

Counter fraud

# The financial cost of UK Public Sector Fraud

A less painful way to reduce public expenditure

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# Foreword

In the run up to the general election (6 May 2010), with all political parties struggling to devise ways of reducing public expenditure, there has been little comment about one way in which major savings can be achieved - and painlessly. There is now the potential for real savings, rather than just rhetorical ones, from reducing losses to fraud.

This Report outlines

- What the real losses are
- How much they can be reduced by
- How quickly
- Where the savings can be made
- What needs to be done.

Fraud losses affect the public sector in many areas, depriving UK citizens of the extent and quality of public services which they have paid their taxes in order to receive. They occur in expenditure on payroll, procurement, benefits, public housing, healthcare and education, and also result in lost income across local and national taxation. Fraudsters include staff and managers, contractors and citizens. A dishonest minority affects all public sector organisations of any size and the greatest financial costs are incurred from high volume, low value fraud, rather than vice versa.

Historically, the cost of such fraud has not been reliably quantifiable. And if you can't measure a cost, how can you possibly plan to reduce it, or prove any subsequent reduction?

However, the last decade has seen the development of accurate (+or- 1%) and statistically valid (95% statistical confidence) measurement methodologies for treating fraud (and error) losses like any other business cost. These methodologies represent a quantum leap forward in estimating the financial cost of fraud.

The picture shown by the latest global data is unequivocal. Two thirds of the exercises show losses of between 3 and 9%, with an average percentage loss of 4.57% generally and 5.59% in respect of healthcare expenditure. The nature of the base data for these figures makes them highly credible. They are referred to in this Report as the 'global survey percentages'.

What has also been discovered is that the most effective way of reducing losses is in fact to change the culture - mobilising the honest majority of people, incentivising them with the clear financial benefits that flow from good practice, and creating strong peer group pressure against fraud. Knowing how much you are losing is key to this process. By combining that pressure to do 'the right thing' with information targeted at the dishonest minority about the real risks of detection, investigation and sanctions, it is possible to deter - and significantly reduce - the dishonest minority.

This new approach may come as a shock to those brought up on a diet of cops and robbers TV shows such as 'The Sweeney', or more recently, 'Ashes to Ashes', but we now have the means to make savings real, tangible and provable.

Furthermore, the news from around the world is that the scale of existing losses makes work to reduce them highly beneficial. Between 1998 and 2006 I was CEO of the Counter Fraud Service in the much criticised NHS, one of the largest areas of UK public expenditure. We achieved a reduction of losses by up to 40% within 15 months and up to 60% over 8 years. This delivered over £800 million in financial benefits at a return of 12 : 1 on the costs of the work.

The statistics are dramatic. Applying the global survey percentages to UK public expenditure - after taking account of areas of expenditure where accurate loss measurement has already been progressed - would indicate losses to expenditure of £22.4 billion. Official estimates of losses to revenue from taxation add £16.1 billion to this figure, making total losses of over £38 billion.

Excluding expenditure by the Department of Work and Pensions on benefits, for reasons described later in this Report, then a rate of loss reduction comparable with the average achieved elsewhere, would over the course of three years be delivering recurring financial benefits of more than £11 billion a year. This would be a real step forwards in closing the UK's existing budget deficit and reducing public expenditure as painlessly and effectively as possible.

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*"We now have the means to make savings real, tangible and provable."*

# Introduction

This Report applies the most accurate figures which are available to estimate the financial cost of fraud in UK public expenditure and taxation revenue, losses occurred in respect of ungathered tax revenue at both national and local levels.

Where organisations (like the Department of Work and Pensions) have undertaken their own accurate and statistically valid measurement exercises, the figures derived from this work have been accepted as the best available. Where this has not happened (as in most cases) the Report has applied the 'global survey percentages'. These percentages are the result of the most extensive global research ever undertaken into the financial cost of fraud and error in public expenditure - '*The Financial Cost of Fraud Report*'<sup>1</sup> published in late 2009 and '*The Financial Cost of Healthcare Fraud Report*'<sup>2</sup> published in January 2010. Where no figures derived from accurate and statistically valid measurement are available the Report has included prevailing official estimates.

The extensive Global Research, from which the global survey percentages were derived, was built on previously established knowledge from relevant measurement exercises. The data has then been analysed electronically. Exercises were collated from Europe, North America and Australia and New Zealand. None were found in Asia or Africa.

## What the research shows

The volume and variety of the research, and the consistent picture which emerges no matter the type of public expenditure, organisation or country concerned, make the findings of an average 4.57% percentage loss rate, and 5.59% in respect of healthcare expenditure, highly credible.

Of course no research can be perfect and a perfect estimate of losses is impossible - there is always more to be done. However, the Report consciously seeks to apply the best available figures with 'best' defined as those derived from accurate and statistically valid measurement of losses.

The research also shows how quickly such losses can be reduced and by how much (which is discussed on page 14).

Finally, this Report makes a number of recommendations drawn from best practice implemented in cases where losses were successfully reduced, to point the way to achieving equivalent gains in respect of UK public expenditure.

