

POLICY *Brief*

Corruption and fraud in agricultural and energy subsidies: Identifying the key issues

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HOW ARE GOVERNMENT SUBSIDIES AFFECTED BY CORRUPTION AND FRAUD?

Government subsidy programs, like many areas of government expenditure, are at risk of corruption and fraud that cost taxpayers millions of dollars. The extent to which these two factors affect subsidy policy is difficult to fully estimate because it is not commonly detected or reported to official sources. Precise figures are difficult to obtain, and governments are also often unwilling to publicize occurrences of fraud and corruption out of fear of bad publicity or public concern at their lack of oversight.

Research by the Global Subsidies Initiative (GSI) into subsidies often identifies issues relating to fraud and corruption. Because certain actors can generate substantial amounts of illegal money, they often resist reform and calls for greater transparency. The GSI is concerned that fraud and corruption are not being sufficiently addressed in order to remove what may be a significant barrier to subsidy reform.

The research and literature on the effects of fraud and corruption on subsidy policy are not extensive. The media tracks cases and helps publicize the issue, as do non-governmental organizations working in the areas of transparency, such as Transparency International and the U4 Anti-Corruption Resource Centre. Official audit agencies and government departments mandated to counter fraud and corruption are good sources of information, but the quality of this information varies depending on the overall transparency of the government. A number of prominent international organizations are also involved in this area, including the Organization for Economic Co-operation and Development's (OECD's) Working Group on Bribery, which is made up of representatives from the 38 countries party to the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions ("Anti-Bribery Convention")¹. The United Nations Office on Drugs and Crime also works on corruption issues and hosts the only legally binding universal anti-corruption instrument, the United Nations Convention against Corruption (UNCAC)². The European Commission's European

¹ www.oecd.org/daf/nocorruption/convention

² <http://www.unodc.org/unodc/en/treaties/CAC/index.html#UNCACfulltext>

HOW ARE GOVERNMENT SUBSIDIES AFFECTED BY CORRUPTION AND FRAUD?

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Anti-Fraud Office (OLAF) focuses more on investigating fraud and corruption. There is also a host of regional (GRECO³ and AOS⁴) and national organizations working on issues relating to domestic subsidy programs that are suspected of being affected by fraud and corruption.

The number of fraud and corruption cases reported to official sources is likely to be only a small percentage of the actual figure perpetrated against governments⁵. The majority of cases reported to authorities never make it to the stage of criminal prosecution, either due to inadequate evidence against the suspects, or political intervention to resolve the matter before the judiciary becomes involved. Of those reported cases that do progress to a criminal court case, few conclude with a successful prosecution. The reasons vary by country. They can include the influence of a corrupt judiciary, where offenders can bribe officials in order to have the case against them dismissed. Another reason is that many law-enforcement organizations have insufficient expertise or resources to prosecute lengthy cases involving technical and complex subsidy programs.⁶ Governments appear willing to provide publicly funded subsidy programs totaling billions of dollars, but commit significantly fewer resources to monitor them effectively.

This policy brief focuses principally on fraud and corruption involving subsidy programs in the energy and agricultural sectors. It will define these problems and give examples of affected subsidy programs. It will also identify and discuss a number of factors that influence how vulnerable subsidy programs are to abuse. The brief concludes with a set of policy recommendations to policy-makers on how to design subsidy policies that minimize opportunities for fraud and corruption.

RECOGNIZING THE DIFFERENCE BETWEEN FRAUD, CORRUPTION AND POORLY DESIGNED SUBSIDY POLICIES

Fraud and corruption thrive in organizations with enormous financial resources and where budgetary information is scarce. Many national Energy and Agricultural Ministries provide only highly aggregated data on subsidy programs with little detailed information. When combined with poor internal control procedures, these systems can be abused by government officials, external contractors and individuals or companies. Subsidy programs typically attract a wide array of actors hoping to access government funding via programs that may be set up with few controls. Fraud and corruption becomes a low-risk, high-return activity.

Definitions for fraud or corruption vary across organizations and countries—as do definitions of bribery, a related issue. Many definitions of these terms involve deep legal explanations. Here, we discuss only a few of the most commonly used definitions in order to help build a better understanding of their link to subsidy policy.

