

Projected Economic Effects of the Integrity Framework

**By Dan Ciuriak and Laura Dawson
14 November 2014**



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Summary

The March 2014 revisions by Public Works and Government Services Canada (PWGSC) to its Integrity Framework risk creating a host of negative economic effects. Some of these impacts can be readily quantified and some, though not as easy to quantify, will nonetheless cause significant and far-reaching harm to Canada's economy and competitiveness. The new rules are having a chilling effect on international investment prospects by increasing Canada's political risk profile, while at the same time raising the nation's vulnerability to trade challenges.

This briefing provides:

- a quantitative assessment of the economic impacts of the Framework on Canadian firms facing debarment; and
- an outline of the major cross-cutting economic impacts of this policy.

The quantitative projection is achieved by creating a profile of a typical Canadian firm that has, or is about to, lose its right to bid on Government of Canada contracts. It examines the effects of debarment on the firm, its competitors, and the economy as a whole.

Our analysis found that:

- for a typical affected firm, **sales will fall by \$351 million per year;**
- debarment of a single firm results in a **net loss to Canada of more than a billion dollars** over the 10-year suspension period; and
- the debarred firm will have to **fire more than 400 Canadian workers.**

There are a host of other impacts arising from the Integrity Framework, including a reduction in the number of suppliers to government for certain types of goods and resulting price increases. Canadian small and medium enterprises (SMEs) will lose contracts with multinationals, with significant disruption in many sectors. The Integrity Framework has

already started getting attention abroad with the effect of undermining perceptions of Canada's business climate.

Cross-Cutting Economic Impacts of the Integrity Framework

1. Reduction of supply:

The debarment of a firm will reduce the supply of goods and services available to the Government of Canada. To some extent, this effect is mitigated by shift of government purchasing from affected firms to their competitors. However, given imperfect substitutability of alternative sources of supply, **this shift will result in increased prices and reduced quality and variety of goods and services available for government procurement.** In areas such as information technology, for example, many of the big suppliers of high quality, secure network equipment and services are facing the threat of debarment due to past problems with other business units outside of Canada. This could increase the vulnerability of Canada's government networks to successful cyber attacks.

2. Red tape, supply chain impacts and SMEs:

The application of the Framework to a broad range of affiliated entities generates **additional administrative costs**, not only to the prime supplier but also throughout the supply chain; **the longer the supply chain, the greater the multiplication of costs.**

The risk of debarment to the main supplier makes extended supply chains a major source of risk. Since primary contractors are often large corporations while the subcontractors are SMEs, the Integrity Framework will tend to limit outsourcing and reduce economic efficiency. **Canadian SMEs with limited information about multinational activity in foreign markets are particularly vulnerable**

3. Foreign Direct Investment (FDI):

Very little procurement is undertaken on a cross-border basis. Any firm that intends to pursue government contracts will establish a local presence. For a major company, the stigma of debarment in a G7 country for an unrelated offense of an affiliate in a third country will affect every investment decision, **creating a chilling effect on foreign direct investment in Canada.**² Analysis of factors inhibiting investment shows that market uncertainty is weighted more heavily by firms than other factors such as cost of capital.³ **The risk of debarment for events not necessarily under the control of the firm increases the uncertainty of investing in Canada.**

4. Vulnerability to trade challenges under the WTO, NAFTA and CETA:

The Canadian definition of affiliated parties subject to debarment extends far beyond the standard used in both UNCITRAL⁴ and in major comparator countries, such as the United States, Australia, United Kingdom, and Germany. Exceeding the standards of internationally recognized conventions could make Canada vulnerable to **WTO trade challenges for measures unnecessarily restrictive of trade.**

The framework could also trigger investor-state disputes **such as those permitted under the North American Free Trade Agreement and the Canada-European Union Comprehensive Economic and Trade Agreement.**

5. North American regional integration:

Given the depth of North American integration at the corporate level, the differences between the Canadian and U.S. provisions may have significant **repercussions for mergers and acquisitions activity.**

The Foreign Corrupt Practices Act contains (FCPA) qualifications on successor company liability that are lacking in the Canadian context. There are also sharply different time limits (5 years in the United States and 10 years in Canada), which could not only limit access of a Canadian company to federal contracts but also **reduce the value of Canadian companies to foreign acquirers.**

6. Retaliation against Canadian companies:

The debarment by Canada of a foreign company for reasons of a tenuous affiliation could expose Canadian companies to **legal retaliation abroad**, where conviction on, for example, a competition measure, would have the effect of debarring the company not only from foreign contracts but from Canadian government contracts. Given the pronounced home bias in government procurement worldwide, **the home bias against Canadian companies soliciting business abroad may end up being intensified.**

7. Lack of consistency and transparency:

The Canadian framework provides non-specific grounds for exceptions, increasing the scope for unilateral and inconsistent decision making and decreasing transparency for participants. Given that lack of transparency is a frequent rationale in WTO disputes, the new rules increase the incentives for non-disclosure.

Quantifying the Economic Impacts

A sample of five companies affected by the Integrity Framework reveals the potential for significant economic harm. For illustration purposes, we create a profile of a typical or representative firm affected by the new rules.