<sup>1</sup> '*The Financial Cost of Fraud Report*' published by MacIntyre Hudson LLP and the Centre for Counter Fraud Studies at University of Portsmouth in November 2009

<sup>2</sup> '*The Financial Cost of Healthcare Fraud Report*' published by MacIntyre Hudson LLP and the Centre for Counter Fraud Studies at University of Portsmouth in January 2010

# What is fraud?

Unhelpfully, fraud is often viewed as a purely criminal matter - something for the police to investigate and the courts to penalise; something which is 'perpetrated' by 'bad people' who are then punished. Equally unhelpfully, the solution is sometimes seen simply as improved adherence to ethical principles and higher moral standards. Why are these two views unhelpful?

## Criminal law

The criminal law deals with the individual fraudsters, where its' higher standards of 'beyond reasonable doubt' proof allows it to. The Fraud Act 2006 introduced a new offence of fraud which can be committed in three ways: fraud by false representation, fraud by failing to disclose and fraud by abuse of a position of trust. Other new offences include possession of articles intended for use in fraud, making or supplying articles for use in fraud and fraudulent business carried out by a sole trader.

## Civil law

It is administrative procedures, backed up by the civil law which (mostly) help to recover the losses which are incurred. The concept of fraud in the civil law dates back to *Derry v. Peek* 1889 - this is where someone intentionally or recklessly obtains resources to which they are not entitled - with the standard of proof of the 'balance of probability' being applied. The losses which are subject to civil litigation represent the greatest damage - in the public sector depriving UK citizens of the quality or extent of public services which they have paid their taxes in order to receive. Viewing fraud as a purely criminal matter thus makes its greatest harm less visible.

## Thinking beyond the law

Furthermore, while improved adherence to ethical principles and higher moral standards are clearly good things to happen, seeing this as the main solution to be pursued is a bit like trying to stop the tide coming in. There always will be 'bad people'; the point is that they should not be given the opportunity to cause losses to fraud and the resulting damage. Ethical and moral appeals need to be complimented by the provision of factual information about the extent of losses and their effect on public services - the subject of this Report.

Finally, fraud can also be a disciplinary matter and a regulatory issue, either in addition to or where either criminal or civil legal action is not possible or appropriate. Removing an individual or an organisation from the context in which they have undertaken fraud, helps to deprive them of the opportunity to commit fraud.

A broader view of the law concerning fraud and the potential sanctions to be applied helps, but we need to think beyond the law.

Once there is an accurate figure for the real extent of fraud losses then they can be treated like any other business cost - something to be reduced and minimised in the best interest of the financial health and stability of the organisation concerned. It becomes possible to go beyond reacting to unforeseen individual instances of fraud and to include plans to pre-empt and minimise fraud losses in business plans. Crucially, in the context of likely future reductions in public expenditure, it becomes possible to make these less painful than would otherwise be the case.

*"Unhelpfully, fraud is often viewed as a purely criminal matter - something for the police to investigate and the courts to penalise..."*

# The extent of public expenditure

The last full year for which actual public expenditure figures are available is 2008-2009.

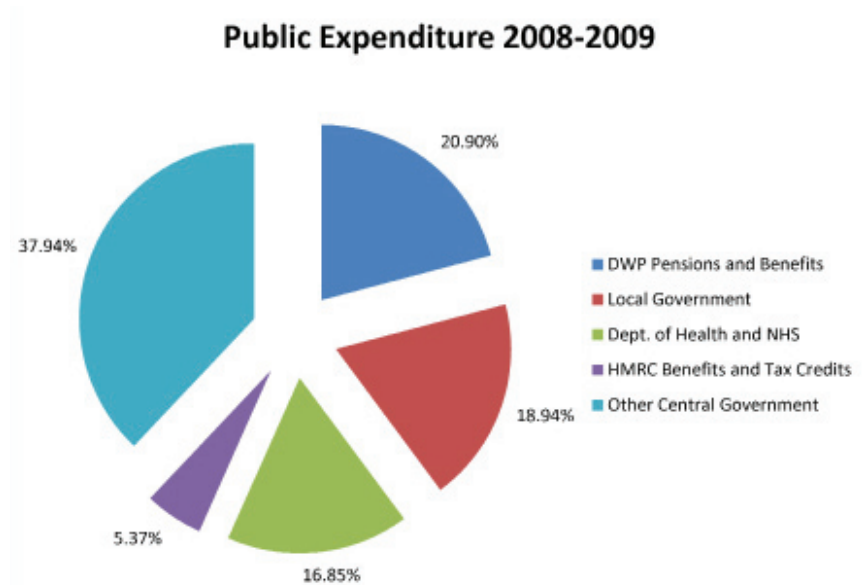
The Institute for Fiscal Studies, analysing Government figures, calculated that total Central Government spending for the year was £618.6 billion<sup>3</sup>. To this we should add £30.768 billion raised in taxation and spent by Local Government<sup>4</sup>, providing a figure for total public expenditure of £649.4 billion. This total includes:

- £135.7 billion spent by the Department for Work and Pensions (including just under £129.9 billion paid out in benefits and pensions)
- £123 billion spent by Local Government (£92.2 billion received in grants centrally with a further £30.8 billion raised and spent locally)
- £109.4 billion spent by the Department of Health (including £94.5 billion spent on the NHS)
- £34.9 billion spent by HM Revenue and Customs on Tax Credits and Child Benefit.

