

Chapter 14

Unintended Consequences: Procurement Policy and the Canadian International Trade Tribunal

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INTRODUCTION

The 1980s and 1990s brought many changes to the procurement environment. This chapter looks at the developments that the new trade agreements brought to procurement, and the implications this has for procurement policy and the associated institutions. During this time period in Canada, the domestic economic environment was transformed – Canada underwent two recessions and experienced the results of over-spending through deficit financing and the accumulation of debt (Lewis, 2003). The entrenchment and institutionalization of regional policy was one of several factors that weakened the federal government's capacity for fiscal recovery. The international environment shifted significantly as well, with a different political environment involving increasing economic integration, and the effects of instantaneous communication achieved through the growing use of information technology.

The offspring of the North American Free Trade Agreement (NAFTA), the Canadian International Trade Tribunal (CITT), is the most important modern institution in terms of procurement in Canada, and it is treated as the central feature impacting procurement in the past seven years. Through its interpretation of NAFTA, World Trade Organization (WTO), and the Canadian Agreement on Internal Trade (AIT) guidelines in the dispute resolution process, the CITT has shaped procurement more than any other reform or new institutional mechanism. This chapter explores the extent to which these trade agreements have shaped and are continuing to shape the conditions for domestic public policy and how the CITT has narrowed the discretion that allows procurement to be used as a policy instrument.

In terms of method, this chapter has an integrated three-strand approach. First, we have examined the literature involving the trade agreements themselves as well as literature based on procurement and trade, economics of institutionalism, and elements of trade law. Second, the chapter uses analysis based on results from interviews of experts in the field of procurement and trade undertaken between 2002 and 2005. Third, we engage the economics of neo-institutionalism perspective, specifically North's seminal work linking transaction costs and the operation of government organizations (1984) where he identifies four variables in the cost of exchange. North's construct is used to help account for the impact of the trade agreements on procurement and the ensuing dynamics that resulted in this period.

The dynamic of this period is characterized by growing economic integration, where government markets are increasingly expanding to include more non-domestic suppliers and more complex trade policy through deepened competition. The relationship of procurement to trade policy is important in terms of economic performance at the macro level, and the functioning of government organizations at the meso level.

As a field of policy, what does trade policy have to say about procurement rules *per se*? First, in neo-liberal approaches to trade policy, elements of procurement policy can be viewed as a form of protection that violates the principles of trade policy. These principles are focused on allowing for, and promoting, the full play of comparative advantage as well as seeking efficiency in exchange and cost reductions (Interview A15, May 13, 2004). From this perspective, procurement is typically inefficient and laden with problems associated with political influence, directly or indirectly. Procurement is a form of protection when government policies related to it provide substantial formal or informal discretion for its use to this end, either as a matter of law or bureaucratic and political culture.

Secondly, procurement policies reflect a unique combination of public policy elements that traditionally have had few rules, especially in the Canadian environment. The same policy objective in two countries may be pursued using very different instruments, and procurement systems have evolved in distinct ways across countries and continents. Even the concept of procurement varies significantly. In Canada, for example, it has been argued that our procurement

system is a part of our cultural endowment as a way to protect it from external regulation (Interview A15, May 13, 2004). As a result of this increasingly interdependent trade environment, there arises a need for a challenge authority and dispute resolution system.

NAFTA, the AIT, and the WTO-AGP require the signatories to maintain an independent bid challenge authority. In Canada, this has taken the form of the CITT. Parliament has implemented these agreements into Canadian legislation to ensure that the procurements covered by these agreements are conducted in an open, fair and transparent manner, and where possible, in a way that maximizes competitiveness. More than one trade agreement may apply to any given procurement, and the “procurement rules” differ between the three trade agreements. Parties do not know with certainty, which trade agreement, or agreements apply to a given procurement until after the CITT renders its decision where a complaint has occurred. Consequently, this uncertainty undermines the existence of objective, transparent and predictable procurement rules of universal application (Attwater, 2002).

Thus, in tracing the nexus of procurement and the liberalization agenda, we come face-to-face with a procurement environment in flux. This is especially evident during the period in which the trade agreements were being negotiated and implemented, and in the period since then in which the CITT has been highly active in interpreting how the new rules affect Canadian procurement processes and policy.

PROCUREMENT IN THE NORTH AMERICAN FREE TRADE AGREEMENT

In terms of coverage, while NAFTA did not result in Canada's objectives being fulfilled entirely, the procurement chapter broke new ground by including services and construction-related procurement for the first time. The NAFTA procurement chapter begins by listing the government entities and enterprises covered by its provisions which apply to contracts for certain types of goods, services and construction work that exceed threshold values: for federal government entities, US \$50,000 for contracts for goods, services or any combination thereof, and US\$4.5 (now 6.5) million for contracts for construction services; for government enterprises, US\$250,000 for goods, services or any combination thereof, and US\$8.0 million for contracts for construction services; and for state and provincial

government entities, the applicable threshold as set out in the Annexes.

The general rule of Chapter Ten, set out in Article 1003, is that the three governments must treat goods and services from another NAFTA country (and suppliers of such goods and services) "no less favorably" than domestic goods, services, and suppliers with respect to purchases by covered government entities (U.S. Department of Commerce International Trade Administration). In terms of trade rules, procurement had typically been in violation of this "national treatment" principle. It was written into the rules that countries could engage in this exception. Thus, this was an important change (Interview A15, May 13, 2004).

Procurement is defined broadly to include procurement by such methods as purchase, lease or rental, with or without an option to buy. It specifically does not include non-contractual agreements or any form of government assistance, including cooperative agreements, grants, loans, equity infusions, guarantees, fiscal incentives, and government provision of goods and services to persons or state, provincial and regional governments (Article 1001(5)).