Profile of a Representative Firm Facing Debarment

The typical firm facing debarment is a foreign multinational, with Canadian sales of about \$2.75 billion. It is a significant exporter that spends a large share of total revenues on R&D in Canada. It employs more than 4000 Canadians and has 666 Canadian suppliers in its purchasing roster. About 18% of its sales come from government procurement. The firm accounts for a little under 3% of the Government of Canada's \$16 billion procurement budget.⁵

Table 1: Characteristics of Representative Firm⁶

Sales in Canada	\$2.8 billion
Exports	\$750 million
R&D Spending	\$278 million
Canadian Supply Purchases	\$635 million
Procurement Sales in Canada	461 million

Procurement Share of Canadian Sales	18%
Share of Government of Canada's Procurement	2.88%
Number of Employees	4,045
Number of Canadian Suppliers	666
Charitable Donations	\$2 million

Source: calculation by authors.

To estimate the impact of debarment, we estimate the Government of Canada's procurement, based on an assumed constant share of procurement to general government expenditures in Canada, 2015-2024.⁷

The representative firm supplies 3% of the procurement market while the remainder of the firms (ROF) supply the balance. We assume they would keep these shares over the projection period (if not for the debarment). We also assume the ROFs have similar ratios of domestic sales to procurement sales and export sales to domestic sales.⁸

Analysis

We provide different scenarios for goods and services with low, medium, and high degrees of substitutability. Substitutability refers to the relative ease that different suppliers can be used to provide the same good or service. Substitutability is related to degree of product specialization and number of suppliers in the marketplace.

Under the low substitutability scenario, the representative firm loses all its Government sales and only makes up some of that through an expansion of sales to the rest of Canada.

Its total sales fall by \$351 million. Over the 10-year debarment period, this works out to \$3.5 billion in lost sales. Other firms (ROFs) only partially fill the gap in sales to the Government of Canada (a gain of \$354 million) while losing some sales in the rest of Canada and in export markets due to increased competition by the debarred firm. The ROFs' annual gain of \$235 million falls short of compensating Canada for the losses of the Representative firm. Canada loses sales of \$114 million in 2015 and about \$1.1 billion over the 10-year debarment period.

Table 2a: Low Substitution Debarment Scenario (\$ millions/year)

	GOC	ROC	Exports	Total Sales
Initial Sales				
Representative Firm	514	2,547	836	3,897
Rest of Firms	17,341	77,189	25,338	119,868
Total Canadian Sales	17,855	79,736	26,174	123,765
Change				
Representative Firm	-514	123	40	-351
Rest of Firms	354	-88	-29	238
Total Canadian Sales	-160	35	11	-114

Taking into account the price and quantity effects, the Representative Firm suffers a 9% decline in the quantity of output and a 3% decline in its prices. Its profit margin (producer surplus) falls by \$115 million or by about \$1.1 billion over the 10-year debarment period. The representative firm also loses some 408 jobs as a result of debarment. These might be offset somewhat by ROF gains but, just as ROFs are unable to fill the gap in sales, they are not expected to make up the net losses in employment either. After the reshuffling of the market, the Government of Canada experiences a “consumer welfare” loss of \$1,001 billion or about \$10 billion over the 10-year debarment period as a result of diminished value for money in government procurement.

Table 2b: Low Substitution Debarment Scenario

Producer Impacts	Change in Output (%)	Change in Producer Price (%)	Change in Producer Surplus (\$ millions)	Total Welfare Impact (\$ millions)	Changes in Employment (number)
Representative Firm	-9.00	-3.09	-115	-115	-408
ROF	0.20	0.07	79	79	na
GOC				-1,001	

The following tables show the effects of a firm’s debarment under the medium and high substitution scenarios.

Table 3a: Medium Substitution Debarment Scenario (\$ millions/year)

	GOC	ROC	Exports	Total Sales
Initial Sales				
Representative Firm	514	2,547	836	3,897
Rest of Firms	17,341	77,189	25,338	119,868
Total Canadian Sales	17,855	79,736	26,174	123,765
Change				
Representative Firm	-514	235	77	-202
Rest of Firms	491	-226	-74	190
Total Canadian Sales	-23	9	3	-12

Table 3b: Medium Substitution Debarment Scenario

Producer Impacts	Change in Output (%)	Change in Producer Price (%)	Change in Producer Surplus (\$ millions)	Total Welfare Impact (\$ millions)	Employment (number)
Representative Firm	-5.18	-1.76	-6.84	-67	-205
ROF	0.16	0.05	0.21	63	na
GOC	0.00	0.05	0.00	-141	

Table 4a: High Substitution Debarment Scenario (\$ millions/year)

	GOC	ROC	Exports	Total Sales
Initial Sales				
Representative Firm	514	2,547	836	3,897
Rest of Firms	17,341	77,189	25,338	119,868
Total Canadian Sales	17,855	79,736	26,174	123,765
Change				
Representative Firm	-514	293	96	-125
Rest of Firms	502	-287	-94	120
Total Canadian Sales	-12	5	2	-5