³ Group of States against Corruption – http://www.coe.int/t/dghl/monitoring/greco/general/about_en.asp

⁴ Organization of American States – Inter-American Convention against Corruption (MESICIC) – <http://www.oas.org/juridico/english/FightCur.html>

⁵ The OECD's Working Group on Bribery published for the first time in June 2009 an extensive list of enforcement data on prosecuted foreign bribery cases: http://www.oecd.org/document/3/0,3343,en_2649_34859_45452483_1_1_1_1,00.html

⁶ According to the OLAF 2009 annual report (http://ec.europa.eu/anti_fraud/reports/olaf/2008/EN.pdf) the active stage duration of an investigation decreased from 28 to 24 months in 2008.

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Defining Fraud

The Oxford Dictionary defines fraud as “wrongful or criminal deception intended to result in financial or personal gain.” The two main elements of this definition involve some form of misrepresentation resulting in a financial loss to someone and personal gain for the person committing the act. The OECD defines fraud as “the acquisition of another person’s property by deception.”

Example: South Korea’s Rice Subsidy Scheme set up to cushion rice farmers from the opening of the Korean market to foreign imports

Rice farmers were eligible to receive subsidies. However, from 2005-08 it has been estimated that over US\$100 million in government funds intended for rice farmers were instead distributed to tens of thousands of fraudulent applicants, including many public servants who were land owners but not farmers. The process for applying for the subsidy did not require applicants to prove they were actually farming the land for which they were making claims.⁷ All elements of the definition of fraud were evident. The government was wrongfully and intentionally deceived by applicants claiming to be actively farming parcels of land. The payouts constituted a financial loss for the government and a personal gain for the applicants (GSI, 2008).

Defining Corruption

As with fraud, corruption takes many forms and can be defined in a variety of ways. The OECD defines corruption as “active or passive misuse of the powers of public officials (appointed or elected) for private financial or other benefits.”⁸ Transparency International’s definition is often commonly referred to, which is “corruption is the abuse of entrusted power for private gain” (Transparency International, 2010). The Oxford Dictionary defines it as “dishonest or fraudulent conduct by those in power, typically involving bribery.” The main elements of this definition are that individuals, such as government officials, misuse the authority granted to them by their position for personal gain or the benefit of others. As the act of bribery is often involved it is also worth defining.

To bribe is commonly defined as “to dishonestly persuade (someone) to act in one’s favour by a gift of money or other inducement” (Oxford Dictionary, 2010). The OECD defines two forms of bribery—active (offering) and passive (receiving). Passive bribery is “the offence committed by the official receiving the bribe.” Active transnational bribery, as defined in Article 1 of the OECD Anti-Bribery Convention is defined as “offering, promising or giving any undue pecuniary or other advantage, whether directly or through intermediaries, to a foreign public official, for that official or for a third party, in order that the official act or refrain from acting in relation to the performance of official duties, in order to obtain or retain business or other improper advantage in the conduct of international business.”

⁷ The Ministry of Public Administration and Security gave public officials the opportunity to submit voluntary reports of misconduct if they illegally received rice subsidies between 2005 and 2008. Some 45,000 voluntary confessions from federal and local public servants resulted, including four confessions by undisclosed high-ranking officials.

⁸ OECD Glossary of Statistical Terms, available at: <http://stats.oecd.org/glossary/detail.asp?ID=4773>

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Example of corruption: the misappropriation of agricultural subsidies

A number of ongoing investigations into the disbursement of subsidies to the agricultural sector have appeared in the media. It is difficult to speculate on the details of these investigations and how they will conclude, because they are complicated and involve a number of parties. A common theme, however, appears to be the diversion of agricultural subsidies to individuals or groups associated with members of the government. Officials responsible for managing the disbursement of these funds may knowingly approve agricultural subsidies for family members or associates who were not eligible. It is likely that complex company ownership structures may be involved to shield the real recipients from being identified. It is also possible some of the recipients may provide political support in exchange for receiving the subsidies. The elements of corruption are present if government officials misused their positions in an official capacity to illegally aid or support family members, individuals or groups in their application to agricultural subsidy programs (Stanimir, 2010).