What is not included in the procurement clauses seems to leave some room and protect the ability of the federal government to promote regional development within Canada through purchasing broadly defined. Grants, loans, and other instruments are not considered part of the procurement package in terms of the NAFTA chapter. However, one has to look more carefully at where these instruments fall and their relationship to the procurement function. As rules in the specific procurement chapter of NAFTA squeezed the discretion that still existed in terms of using procurement for socio-economic development, efforts to promote regional industry were funneled in other directions. Even so, these came under international scrutiny. For example, Technology Partnerships Canada came under attack as an unfair and anti-competitive program supporting the aircraft industry.¹

The many exceptions negotiated leave a confusing array of covered/not covered entities and services. There are notable exceptions in negative lists, including shipbuilding, urban rail and transport equipment, and communications equipment. All three

parties are exempt from many types of goods purchased by the military.

Services-related procurement has many exceptions as well, including transportation, services relating to research and development, financial and related services, utilities, and for Canada only, education, health, and social services (Hart & Sauvé, 1997).

In terms of procedure, NAFTA replicates much of what is found in the GPA and the FTA in regards to transparency and procedural obligations. Procedures for awarding contracts covered by the agreement were improved significantly. More flexibility was built in to help avoid lengthy procedures when they are shown to impede the efficiency of government. By limiting the criteria used to assess bids, governments are forced to focus on issues of technical specifications instead of on perceived benefits such as local content.

Important provisions guard against practices such as splitting a contract into smaller components to avoid exceeding the threshold value; forbid parties to evaluate bids on the basis of offsetting factors such as local content, technology licensing, or investment; forbid parties to require technical specifications or seek technical advice with the purpose of creating obstacles to trade; require entities to specify their needs in terms of performance criteria rather than particular designs or trademarks (Hart & Sauvé, 1997). Guidelines to ensure non-discrimination or otherwise preclude competition include those details involved in tendering of contracts. Limited tendering still may be used in some circumstances such as extreme urgency, exceptionally advantageous purchasing conditions, or the requirement for consulting services of a confidential nature (Hart & Sauvé, 1997).

NAFTA marked the first time an international agreement has been taken into domestic law in Canada. In a civil law country, international agreements become part of the law-of-the-land through codification and statute. In common law countries, domestic law generally interprets international law, and it may or may not apply. English common law concepts are based in legal organizational methods that give a pre-eminent position to case law as opposed to legislation. The CITT was a new and special case. It was created as a quasi-judicial body with considerable powers (Interview A15, 13 May 2004, and A7, 10 March 2004). Its jurisdiction over disputes arising

from international obligations has put it at the center of much government/business conflict.

NAFTA Chapter 10 was the sleeper chapter that was to have more real world impact on procurement than any other (Interview A7, 10 March 2004). Suppliers now believe there are real recourses, and that there are teeth to the recourse mechanisms when a procurement bid is anti-competitive in some manner. The game became more open and more suppliers started participating; the hidden side to this trend was that many suppliers, who were not well qualified or extensively experienced, began bidding on contracts.

As one interviewee emphasized, in the immediate years following the implementation of the agreements, many bids were of very poor quality (Interview A7, March 10, 2004; Interview A15, May 13, 2004). A small industry emerged that focused on assisting companies in writing bids and negotiating the contract submission process.

ECONOMICS IN INSTITUTIONALISM AS A FRAME FOR CHANGE IN PROCUREMENT – TRADE AGREEMENTS AND REPERCUSSIONS

This section will account for the impact of NAFTA, the WTO Agreement on Government Procurement (AGP), and the Canadian Agreement on Internal Trade on procurement and the ensuing dynamics with the public policy environment. The theoretical constructs of economics and institutionalism, based on extending the neoclassical assumptions and including the cost incurred when any form of exchange takes place, are highly applicable to procurement in a policy context. Procurement activities are “exchanges” or “transactions” in their most basic format. This exchange is one of the primary activities of all organizations, obtaining goods and services to engage in buying, selling, or providing services. The analysis in this section proceeds from the view that efficiency in procurement is a worthy objective. In the public sector environment, this objective is complicated by the pursuit of other socio-economic objectives.

In economic terms, there is a social welfare loss – a sacrifice, when purchasing is associated with the pursuit of objectives other than best value. Until recent years, it was implicitly accepted that the Canadian government would trade off this loss against the gain it believed to be getting from pursuing regional or industrial development through the manipulation of purchasing.

If choices are made based on any other objective besides obtaining the best possible goods and services in an efficient and cost-effective manner, the cost of exchange increases. Due to factors of uncertainty and lack of proximity and/or familiarity for both purchasers and suppliers, and lack of information, exchange involving not-from-Canada players raises the prospect of increasing the cost of transactions. In trade terms, any tariff or non-tariff barrier, either within countries or amongst them, raises the cost of transacting.

New institutions and their evolution, in this case trade agreements, have had a substantial impact on procurement and its characteristics of exchange. North (1984) identifies four variables in the cost of exchange: the cost of measuring, the nature of the exchange process, enforcement, and ideology. We look at each variable in turn, together presented as a frame for examining how the trade agreements impact procurement. North's transaction cost construct along with the cost of specifying property rights are useful in the examination of how the institutionalization of trade agreements and associated repercussions have impacted procurement policy.

North defines the transaction cost as: "the costs of specifying and enforcing the contracts that underlie exchange. They include all the costs involved in capturing the gains from trade. Whether exchange occurs across markets or as part of the production process inside firms, the resources devoted to the organization and integration of the production and marketing of goods and services are a large – and growing – share of the total costs of goods and services." He further explains that: "underlying these strictly economic costs are the costs of specifying and enforcing the body of property rights (as well as the costs of attempting to alter the property rights), which are a large share of the costs of government" (North, 1984, p. 255). From North's definition we now look at the separated variables he described and use them to further examine the procurement exchange.

