliament (paragraphs 1.21, 1.22 and Figures 2 and 4).

Progress in removing barriers SMEs face when bidding for contracts

12 The government has introduced initiatives to reduce the barriers faced by SMEs when bidding for public sector work. In 2011, the Cabinet Office launched a package of measures aiming to make sure that SMEs were better able to compete for government contracts. The Cabinet Office identified barriers such as the poor visibility of opportunities and burdensome pre-qualification requirements. It has launched initiatives aimed at reducing these barriers. For example, government has abolished pre-qualification questionnaires for low-value contracts and departments are now required to use Contracts Finder (a portal for advertising government tenders, first launched in 2011). Furthermore, the Social Value Act 2012 requires commissioners to consider wider social, economic and environmental benefits in procurement processes, which is often thought to benefit VCSEs in particular (paragraphs 2.2 to 2.21 and Appendix Three).

13 But SMEs still face barriers. SMEs told us the government initiatives had resulted in positive changes but, in practice, are still not sufficient to ensure that more work flows to SMEs. For example, the centrally-led initiatives depend on individual commissioning teams in departments choosing to implement them. The barriers most commonly cited by SMEs – and echoed by government departments – have not significantly changed. They include:

- **Transparency of information:** SMEs struggle to find contracting opportunities and have difficulty identifying where to go to for support.
- **Departmental appetite for risk:** Commissioners may be wary of using SMEs that have no financial track record or parent company guarantee.
- **Disproportionate bidding requirements:** SMEs often do not have the resources to complete lengthy tender documentation.
- **Capability of commissioners:** Commissioners who lack commercial expertise can be more risk averse. They are less likely to seek out innovative approaches or take social value into account.
- **Delays in payments:** SMEs are less likely to have the financial capacity to absorb delays in payment and may struggle to manage their cash flow (paragraphs 2.26, 2.27, Figure 6 and Appendix Three).

Achieving the benefits of using SMEs in delivery

14 Commissioners must balance the government's aspirations for using SMEs with other conflicting priorities. Most contracting decisions are made by commissioners across government, rather than by the CCS. The SME agenda is only one part of significant ongoing changes in the way the government does business with its providers. Some of these trends may make it harder for SMEs to win contracts as commissioners seek to balance different government priorities in decisions about contracts, including:

- **Reductions in commissioner capacity**

Our recent reports have highlighted gaps in government's commercial capability. Most government departments plan to make further cuts by 2020, which is likely to affect capacity in commercial teams. Departments' efforts to improve the way they manage contracts has focused on larger contractors. Government has not yet set out how it will manage smaller contractors. Departments may rely on larger contractors (prime contractors) to manage supply chains on their behalf so commissioners only have one contract to manage rather than many. In recent years, government has extended this model to new areas of spending, such as estates management and learning and development. This trend is likely to continue if spending cuts reduce the capacity of commissioning teams to manage a larger number of contracts (paragraphs 3.4 to 3.8).

- **Greater use of government's collective buying power**

In many areas of government, particularly for common goods and services (such as office supplies and training), government is increasingly merging the spending of different departments and using its collective buying power to simplify procurement and cut costs. This allows it to standardise products and services so providers compete on the basis of price rather than quality. Providers of these products and services can no longer rely on their pre-existing relationships or specialised nature of their product or service to win contracts. This can limit opportunities for SMEs that rely on their specialist services to secure business. While the CCS has shown that SMEs can win contracts even when government merges its spending, the move towards greater price competition and standardisation changes the type of SME that is likely to win these contracts. This reduces the likelihood that SMEs will bring innovation or niche expertise (paragraphs 3.9 to 3.12 and Figure 8).

- **Pressure on departments to make savings**

Government's austerity policy means departments will need to achieve further cost savings by 2020. With reduced budgets, departments are less able to absorb the cost of projects overrunning or exceeding budgets. When delivery is outsourced, commissioners can seek to transfer most of the financial risks of delivering the contract to the provider, by agreeing a fixed price at the start of the project. However, it means providers must be willing and able to take on financial risk. SMEs often do not have the resources or financial support (eg from a parent company) to be able to do this so commissioners may perceive them as more risky than larger providers (paragraphs 3.13 to 3.15).

15 Consequently, most SMEs working on government contracts are part of the supply chain and it is not clear that this will lead to increased competition and innovation.

These SMEs make up 60% of government's annual £12 billion estimated spending with SMEs. They work for larger prime contractors and may not compete directly for government contracts. In most areas, government has limited knowledge of these supply chains, as prime providers appoint, set contract terms for, and manage the supply chain directly. These SMEs can bring other benefits and subcontractor roles can help them increase their capacity and experience, to be better able to compete for future work. However, the Cabinet Office has no way of knowing whether it is making progress towards its overall aim of increased competition and innovation. Prime providers will also take a management fee, which either reduces the income received by subcontractors or increases the cost to government of delivering services (paragraphs 1.7, 1.15 and 3.26 to 3.28).