AN OVERVIEW OF SOME OF THE MAIN POLICY AREAS AFFECTED BY FRAUD AND CORRUPTION

The extent to which subsidy programs may be defrauded or subject to corruption varies by country and region. In some countries, such as China, it is a major issue. China's National Audit Agency identified US\$170 billion in misappropriated and misspent public funds during annual audits from 1996 to 2005. These illegal activities represent approximately 8 per cent of China's on-budget spending during this timeframe (Carnegie Endowment for International Peace, 2007). While potentially only a small portion of the US\$170 billion related to subsidy programs, it provides an example of the pervasiveness of this issue in the context of government expenditure. While the effects of fraud and corruption vary across subsidy programs, sectors and countries, a number of specific policy areas are more susceptible to fraud and corruption. **This list of problem areas is not exhaustive and there are likely many more areas of subsidy policy which suffer from fraud and corruption.** They include:

1. Oil companies' calculating and reporting of royalties to government

Royalty rates are often associated with the provision of subsidies. There is debate over how to set fair rates, especially between sectors and countries, and how to estimate the subsidy value. Companies extracting oil can fraudulently manipulate their royalty payments, thereby depriving governments of large amounts of tax revenue. There are several well-publicized cases of U.S. oil companies deliberately underpaying royalties. Examples include:

- The oil company Kerr-McGee, owned by Anadarko Petroleum, was convicted of underpaying royalties on 57 oil leases it held with the U.S. government. A federal judge ordered the company to pay US\$22.9 million in penalties, including US\$5.7 million to the auditor who pursued the case. Kerr-McGee sold oil to the Texon Corporation at prices below-market rates from 1999 to 2002 as part of an agreement with them to provide services such as marketing (USA v. Kerr-McGee Corporation, 2007) (Lichtblau, 2010).



AN OVERVIEW OF SOME OF THE MAIN POLICY AREAS AFFECTED BY FRAUD AND CORRUPTION

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- The Chevron Corporation, Texaco, Unocal Incorporated and their affiliates agreed to pay authorities US\$45.5 million to resolve a charge they violated the False Claims Act by deliberately underpaying royalties. The companies reported monthly to the Department of Interior's Minerals Management Service the value of the natural gas produced from their federal and Indian leases and paid a percentage of the reported value as royalties. It was claimed they improperly deducted the cost of boosting gas up to pipeline pressures from royalty values, used affiliate transactions to falsely reduce the reported value of gas taken from federal and Indian leases, and improperly reported processed gas as unprocessed to reduce royalty payments (Taxpayers against Fraud (TAF), 2009; U.S. ex rel. Wright v. Chevron USA, Inc. et al., 2009).

It should be noted that the high level of transparency in the United States allows for criminal cases to be publically brought against these companies, while in other, less transparent countries, it is likely no public investigation would have been undertaken.

2. Awarding upstream licenses to foreign companies for oil and gas exploration

The ways in which governments award licenses for companies to carry out exploration for oil and gas deposits differ by country. Increasing demand for energy makes these licenses valuable, and, in energy-rich countries, if the procedures for assigning these licenses are not properly regulated or transparent, they provide a significant entry point for the bribery of foreign public officials in international business transactions ('foreign bribery') and corruption. A notable case involved Nigeria:

- Prior to President Obasanjo taking office in 1999, licenses were granted on a discretionary basis to companies by the Minister of Petroleum, with few criteria for awarding licenses to applicants or ensuring the terms of the licenses were fair. The opportunity for foreign oil companies to influence the bidding process would have been significant. With licenses often including specific terms for sharing future revenues, preferential terms would provide oil companies with significant subsidies. After 1999, the Nigerian Government set out to publicly advertise the oil blocks that were coming up for public bid, as well as the selection criteria used to assess applicants who submitted bids (Gillies, 2009).