THE COST OF MEASURING

The cost of measuring involves measuring the valuable attributes of the goods and services being exchanged or measuring the performance of agents. This is essential to the specification and enforcement of property rights and underlies all the costs of contracting. In terms of the procurement function, knowledge about

the characteristics of the goods or services and the performance of agents is particularly problematic given that effective contracts are established based on the disclosure of information. That same information may be what provides one supplier an advantage over another. When tariffs or other non-tariff barriers exist, there is increasing complexity in obtaining information and added administration. The performance of agents is increasingly difficult to measure when, in addition to the economic objectives, the procurement is used for social objectives.

An interesting conundrum emerges. While barriers to open competition may increase the cost of measuring attributes and performance, at the same time this need to know may drive procuring organizations towards domestic suppliers and products. De Mestral (1982) notes that even in a vast country like Canada, domestic suppliers are likely to know the needs of their government departments and to be more able to supply these needs with acceptable products. In the same way, government buyers are more likely to turn to the domestic enterprises they know best. Assurances of delivery, control of quality, lack of transportation difficulties, and certainty as to legal recourse in the event of difficulties are contributing factors of some importance (deMestral, 1982). Helliwell (1998) points out that the issue for the nation-state is whether the grouping of a high proportion of transactions within national markets is justified in terms of lower transaction costs provided by the ability to operate within commonly understood procedures and within trusted and well understood channels of distribution. In an increasingly integrated and interconnected business environment, the transaction costs of trading in cross-border markets should be reduced. Thus, there is less of a need to rely on domestic markets.

Measuring the performance of agents becomes an issue once a procurement bid is challenged under the auspices of the Canadian International Trade Tribunal. This is an *ex ante* measurement, as it is the conduct or questionable motives that often are challenged. "On occasion, a potential supplier may have reason to believe that a contract has been or is about to be awarded improperly or illegally. Similarly, a potential supplier may have reason to believe that in some way it was wrongfully denied a contract or an opportunity to compete for a contract." (Attwater, 2002, p. 1-1). As soon as the spectre of a challenge is raised, the cost of the procurement

transaction goes up. It is very difficult to tell by how much, as the variables involved will be different each time.

Competitive bidding is intended to select the lowest cost bidder, and prevent corruption and favoritism that are opposed to efficiency. It offers a clear yardstick with which to compare offers. Theoretically, the more competitive bidding that the government is engaged in, the more efficient its purchasing should be, and the capacity to actually measure the efficiency is also increased.²

THE NATURE OF THE EXCHANGE PROCESS

This element of North's construct asks what the nature of the exchange process is. We extend this to ask what, with respect to procurement, are the impediments or accelerators of the exchange that may translate into increased or decreased costs of exchange?

The most important characteristic of the procurement exchange process as it has evolved in Canada and many other countries is its foundation in highly discriminatory practices. As tariffs and quotas were slowly being negotiated out of the trade process, governments found new and creative ways to protect their control over the exchange process. The emergence of state intervention through subsidies, government procurement preferences, and the application of trade remedy laws had all but replaced tariffs and quotas as powerful and discriminatory instruments of protection (Hart, Dymond & Robertson, 1994). The GATT and its subsidiary agreements constituted valiant attempts to discipline the application of state intervention and trade remedy law, but all of these instruments of intervention or protection are inherently discriminatory in some sense.

Subsidies and procurement preferences expressly favor domestic over imported products and seek to overcome lack of comparative advantage. Trade remedy laws providing for the application of anti-dumping and countervailing duties and similar measures are equally discriminatory (Hart, Dymond & Robertson, 1994).

Stegeman and Acheson (1972) noted that if the contracting parties of GATT were seriously interested in negotiating a reduction in these barriers, then an incentive existed for participating countries to make their policies more objective and visible so that they could be used as a counter in the negotiations. Unfortunately, future

negotiations also provided an incentive for contracting countries to make their policies more restrictive in the interim in order to strengthen their bargaining power.

North (1984) notes that absent the factors of kinship ties, friendship, personal loyalty, repeat dealing and personal knowledge, the exchange process becomes more costly. "In impersonal exchange there is nothing to constrain the parties from taking advantage of each other if they can gain by doing so." (257) North would say that this is why contracts must be specified as precisely as possible and elaborate safeguards developed to enforce compliance.

Theoretically then, the use of foreign suppliers (those in other provinces or states can be included in the absence of internal trade agreements) would result in parties being more likely to take advantage of one another and thus incur more costly exchange. The principles underlying the opening of more procurement attempt to deal with this feature.

Most-favored nation and *national treatment* are essential features of liberalization based on reciprocal trade negotiations. At the post-war conferences that established the GATT, agreement on most-favoured nation and national treatment enabled the first round of tariff cutting to succeed. These principles provided assurance that the expanded trade opportunities resulting from the reduction of trade barriers would not be denied through measures of external or internal discrimination. Without such assurance, the reduction of trade barriers would have been foolhardy and investment to exploit comparative advantage and pursue specialization based on larger markets a huge gamble (Hart, Dymond and Robertson, 1994).

Despite these attempts to base the emerging exchange process on principles that would remove some of the discriminatory aspects, the difficulty with moving procurement away from its other socioeconomic uses was evident. By the mid 1980s, there had also developed a huge number of voluntary restraints and orderly marketing arrangements which denied most-favoured-nation treatment in all but name; thus *degrees* of most-favoured nation treatment had been established (Hart, Dymond & Robertson, 1994).

ENFORCEMENT

As a variable in the cost of exchange, enforcement has become increasingly relevant due to its inclusion in the clauses of the trade agreements and the challenges made under these laws. The more open trade becomes, the enforcement mechanisms consequently also become increasingly important.