16 Some parts of government have identified categories of spending where SMEs can have the most impact on delivery. The CCS expects all departments to try and increase their use of SMEs. We found some examples of commissioners identifying areas where they could make greater use of SMEs. For example, sectors where SMEs are already thriving (eg digital services) or where government is keen to support SMEs to grow (eg construction). Commissioners have developed plans to reduce barriers to bidding in these areas, and make contracting arrangements more SME friendly. For example, Highways England has reduced the lot size for some construction contracts to make them accessible to SMEs (paragraphs 3.16 to 3.25 and 3.29).

17 The fractured nature of government procurement systems makes it harder for the CCS to pursue a more targeted approach for government as a whole. An underlying theme of this report is that government lacks an integrated digital platform for procurement. We reported in 2014 that individual departments do not have systems that integrate information on contracts, payments, and contractor performance. In areas not covered by CCS frameworks, this makes it harder for CCS to assemble information on cross-government spending or contracts and identify areas in which SMEs are making significant contributions to the delivery of government services or have the potential to have a greater impact. Contracts Finder holds information on some of government's contracts, but it depends on public bodies uploading information to it that is currently held in over 200 different procurement portals and the CCS has limited oversight of this data. Since July 2015, the CCS has begun to carry out a small number of spot checks to confirm that public bodies are using Contracts Finder to publicise their contract opportunities.

Conclusion

18 Over the last five years, the Government has had a clear and sustained focus on the involvement of SMEs in government contracts. Government reported that over 25% of its spending reached SMEs in 2014-15. It now aims to increase this to 33% by 2020. However, we cannot be certain that the amount government spends with SMEs has increased since it set its original target in 2010. As it seeks to increase it further, government needs to think carefully about the full range of risks and opportunities that contracting with SMEs presents, compared to working with larger providers.

19 Government will be more likely to harness the potential benefits of using SMEs if it takes a more focused approach. It currently bases its approach on the assumption that more SMEs will win government work if there are fewer barriers to SMEs being able to bid. However, wider trends in government contracting mean that, although SMEs can bid for work, they are often not suitable to deliver it. If the government is serious about increasing its use of SMEs, it will need to focus on those areas where SMEs can deliver real benefits. This will take a more concerted effort not only to remove barriers to bidding, but to ensure that what and how government procures achieves the desired benefits of using SMEs.

Recommendations

20 To support the CCS in developing its strategy to meet government's 2020 target, we make the following recommendations to the CCS:

a Taking a more focused approach to achieving the benefits of using SMEs

The CCS needs to move from a generic approach of lifting barriers to SMEs bidding for contracts to an approach that involves working with departments to identify areas where different types of SME can bring the most benefit. It should:

- **Stop changing its basis for estimating SME spending**

The CCS should settle on a methodology for 2015-16 and ensure that any subsequent years' data can be compared with this 2015-16 baseline.

- **Identify those areas of government where different providers can bring the most benefits**

The CCS should ensure that, as departments develop plans to meet the 2020 target, they are identifying areas of spending where SMEs can have the most impact and the types of providers they would like to encourage in those areas (such as innovative businesses or VCSEs).

- **Use best practice to inform future decisions**

The CCS should identify where departments are effectively harnessing the benefits of using SMEs and VCSEs. It should disseminate these across government to help departments to shape their procurement and contracts to maximise the benefits from using these providers.

The CCS should also use this evidence to review the impact of SMEs on the public sector marketplace, to inform its own decisions about the quantitative target and central initiatives.

- **Identify where government needs to have oversight of the relationship between prime contractors and their subcontractors**

Government should identify areas where the majority of SMEs will continue to operate within a supply chain. In these areas, it should ensure prime contractors' behaviour does not prevent subcontractors delivering benefits for the public sector. For example, by introducing codes of conduct for prime contractors, or project bank accounts to ensure prompt payments.

21 In addition, there is a need for greater visibility and transparency of government's procurement, so the CCS should work with the Cabinet Office and the Government Digital Service to:

- **Assess the feasibility of an integrated cross-government procurement platform to support its commercial strategy**

This might be built of many systems with compatible data or a single system.

This will require leadership from the centre of government now if it is to be achieved during this Parliament.

- **As a first step, improve the quality of data in Contracts Finder**

The CCS should ensure there are clear lines of governance and accountability for the use of Contracts Finder, particularly enforcing the requirement for public bodies to use it to advertise opportunities.