3. State-owned enterprises operating in the energy sectors of countries with poor transparency

State-owned enterprises (SOEs) operating in energy markets in countries with low levels of transparency are often associated with high levels of fraud and corruption. An overall lack of transparency makes it difficult though to identify the extent of corruption. Pertamina, a major SOE operating in Indonesia's energy market, was identified by the State Audit Agency as having had irregularities in its financial statements for the period 2001-08. These related to the calculation of domestic fuel-subsidy figures. Pertamina requested 18.3 trillion Rupees (US\$113 million) from central government based on the sale of subsidized domestic energy products to the general public. Few official public documents on this issue were available apart from a press statement issued by the Public Information Agency. The statement said the State Audit Agency had confirmed that Pertamina had applied



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inappropriate price criteria and standards and would reduce the subsidy figure sought from central government (Public Information Agency of the Ministry of Communication and Information, 2010). Media and industry experts alleged these irregularities involved the embezzlement of funds by corrupt Pertamina officials, the forgery of Pertamina records, and inaccurate accounting practices, though these assessments cannot be independently verified (Hendri Firzani, 2010; Wahyuni, 2010).

4. Large scope for bribing officials involved in administering Production Sharing Agreements distributing profits between oil companies and government

Production Sharing Agreements (PSAs) allow oil companies operating in a foreign country to recover legitimate costs, such as capital investments and operating costs, which are deducted from company revenues obtained from selling oil. Oil companies can reduce their investment risk through host countries providing favorable terms in a PSA. Companies can overcharge host countries for overheads relating to investment and operating costs. To monitor and audit these costs there are management and auditing committees consisting of officials from host countries. These officials can be easily influenced through bribes that are very difficult to detect. That is why it is difficult to find any published references to such corruption. But this is a well-known phenomenon in the upstream energy sector. Giving rewards (especially if lost revenue is recouped) to whistle-blowers when this type of corruption is identified may be a way to improve revenue collections in the upstream sector of the oil industry.

5. Newly introduced subsidy programs of substantial financial value

Large subsidy programs may be subject to fraud and corruption during their introductory phase, as individuals or organizations move to exploit loopholes in the monitoring and governance systems. After the subsidy program is established and running for a period, a feedback process is initiated as governments respond to reports of fraud and corruption. This allows for corrective action to be taken to improve the management of the subsidy program and prosecute criminals who may have committed corruption and fraud. The renewable energy industry relies heavily on subsidies and has been subject to fraud and corruption, notably the solar power industry in Spain and the wind power industry in southern Italy.

Operators of photovoltaic plants with about 800 megawatts of capacity were asked to prove that their panels were connected to Spain's power grid before September 2008—a benchmark for earning the highest subsidy premium on power generated. Operators had been able to defraud the system through poorly designed and monitored regulations for qualifying for the subsidy. Many operators claimed they were connected to the grid in September 2008 who, in fact, were not. The Spanish Government recently announced it may require the owners of solar plants who forged their paperwork to repay the higher subsidy payments gained through this deception (Ministerio de Industria, Turismo y Comercio, 2010). Eventually these risk areas were identified and the government moved to tighten the requirements for applicants receiving the subsidy (Kyreo.com, 2010; Abend, 2008).



AN OVERVIEW OF SOME OF THE MAIN POLICY AREAS AFFECTED BY FRAUD AND CORRUPTION

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In southern Italy, wind power has been a growth industry and the security firm Kroll identified organized crime participating in activities to defraud the European Commission (EC) of funds provided under large incentive schemes. It is relatively easy to access grants within the European Union: while there are some controls on the companies that apply for funding directly from the EC, there are no controls over sub-contractors. Renewable-energy companies have used local subcontractors with strong organized crime connections that have invoiced the parent company paid by the EU grants; the result has been many projects that are fully paid for but only half implemented (NewEnergyWorldNetwork.com, 2010). Areas already suffering from corruption, such as southern Italy, mean subsidy programs in those areas are more vulnerable to criminal exploitation. Countries with low levels of corruption are able to implement large subsidy programs with relatively little exploitation from fraud and corruption.

6. Countries with cheap, subsidized fuels that can be diverted by middlemen for blending with more expensive transport fuels

In India, subsidized kerosene is sold at much lower prices than gasoline or diesel. Subsidized products like kerosene are often diverted to the black market or used for blending with higher value products, notably transport fuels. This creates a lucrative business for corrupt fuel distributors who illegally appropriate subsidized fuel destined for particular segments of the population. By on-selling the product, including as part of a higher value blended product, they are able to gain significant profits. In turn, distributors or middlemen bribe government officials to obtain licenses to distribute or blend the fuel and to maintain the subsidy policy. Subsidies do not reach the intended beneficiaries, and the money created is used to influence bureaucrats and the political system through corruption (Shenoy, 2010).