Table 4b: High Substitution Debarment Scenario

Producer Impacts	Change in Output (%)	Change in Producer Price (%)	Change in Producer Surplus (\$ millions)	Total Welfare Impact (\$ millions)	Employment (number)
Representative Firm	-3.22	-1.09	-4.27	-42	-127
ROF	0.10	0.03	0.13	40	na
GOC	0.00	0.05	0.00	-64	
Producer Impacts	Change in Output (%)	Change in Producer Price (%)	Change in Producer Surplus (\$ millions)	Total Welfare Impact (\$ millions)	
Representative Firm	-3.22	-1.09	-4.27	-42	
ROF	0.10	0.03	0.13	40	
GOC	0.00	0.05	0.00	-64	

Conclusions

Debarment imposes a direct cost on the debarred firms but also on innocent parties and society at large. The costs are greater for goods and services that are less substitutable. Debarment results in a reshuffling of the economy as different suppliers move to different markets. Although they are not reflected in the calculations above, these market shifts are not costless and include administrative expenditures associated with a mass of re-contracting. While not all of the indirect impacts can be quantified, they are likely to increase the costs predicted here by a significant margin.

Annex: The Revised Integrity Framework

Effective 1 March 2014, the Department of Public Works and Government Services Canada (PWGSC) introduced changes to its Integrity Framework for its procurement and real property transactions.⁹ The updated provisions introduce new Canadian offences and similar foreign offences, introduce a time period following a conviction within which convicted suppliers will be ineligible to do business with PWGSC, and extend the Integrity Provisions to subcontractors.

The Integrity Framework applies directly only to PWGSC managed contracts and real property transactions. However, other government departments and agencies may apply the framework to their solicitations and contracts and PWGSC has entered into memoranda of understanding (MOUs) with a number of other Federal Government Departments and Agencies to support their application of the framework through PWGSC-conducted supplier checks. These other Departments include:

- Aboriginal Affairs and Northern Development Canada;
- Agriculture and Agri-Food Canada;
- The Canada Revenue Agency;
- Defence Construction Canada;
- Economic and Social Development Canada;
- The Jacques Cartier and Champlain Bridges Crown Corporation and;
- Shared Services Canada.

Legal commentary suggests that the Framework applies government-wide on a de facto basis (Swick, 2014).

Under the Framework, a supplier is ineligible to do business for a period of 10 years with a Government Department that applies the Framework, following a conviction or a guilty plea with a conditional or absolute discharge for any of the following Canadian or similar foreign offences (new additions highlighted):

- frauds against the government under the *Criminal Code of Canada*;
- frauds under the *Financial Administration Act*;
- payment of a contingency fee to a person to whom the *Lobbying Act* applies;
- corruption, collusion, bid-rigging or any other anti-competitive activity under the *Competition Act*;
- money laundering;
- participation in activities of criminal organizations;

- income and excise tax evasion;
- bribing a foreign public official;
- offences in relation to drug trafficking;
- extortion;
- bribery of judicial officers;
- bribery of officers;
- secret commissions;
- criminal breach of contracts;
- fraudulent manipulation of stock exchange transactions;
- prohibited insider trading;
- forgery and other offences resembling forgery; and
- falsification of books and documents.

A supplier may be debarred if the supplier or an affiliated entity is convicted of one of the above offenses. As Swick (2014) notes “The definition of affiliates is broad and includes parent companies, subsidiaries, sister companies and directors, provided that they have control of each other or are under the common control of a third party. Indicia of control include interlocking management or ownership, identity of interests, family members, shared facilities and equipment or common use of employees.”

Several grounds are provided for exceptions:

- no other supplier is capable of performing the contract;
- there is an emergency,
- national security,
- health and safety, or
- economic harm.

The Integrity Framework is encoded in a manual; it is a policy statement rather than a formal regulation or law. There has been, accordingly, no regulatory impact assessment conducted.

Notes

¹ This briefing provides a preliminary evaluation of the economic effects of the PWGSC Integrity Framework. While it is based on a limited number of cases, the affected businesses represent national and global leaders in their field. Data is based on direct reporting from businesses, November 2014. Business names withheld to protect confidentiality.

² Waelde (2007) argues that “it would be a sign of negligent management and counsel if political risk management and investment protection were not planned with the potential of investment-treaty based arbitration in mind.” (cited in UNCTAD, 2009). On the linkage between political risk and investment, see also Kekic and Sauvart (2007) and Yackee (2010) and Alfaro et al. (2003).

³ See Dixit and Pindyck (1994).

⁴ UNCITRAL Model Law on Public Procurement (2011).

⁵ Treasury Board Purchasing Activity Report, 2011.

⁶ 2013 sales and trade data. All figures in Canadian dollars.

⁷ Consistent with projections of the IMF World Economic Outlook.

⁸ We further assume that the Government’s decision to tender means that it has made up its mind on the procurement and its demand for the goods and services can be treated as highly inelastic. We assume a moderate supply elasticity for both the representative firm and the alternative suppliers. This means that the switch by the Government of Canada to alternative suppliers puts pressure on their costs in order for them to meet the additional demand.

⁹ Policy Notification 107U1 – Integrity Provisions (PN-107U1).