In a situation of perfect enforcement, there would be a neutral third party impartially evaluating disputes and awarding compensation to the injured party as a result of contract violation, as in domestic legal systems (assuming equality of legal status among contracting parties). Opportunism, shirking, and cheating would not be worthwhile. This situation does not exist because the costliness of measurement (or the lack of transparency in the design of contract specifications) frequently makes it difficult to determine whether a contract has been violated (and by whom). In reality, an impersonal body of law, courts, and the coercive power to enforce judgments are fundamental factors in permitting the complex contracting essential in an environment of specialization and impersonal exchange (North, 1984).

Procurement involves a variety of types of contracts, broadly categorized as complete contracts and incomplete contracts. With incomplete contracts, even if the parties to a transaction are symmetrically informed about the terms of the transaction and can monitor each other at zero cost, the contract by virtue of its incompleteness, cannot be monitored by a third party and is therefore unenforceable by such a party. Consequently, there exists a large body of procurement relationships (known as public-private partnerships, relational contracts, benefits-driven procurement, common purpose procurement, and many others) that do not seem to fall under the trade agreements in terms of their enforceability.

In relational contracting, most transactions are embedded in an ongoing relationship and interactions are mediated by a balance of cooperation and coercion, communication and strategy (Furubotn & Richter, 1998).

Breton says that if the goods and services (i.e., partnership-type contracts) that have important non-verifiable characteristics are not excluded from the AIT agreement, their presence will lead to an unravelling of the whole chapter on procurement. After the

endorsement of more open and transparent procurement in numerous GATT rounds, EC directives and court rulings, countries still pursue discriminatory protectionist procurement policies. “What would we have to say if it turned out that these policies were a response to incomplete contracts and were, therefore, not protectionist? We would have to say that if governments abided by the agreements they had signed, they would be worsening the allocation of resources and reducing growth and wealth” (Breton, 1994, p. 93).³

Arrowsmith (1995) notes that the full importance of measures designed to achieve free trade in public markets have been felt only recently due to the fact that their impact on secondary policies has now been the subject of judicial decisions; and also because it is only in the last few years that serious attempts have been made to enforce the rules. The freedom to use procurement as a tool of national policy has been reined in by restrictions in European Community law, and the GATT Agreement on Government Procurement (GPA) also imposes limitations in this field.

In Canada, suppliers may challenge federal government procurement decisions that they believe have not been made in accordance with the requirements of Chapter Ten of NAFTA, Chapter Five of the AIT, the AGP, or the Canada Agreement on the Procurement of Telecommunications Equipment. The bid challenge portions of these agreements came into force on January 1, 1994, July 1, 1995, January 1, 1996, and September 1, 2001, respectively (Government of Canada, CIIT Annual Report, 2003).

The Procurement Review Board was created to fulfil an obligation of the Free Trade Agreement (Article 1305(3)) and was subsequently subsumed and renamed the Canadian International Trade Tribunal. It was responsible for receiving, investigating and making determinations on complaints by suppliers with respect to trade-covered procurement. In making a determination, the PRB could recommend that bids be re-evaluated, that the procurement be re-tendered, or that the contract be terminated. It could also issue recommendations to contracting authorities regarding changes to procurement procedures. Its powers were expanded under the CITT Act in parallel with the expanded scope of the FTA-NAFTA.

The procurement review mechanism constitutes an instrument of domestic socio-economic policy, and the CITT has become the most

important institution with regards to procurement in a policy context. It has been focused on taking the discretion out of procurement decisions and discipline processes where possible. The foundation is the use of trade policy to reduce and eliminate discretion, bring greater certainty to the marketplace, and encourage the free flow of comparative advantage. Indeed, in its role as reviewer of challenges to the trade agreement, it has by default, a pro-liberalization bias. For those in government charged with continuing programs that utilize procurement outside of the trade objectives, it has become a thorn. Interviewees in government implicitly, if not explicitly, spoke of their frustration of being at the mercy of what the CITT will decide next. Thus, there is substantial tension created in the spectrum of activities between government and its suppliers.

Bid protest procedures under the AIT are quite different from those of the international agreements.⁴ The process, which reflects a strong anti-litigation bias, places emphasis clearly on negotiation and consensual solutions by governments (Miller, 1995). On the one hand, it may have had substantial impact in practical terms on suppliers and government, having opened nearly all procurement to pan-national trade; on the other hand, due to the nature of its enforcement mechanisms, it lacks credibility and legitimacy in the eyes of many in the private sector.

Trebilcock and Behboodi (1995) say that the provisions on government procurement in the AIT can be seen as negative integration measures. They prohibit both explicit discriminatory government procurement policies and government procurement policies or practices that may appear neutral but have an impact on out-of-jurisdiction suppliers; are incompatible with a least-trade-restrictive means test; and suggest in many cases disguised forms of discrimination. "The unresolved debate among the parties about the extent to which government procurement can be used as a legitimate instrument for the pursuit of regional development goals, even where this would explicitly or implicitly entail discrimination against out-of-jurisdiction suppliers, raises the larger issue of subsidies that have the potential to distort trade" (Trebilcock & Behboodi, 1995, p. 51).

The "cost-efficiency" and "better-service" models of managing suppliers seem to yield valuable commercial results for governments in the short term; but in the longer term this model may limit opportunities to enhance national economic performance. The

increasing strength of trade blocs, such as NAFTA, APEC, and the EU, suggests that many nations covertly feel that global free trade is risky and that greater economic security may be found within the more limited, free-trade boundaries of a formal trade group that extends national boundaries without creating a global marketplace (Callender & Matthews, 2002).

THE CANADIAN INTERNATIONAL TRADE TRIBUNAL AND ITS IMPACT ON PROCUREMENT POLICY

We have spoken broadly about the impact of the CITT on procurement and policy implications. In this section, we expand upon these issues and make some comments about the nature of the CITT as an institution with mediating influence on procurement policy.