WHAT ARE THE OBSTACLES TO UNDERSTANDING THE SCALE OF FRAUD AND CORRUPTION?

It can be challenging to estimate the full extent to which government subsidy programs are defrauded or affected by corruption. Many programs are not fully audited or regularly monitored by governments or intergovernmental bodies. There is not a complete picture of subsidy data or policies, which makes it difficult to accurately estimate the affects of fraud and corruption on subsidy policy. As well, no common method for quantifying the global extent of fraud and corruption exists. Generating a meaningful global financial figure on the extent of *fraud* and its effect on subsidy policy would be easier than quantifying subsidy policy affected by *corruption*. This is because there are more sources for fraud-related data, such as public accounts and audit statements. Fraud could be estimated on a country-by-country basis using official sources to track instances where financial transfers to recipients were considered illegal.

The extent to which individuals or companies profit through corruption (as opposed to fraud) is more difficult to measure, as the funds lost by government are harder to estimate. It is worth mentioning also that companies involved in such transactions can lose out due to the actions of employees and the pilfering of money, as can competing companies. The following list provides a number of examples of how a subsidy program may be affected by corruption and difficulties in quantifying its affects:

⁹ Kroll is one the world's leading risk consulting companies, see: <http://www.kroll.com/about/>

WHAT ARE THE OBSTACLES TO UNDERSTANDING THE SCALE OF FRAUD AND CORRUPTION?

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Example

- A government official in the National Energy Ministry is involved in the process for awarding exploration licences to foreign oil companies
- The government official accepts a bribe from an oil company which has submitted a bid with the agreement: the official will aid the company in securing an exploration licence
- The company is successful because of the bribed government official, but the terms of the agreement are made public and there are no preferential subsidy rates

OR

- The company is awarded the licence which contains a host of preferential subsidy-related terms such as royalty rates which are below market norms

MEANING

- **Determining the extent of the lost revenue or impact on the subsidy program, the company itself, or competitors, will require analysts to make a number of assumptions**

IMPROVING SUBSIDY POLICY—RECOMMENDATIONS TO REDUCE THE RISK OF FRAUD AND CORRUPTION

Actions to counter fraud and corruption in subsidy policy go hand in hand with initiatives to improve the policy itself. Better defining of the objectives for supplying the subsidy, the means for verifying its success in achieving its objectives, and the intended recipients, will all help counter fraud and corruption while aiding subsidy policies achieve their objectives.

A number of steps for can help insulate subsidy programs from fraud and corruption:

Suspend access to subsidies for those companies or individuals convicted of fraud or corruption

The OECD's Anti-Bribery Convention requires all 38 Convention countries to make it against the law for their citizens to bribe foreign public officials in international business transactions. Companies must also be sanctioned. The 2009 paper *Recommendation on Further Combating Bribery of Foreign Public Officials in International Business Transactions*,¹⁰ also calls on Convention countries to debar companies that bribe from public procurement contracts or other public advantages. Countries Party to the OECD Anti-Bribery Convention should be pressured to effectively implement the 2009 Anti-Bribery Recommendation. Countries not yet Party to the Convention could adopt the standards and measures set forth in the Convention to reduce subsidy fraud and corruption.

¹⁰ http://www.oecd.org/document/13/0,3343,en_2649_34859_39884109_1_1_1_1,00.html

IMPROVING SUBSIDY POLICY— RECOMMENDATIONS TO REDUCE THE RISK OF FRAUD AND CORRUPTION

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Involve organizations specializing in internal oversight and auditing when designing subsidy policies

Organizations tasked with monitoring budget expenditure and investigating fraud and corruption are well placed to advise on how best to formulate checks and balances when subsidy programs are being designed. In 2000, the EC identified the granting of subsidies as vulnerable to fraud and corruption and called on greater sharing of information between departments and control measures (European Commission, 2000). In their white paper on reform, the EC decided that new legislation should be submitted to the European Anti-fraud Office (OLAF) for a risk assessment. It noted “OLAF also provided advice on fraud-proofing throughout the legislative process” (The European Commission, 2007). The EC recognized that involving organizations specifically tasked with countering fraud and corruption when setting subsidy policy helped reduce the exposure of subsidy programs to criminal activity. We recommend that other institutions and countries introduce similar measures.

Highlight instances of fraud and corruption

Wasteful or ineffective subsidy programs may not generally come to the attention of the general public. Nor may they be a major concern to administrators managing large budgets or policy makers responsible for setting subsidy policies. However, high profile public allegations that specific subsidy programs have been defrauded or corrupted are much harder for government officials to deflect than accusations that a subsidy program is not able to meet its objectives efficiently. Allegations of fraud and corruption will quickly come to the attention of the public as they are often reported widely by various media sources. Also, policy-makers and government authorities become more accountable for poor procedures or policies when criminal charges are laid in court against an individual or company. Taxpayers do not appreciate individuals or organizations profiting at their expense. Court proceedings will generally involve the identification of a suspect and will lead to some outcome—either a guilty or not guilty verdict for the accused. The result may further spur debate on the issue. The increased visibility of the problem encourages civil society to become more concerned, thus making policy makers more accountable to their constituents on the use of government funds and their own performance in allocating and managing those resources. Consequently, publicized instances of subsidy policy affected by fraud and corruption provide a relatively unique opportunity for civil society and the NGO community to promote the reform of ineffective and poorly designed subsidy programs.



IMPROVING SUBSIDY POLICY— RECOMMENDATIONS TO REDUCE THE RISK OF FRAUD AND CORRUPTION

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Publish information about the recipients of subsidies

Individuals or organizations who receive public subsidies should not be able to shelter behind confidentiality. Fraud and corruption could be reduced if information on public subsidies to individuals or organizations was made more transparent and available to the general public. Governments should 'Publish what they pay'.¹¹ This would help to ensure that subsidies are reaching their intended beneficiaries and are not misappropriated by those who are not entitled to it. Public scrutiny would discourage individuals not entitled to subsidy payments from applying for or accessing the program because they could be publicly identified. It may also help expose potential conflicts of interest involving government officials and their commercial interests. If anyone objected to such a transparent process, they would be welcome to decline the subsidy (Grey, 2000). Where subsidy programs may involve commercially sensitive information, sufficient access to internal government documentation should be provided to auditors or independent oversight organizations within the government so that they can verify procedures were properly followed.

NEXT STEPS— DEVELOPING A GLOBAL ESTIMATE OF THE SCALE OF FRAUD AND CORRUPTION ON SUBSIDY POLICIES

A small research effort could be undertaken to develop a global estimate on the financial losses to subsidy policy from fraud and corruption by combining the different data sources. A number of regional estimates could be developed that draw on data from organizations such as the OECD, APEC and OLAF. These regional estimates (and a global one) could be based on individual country estimates. Country level figures would be useful to national organizations trying to promote subsidy reform. Information and data would, however, need to be harmonized in some way. Information could include media reports or analysis provided by NGOs such as Transparency International or Farmsubsidy.org. Given the interest of media in this issue, a global figure or estimate would likely increase both the reporting on and the profile of the issue. Such an effort could continue to draw attention to poorly-designed subsidy policy. To be effective in promoting changes in subsidy policies, the results of the findings would need to be effectively communicated to stakeholders working on subsidy policy reform.

¹¹ See <http://www.publishwhatyoupay.org>.



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FURTHER DETAILS AND CONTACT INFORMATION

The GSI is an initiative of the International Institute for Sustainable Development (IISD). Established in 1990, the IISD is a Canadian-based not-for-profit organization with a diverse team of more than 150 people located in more than 30 countries. The GSI is headquartered in Geneva, Switzerland and works with partners located around the world. Its principal funders have included the governments of Denmark, the Netherlands, New Zealand, Norway, Sweden and the United Kingdom. The William and Flora Hewlett Foundation have also contributed to funding GSI research and communications activities.

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