Many now speak of the “legalization” of procurement in Canada. It arises from the fact that procurement and contracting has traditionally received little attention, and in the past 10 years it has emerged as an important policy area in the legal field largely due to the interest in the decisions made by the CITT.

In some jurisdictions, there is a considerable body of law and legal writing concerned specifically with the contracting of government.⁵ In the United States, although there exists no conceptually distinct concept of the “administrative contract” and the agreements of public bodies are, like Canada’s, governed in principle by the private law, there is a large body of special rules (both legislative and judicially created) which apply the contracts of government. In the U.S. and other similar systems, government contracting has been a distinct area of study with a substantial body of literature on the subject (Arrowsmith, 1988).

In Commonwealth jurisdictions, there was growth in the latter half of the century in the literature on government contracting, arising from attention to a particular issue: the potential for conflict between contractual obligations of public authorities and the need for effective government – that is, for the government to be able to exercise its discretionary powers in the manner most conducive to the public interest at any time (Arrowsmith, 1988).

The dispute resolution mechanisms adopted under the Canada-U.S. Free Trade Agreement and subsequently NAFTA, are innovative in that they resort to the domestic courts and administrative agencies

of the parties, international commercial arbitration, and traditional international dispute resolution mechanisms. The procedural and substantive rules employ both domestic and international law. As a result, depending on the particular chapter, to a greater or lesser extent, panels established under the agreements attempt to reconcile different domestic laws, international trade law and general principles of international law. This raises the question of what effect these dispute resolution mechanisms will have on domestic administrative agencies, courts, particularly the Federal Court of Canada, and domestic law (Lemieux & Stuhec, 1999).

The body of work is now significant in Canada, owing to the existence of the CITT and its decisions. Table 1 summarizes the significant procurement cases in the past five years and identifies their importance in terms of procurement per se and their larger public policy impact.

TABLE 1
CITT Procurement Cases and Public Policy Impact

Key issue	Case or example	Impact on Procurement	Larger public policy impact
Incumbency, conversion, trade mark technology exceedingly problematic, also problem of allowing alternative/substitute product	Corel 1999, other Telecom cases such as Bell Canada, Telus, AT&T Canada, Telesat, Accutel Conferencing, Systems Inc., Foundry Networks	Government must respect legislative scheme, non-compliance to be very exceptional, CITT must balance legitimate transition cost and compatibility concerns versus unfair incumbent advantage, tender documents must be very clear, specs must be generic	Corel case received much public attention; first real situation making procurement officials worried about loss of discretion, balance extremely difficult for PWGSC
CITT used as domestic complaint mechanism, not foreign	National Airmotive Corporation, June 1999	Anything not falling under CITT jurisdiction – no recourse for suppliers in Canada	Lack of understanding of role/power of CITT, foreign suppliers may not realize this translates into further discrimination

TABLE 1 (Continued)

Key issue	Case or example	Impact on Procurement	Larger public policy impact
Non-implementation of CITT recommendations	Wang Ltd. V. Canada and Attorney General of Canada V. Symtron Systems Inc.	Federal Court said Tribunal recommendations are to be followed, imposed costs of court proceedings on the department	Rigorous respect of legislative scheme required, giving “teeth” to the CITT
Emphasis that competitive process should be the norm	Wescam	Government bears burden to prove why it should derogate from normal tendering procedures	Positive and compelling evidence to prove non-competitive process legitimate, risk good faith called into question
Ease of launching complaint	Various	CITT has begun to make compensation awards for aggravated damages, punitive damages	Discussion on-going with respect to government’s right to sole-source vs. principle of competition
When is a contract a contract	MIL Fleetway	CITT approach seems to be the award of the right to be called upon by task requisition or the call-up itself	Power of postponement, point is very early in process
Access to information	Western Star Trucks	Government requires some flexibility but must be wary of perceived discrimination	Intent of motives very hard to prove, must have compelling evidence
Politicization	EH-101 helicopter	Using CITT process as a tool to slow procurement down in supplier’s interest	Not beneficial to effective and timely program implementation
Amendment clauses allow contract extension	Tendering Publications Limited April 2002	CITT says amendment clauses permit extension during term but not the extension of the contract	Closing back door on discretion to extend contracts if needed and avoid competitive process

Each of these cases brought a new dimension to the procurement and contracting environment. The CITT complaint case results directly shaped new behavior on the part of both the government and its suppliers. Patricia Close (2003), now the Vice-Chair of the CITT and lecturer at NPSIA, refers to one of the key impacts as domestic spin-offs, highlighting the unintended consequence of the dispute resolution system being primarily used by Canadian suppliers, as opposed to foreign suppliers (at the outset it was expected that it would be primarily used by foreign suppliers). This third-party tribunal has become a new instrument of government by virtue of the implications of its determinations. In fact, government officials have found that dealing with the implications of the decisions of the CITT has made their jobs so difficult, that there is an effort (this seems to be both explicit and implicit in the way in which recommendations for change are being made in the official review, as well as somewhat “underground” in the efforts of officials to retain power and discretion in how contractors are chosen) underway to alter its design and power. The current Government-Wide Procurement Reform Review is in fact looking at altering the terms under which the CITT operates.

IDEOLOGY

North's fourth variable (1984) in the cost of exchange is ideology. He refers to beliefs, ideas, convictions and attitudes, especially towards justice and rules about how society functions. This seems particularly relevant in the case of procurement due to the importance of whether procurement is viewed strictly as a mechanism for cost-effective purchasing, or an instrument for socio-economic objectives. Underlying this is the question of fairness – are we “fair” by following disciplined trade rules ensuring the least cost/best value solution is chosen no matter where the supplier is located – or is it more “fair” to view the purchasing of goods and services in a domestic context where suppliers can be chosen because they are part of the government's objectives to support industry in a particular region or other such programs? The cost of contracting increases because we do not have a common view of fairness in all situations.

The neoclassical assumption that behavior is only constrained by rules and the effectiveness of their enforcement is clearly incomplete; honesty, integrity and living up to the spirit as well as the letter of the

law do matter. But North asks, how much? If the amount were constant over time, we could stick with the neoclassical assumption that preferences or tastes matter but are held constant. But ideological attitudes, the fourth variable, are not constant.⁶

Until the 1970s, access to government purchasing as an issue was hardly open to discussion and debate in Canada. “Governments held it as an article of faith that they should, whenever possible, return tax revenues to their own economies by reserving the bulk of their purchasing to their domestic suppliers; for this reason governments have been slow to criticize others for adopting a similar course. Despite the fact that this practice must in at least some cases increase the tax burden through increased costs, there has been in the past and even today there is little or no public criticism of this government policy”(de Mestral, 1982, p. 172).

Governments perceived themselves as being highly vulnerable to the criticisms of “neglecting national interests,” “exporting jobs,” and “failing to protect domestic industry” when they are in a position to do so (de Mestral, 1982). This represents the prevailing ideological attitude towards procurement for the post-war period.

Interestingly, the decisions to go bravely down the free trade road were not a product of ideological enthusiasm. The Canadian Prime Minister Brian Mulroney was not so much following the ideological waves of conservatism demonstrated by Reagan and Thatcher at the time, though he undoubtedly favored liberalized markets, as he was making an intuitive political judgment that this was “a policy whose time had come” in that it was needed to ensure Canadian access to U.S. markets when protectionist pressures there were in the ascendancy (Doern & Tomlin, 1991).

While specific decisions about free trade may not have been ideologically based, there can be no doubt that Canadians struggle with the notion of economic integration because it challenges our regional identities and consequently feeds into our larger questions about the Canadian identity. Albert Breton (1995) in “A Comment” to Trebilcock and Behboodi’s article, considers the underlying economic ideological reasoning behind moving further towards economic union, though stressing that it is one of the most difficult problems to wrestle with and one that encourages extreme positions. He notes that harmonization and integration have joined cooperation and globalization as motherhood sacred icons, and they seem nearly

impossible to be against. He asserts that it is not possible to provide a rationale for, or a defense of, federal states that do not give pride of place to differences in the preferences of citizens, thus there is genuine tradeoff between the requirements of economic integration and those of federalism (Breton, 1995).

The economic reasoning that would dominate government decisions underlying the FTA and the AIT was largely the result of The Royal Commission on the Economic Union and Development Prospects for Canada (the MacDonald Commission) that reported in September 1985. The Commission urged the Canadian government to raise long-term productivity by opening up the Canadian market to more competition. Consultations were dominated by large business interests and traditional neo-classical economists making it difficult to reconcile the imperatives of neo-classical economics, distributive justice and pareto optimality while compensating beneficiaries such as the provinces and manufacturers for the loss of institutionalized entitlements. The MacDonald Commission concluded, "Our proposals ... to enter into a free trade agreement with the United States reflect our general preference for market forces over state intervention as the appropriate means through which to generate incentives in the economy, from which growth will follow" (Government of Canada, Royal Commission on the Economic Union and Development Prospects for Canada, 1985).

There were difficult contradictions to be managed through the negotiations of the trade agreements. The contradictions were based in the tensions between satisfying the path dependent, regional policy dominated federalism of the 1970s and 1980s and the powerful ideology of market forces encouraged by the MacDonald Commission that meant the removal of discretionary policies of benefit to regions and sectors.

Breton comments that there was almost a complete absence of economic theory from the debates and negotiations leading to the AIT, for example, except for the largely ideological premise that negative and positive integration mean more economic growth and more wealth. In reality, the ideological foundations were already strongly in place. The tensions between retaining some form of domestic protection and further market liberalization now took the form of the extent to which positive or negative integration would be embraced.

Negative and positive integration are two different approaches to reconciling the tensions of inter-jurisdictional agreements and federalism (and continental economic integration at another level).⁷ Positive integration can be described as the removal of internal barriers to trade combined with shared rules imposed by a central authority. Negative integration is a framework of rules that prohibits certain forms of behavior by participating governments, while accommodating varying levels of policy differences within the different elements of that framework (MacDonald, 2001 and Hale, 2003). Negative integration was a conceptual framework that could help to balance domestic and international pressures arising from federalism and the entrenched regional policy paradigm. Sub-national governments persisted in looking to retain and expand their sovereignty in face of pressure to accede to both international trade agreements and the AIT. By negotiating exclusions from the AIT, at least in the initial stages, provinces and other stakeholders could see the possibility for retaining some measure of “special access” to contracts that they had traditionally counted on in terms of regional and industrial development (such as the original MASH sector exclusion). In the face of increasing economic integration, both domestically and internationally, provinces would not as a rule be able to accept a federal government agenda that could, in some circumstances, tend to suppress federalism (Breton, 1985, p. 91).⁸

The AIT has many opinionated observers. Armand de Mestral (1995) is very concerned that the AIT is not consistent with the principles and institutions of Canadian federalism that involve a very high degree of economic integration. Instead, the provinces modelled the AIT on the international law of the GATT, and have not even committed to the extent of the Uruguay Round negotiations. “It’s ‘no law, bad law, and the wrong kind of law’” (de Mestral, 1995, p. 95).

De Mestral (1995) strongly asserts that it is a political text not grounded in any legal system, be it federal, provincial, international or Canadian constitutional law. The dispute settlement system has no guidance as to the law in which the agreement is based. There is very little commitment by the parties, and the right of provinces to pursue their own policy goals appears often. Because the text is drafted similarly to GATT or NAFTA, the impression is that the provinces are independent sovereign actors capable of making concessions comparable to those made by governments in NAFTA. But inter-provincial trade falls under federal, not provincial

jurisdiction. Thus, there is a confusing and potentially unconstitutional series of provisions relating to inter-provincial trade.

Indeed, the backdrop for inter-provincial trade is changing. Provinces and regions are highly integrated north-south, and since they are distinct industrially from other east-west provinces/regions, there will be a tendency for them to enact policies that will enhance their ability to compete in North American economic space.⁹ Courchene believes that this is the emergence of North American economic region states, and likely this will result in an enhanced degree of decentralization and therefore greater asymmetry.¹⁰ It is possible, as Courchene argues, that the focus on symmetry as a philosophical goal of federalism has been trumped by the provincial/regional realities of North American trade integration (Courchene, 2003, p. 6).

CONCLUSION

The purpose of this chapter was to outline the fundamentals of the key trade agreements in terms of their procurement elements, to look at the impacts of the Canadian International Trade Tribunal with respect to procurement, and through the use of North's transaction cost framework in the economics of institutionalism, to examine the impact and effect of liberalization and trade on procurement policy.

The initial amount of trade that was opened up under the series of trade agreements was not extensive, and there were many exceptions that allowed Canada to continue using procurement to protect industry and to promote development programs. This demonstrated the continuing existence of the strong regional policy paradigm and the desire for stakeholders to continue receiving the benefits to which they had become accustomed. "Negative integration" approaches to economic liberalization held more promise (than positive integration) for politicians to protect traditionally subsidized industries and regions. But over time, the exceptions and set-asides were increasingly reduced. For example, two important extensions to the AIT increased its impact. First, the expanded coverage to the municipalities, schools and hospitals sector (MASH) reduced inter-provincial barriers to access of procurement contracts. Second, the extension of coverage to defence reduced the extent to which exceptions could be made for anything but highly scrutinized "security" issues.

Thus, there was a significant shift in the capacity for the government to use procurement as a tool for economic development, socio-economic policy, defence industry protection, and directed spending. The rules-based regime stemming from the legalistic context in which procurement now functioned changed the way the procurement officers had to approach all processes around the bid system. Trade agreements had to be considered first, along with lessons learned from CITT, decisions including now the consideration of probable biases and the body of case law already in place. The liberalization process and the direct association of trade policy with procurement (now as included directly in the trade agreements) means that procurement choices are now shaped with externally imposed constraints at the forefront.

In the economic institutional framework developed, the cost of exchange and how this relates to procurement as a transaction is broken down into four categories. Each of these has an impact on the nature of procurement and in turn has altered the conditions for policy making. The new dynamics include the use of competitive bidding as the yardstick due to the difficulty in obtaining sufficient information otherwise; adherence to non-discriminatory principles as way to govern exchange between parties; enforcement mechanisms based in the growing body decisions of the CITT; and the growing ideological foundation of procurement in “fairness” in a liberal trade sense (not a domestic regional policy sense).

The cost of measuring any procurement exchange increases if the mechanism for obtaining goods and services is not competitive bidding. In a competitive bidding situation, the objective is clear (although having only two bids in a given situation may not be considered very competitive, e.g., the EH-101 helicopter bid) and any discretion exercised around who is allowed to bid introduces inefficiency. Corruption, difficult to identify and measure, is consequently inefficient and contrary to competitive bidding practices. In the context of procurement policy, success is measured by the number of CITT challenges (low is better); this seems to hold some potential as a yardstick for effective procurement in government. While it is reasonable to expect a spike in the number of cases heard by any administrative tribunal following its creation or the expansion of its jurisdiction to clarify the case law and establish its effective authority, the number of these cases judged in context over time is an important variable in the examination of the evolving

procurement environment. The increasing emphasis on competitive bidding reduces the capacity for political and bureaucratic discretion, and for better or worse is required with respect to compliance with international trade agreements.

The nature of procurement exchange, the rules under which contracting proceeds, is now governed by principles of “most-favored nation” and “national treatment.” Despite the continuing existence of categories of goods and services that do not fall under the trade agreements, these exceptions are increasingly being reduced, and thus discretion is removed from officials in contracting and mechanisms for contracting.

The enforcement of procurement exchange looks far different from 20 years ago; there is little choice on the part of procurement officials with respect to how bids are developed and published, and the way in which bids must be evaluated. The CITT case history now presents a formidable series of judgments (although the CITT is not bound by its own case law and has been criticized for inconsistency in the way it addresses issues) that officials must know and understand in order to avoid being challenged by the potential suppliers. The CITT has become a policy-making institution by essentially controlling the conduct of procurement by much of the federal government (Attwater, 2002, p. 2-5-3-1). It is slowly constricting the discretion of procurement officials by the nature of its decisions and choices as to how procurement contracts will be solicited, managed, and enforced.

The traditional institutions of procurement, Public Works and Government Services Canada (and its earlier incarnations), Treasury Board, Industry Canada (and earlier forms), now operate in a policy context where the CITT is a fundamental force. In light of the CITT process, effective procurement results to a certain extent through a process of trial and error, whereby these institutions interact and the traditional government organizations shift and react in the pursuit of the best outcomes possible. This environment, as it changes and alters, defines and limits the practicable forms of organization available. Fundamentally, the CITT is now an institution that will limit the practicable organizations and arrangements that can emerge in the procurement field.

While the ideology underlying procurement policy retains the preference for regionalism and decentralized decision-making, the

sheer cost of decentralized institutions and choices based on promoting “inefficient” objectives has moved Canadian procurement policy more towards values of competitiveness and rules-based decision-making. The “ideology” of economic liberalization is attractive in many ways (to a federal government and possibly provinces and large companies), promising more efficient procurement and larger markets. If less regionalism is not acceptable, the Canadian government will continue to pay a premium for subsidization both in terms of transactions costs and in terms of the difficulty of being competitive in the liberalized trade environment. The regional paradigm continues to exert pressure, but the federal government is far less interventionist and more market-oriented than before the key trade agreements discussed here were in place.

NOTES

1. Technology Partnerships Canada (TPC) was a technology investment fund established in 1996 to contribute to the achievement of Canada’s objectives of increasing economic growth, creating jobs, and supporting sustainable development. TPC supported government initiatives by investing strategically in research, development and innovation in order to encourage private sector investment, and so maintain and grow the technology base and technological capabilities of Canadian industry. TPC was theoretically intended to encourage the development of small and medium-sized enterprises (SMEs) in all regions of Canada. Peter Hadekel (2004, p. 167) noted that the government had to camouflage its support of aerospace by allowing other sectors to come in, like biotechnology and environmental science, although two-thirds of the funding was set aside for aerospace. On August 2, 1999, the Appellate Body of the World Trade Organization confirmed an earlier ruling that found the way TPC was administered in support of five projects relating to the regional aircraft industry was inconsistent with WTO rules. Under the ruling, Canada was obliged to make adjustments to the administration of TPC support for the Canadian regional aircraft industry. TPC Contribution Agreements for the Canadian regional aircraft industry were amended in order to terminate all obligations to disburse funds effective November

18, 1999. As a result, some \$16.4 million of funding pursuant to those agreements was cancelled.

2. Note, however, that at some point, competitive bidding for each and every small volume contract is no longer efficient. Grouping of small volumes takes advantage of economies of scale.
3. If public-private partnership-type contracts are “incomplete contracts” with non-verifiable characteristics, and cannot be enforced because they are not included in the agreements, there is potential both for officials to purposefully design more contracts like this (to avoid any CITT challenges) and include discriminatory measures. This does not, at least not yet, seem to be occurring – partnership agreements are exceedingly complicated and costly to negotiate and manage (Breton, 1995, p. 93).
4. If the supplier in one jurisdiction considers that it has been prejudiced by the actions of a government or its entities in another jurisdiction, and it has failed to resolve the matter directly with the party responsible for the procurement, the supplier may approach the contact person in its own jurisdiction, who would then approach the contact person in the procuring government’s jurisdiction and seek to resolve the complaint. If the two contact persons cannot resolve the complaint, a review panel must be struck at the request of the government of the jurisdiction where the aggrieved supplier is located. The composition of the panel is to be determined by the two official points of contact and is to comprise three members, one from each of the two jurisdictions affected and a neutral chairperson, all drawn from a standing roster of panellists to be maintained by each party. A panel reports its findings and recommendations to the procuring organization and the supplier’s government. In the case of challenges regarding procurement by the federal government, where a supplier does not achieve a successful resolution of its complaint with the procuring entity, it may bring the matter to the attention of a reviewing authority with no substantial interest in the outcome of the procurement (Trebilcock & Behboodi, 1995, p. 50).
5. In France, a distinct legal category of *contrats administratifs* is recognized, into which fall many of the government’s contracts of

procurement. These are governed by a conceptually distinct “law of administrative contracts” developed and administered by special administrative courts. Although many of the rules of this “public law” are similar to those governing French civil (private) law transactions, there are also important differences (Arrowsmith, 1988, p. 4).

6. “The strength of ideology can be measured by the premium people are willing to incur rather than “free ride.” Such a premium is the cost of one’s convictions. Not only does the premium vary according to one’s beliefs about the justice of the rules and the contractual arrangements of the society, but it can be influenced by education, propaganda, and symbols. Appeals to justice and fairness do matter, otherwise we would be at a loss to explain a good deal of schooling as well as the immense investments made by politicians, employers, labor leaders, and others trying to convince participants of the fairness or unfairness of a contractual arrangement. Our understanding of ideology is still sketchy, but one more point is significant. Specialization and division of labor produce divergent perceptions of reality and hence contrasting and conflicting views of the fairness and justice of institutional arrangements. In such a world the cost of contracting, *ceteris paribus*, increases because one cannot rely on common perceptions of fairness to enforce compliance of agreements” (North, 1984, p. 258).
7. In terms of the actual mechanisms of positive and negative integration in trade agreements, positive integration is a bottom-up process whereby a good or service has to be explicitly listed in order for the agreement to cover it. Goods or services that are covered, are then subject to exceptions listed in Annexes and listed entities that are covered must exceed specified thresholds. Negative integration is top-down; generally all goods and services are covered and then the agreement proceeds with lists of exclusions.
8. For an interesting discussion of the effect of globalization on regional autonomy and assertiveness, see Pieter Van Houten, (2003). Van Houten’s evidence suggests that political institutions are as important in determining regional assertiveness as any of the effects of globalization. Regions then are unlikely to be weaker in their role with respect to changes imposed from

international trade agreements and will continue to press for “exceptions” such as those captured by negative integration processes.

- 9 There is considerable tension in Canada between the pressures toward policy convergence with the United States versus the benefits of policy independence and thus divergence. The policy convergence approach holds that greater integration creates incentives for policy convergence between countries. The second is associated with “competitive federalism,” where governments are assumed to compete with each other for mobile factors of production by choosing the policies most likely to attract incremental investment and jobs in light of the policies chosen by other governments (Harris, 2003, p. 7).
10. Ontario is by far the most deeply integrated province, with Quebec a close second. For example, as a “percent of goods exports shipped to the U.S.,” Ontario has 93.1% and Quebec 84.6%, whereas Saskatchewan is at 57.8% (Hale, 2003, p. 42).

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