This leaves £246.4 billion spent by the rest of Central Government, which includes £85.5 billion spent on maintaining financial stability and debt interest of £24.1 billion. Just under £136.8 billion was spent on other services and agencies.

<sup>3</sup> 'A Survey of Public Spending in the UK' – Institute for Fiscal Studies – September 2009

<sup>4</sup> 'Analysis of Local Authority Budgets for 2008-9' – Department of Communities and Local Government



# Measuring the cost

Historically, the cost of fraud and error is not something which has been accurately measured. It is only over the last decade that this situation has changed.

Prior to the sort of accurate and statistically valid measurement which is now possible, a variety of techniques were used. Some still prevail but the situation is changing. Each of these is reviewed below.

## Detected fraud

In some cases organisations simply added up the value of the losses found in cases of detected fraud and assumed that this figure represented the total losses incurred. This conveniently ignored the reality that for the figure to be accurate there would need to be a 100% successful detection rate, something that is not even the case for the offence of murder. For this reason, comparisons between accurately measured losses and figures for the value of detected fraud have shown a ratio of up to 30 : 1, and thus figures calculated on the basis of detected fraud are likely to represent a significant underestimate of the true position.

## 'Guesstimates'

In other cases organisations have relied on 'guesstimates' from leading individuals and / or surveys of opinion. These tend to vary significantly according to the perceived seriousness of the problem at the time by those surveyed and / or the extent to which their organisation has an appetite to do something about it. While they sometimes represent a valid survey of opinion, that is very different from a valid survey of losses.

## HM Treasury figures

HM Treasury publishes an annual document entitled '2008-2009 Fraud Report'<sup>5</sup>. This is described as 'an analysis of reported fraud in government departments'. For 2008-2009, it stated that the cost of fraud was £4.219 million or 0.026% of Government Department's administrative expenditure, 175 times less than the global survey percentages would indicate to be the case (as we shall see below). In a significantly understated manner, the Treasury states that this does 'not necessarily' represent 'a complete picture'!

In reality, this report adds up the detected 'internal' fraud involving those working for Government Department's, and does not include any other types of fraud.

## Audit Commission figures

The Audit Commission regulates the proper control of public finances by local authorities and the National Health Service in England. Audit Wales, Audit Scotland and the Northern Ireland Audit Office perform similar functions for their respective countries.

The Audit Commission has supplied information to the National Fraud Authority (NFA) concerning fraud losses in local government. It surveyed 24 London local authorities about the detected fraud losses and the NFA then extrapolated these figures and added some figures from Audit Scotland. The Audit Commission also provided some figures for housing tenancy fraud – 50,000 properties are estimated to be unlawfully occupied – and for single person discount council tax fraud. In respect of the latter, the Audit Commission estimates 'conservatively' that 4% of council tax revenue is not collected because of fraud.

The Audit Commission should be congratulated for the first ever attempts to assess losses in these areas. However, none of these estimates are based on statistically valid, survey based, loss measurement exercises.

## NFA estimates

The National Fraud Authority (NFA) estimates that public sector fraud cost £17.6 billion<sup>6</sup> in its Annual Fraud Indicator published in January 2010. This figure is derived from an exercise which asked constituent parts of the public sector (or those auditing them) for their views on the extent of losses.

They are to be congratulated for collating this information for the first time – a difficult task. However, there are intrinsic problems associated with asking parts of the public sector to estimate their own losses. First, losses for some parts of the public sector have not been included because they simply have not provided the NFA with the information that it sought. By undertaking the survey in this way it was inevitable that this would be the case and therefore that the estimate would be incomplete.

Secondly, the 'methodologies' (to the extent to which they exist) which have been applied to provide losses estimates vary significantly – from accurate and statistically valid measurement by the DWP to obvious 'guesstimates' elsewhere. In particular, an interesting feature is that unmeasured estimates of losses resulting from the behaviour of people as citizens (for example evading taxation) are consistently higher than similarly unmeasured estimates of losses resulting from the behaviour of public sector employees (for example HM Treasury estimates of losses to internal fraud by Government employees). Accurate measurement of both types of losses would, of course, provide objective information. However, in the absence of this, it might appear that the scale of the estimates reflects the different levels of potential embarrassment that might be caused.

### **The Department of Work and Pensions (DWP):**

DWP provided estimates of losses to fraud involving the benefits which they administer. They estimate for 2008-2009 that £1.1 billion (or 0.8% of total expenditure) was lost to fraud. This is a low figure, but one which, for the most part, is based on statistically valid and accurate loss measurement exercises – something which the DWP should be congratulated for undertaking. The low figure may reflect the length of time that DWP have been tackling this problem.

### **Local government:**

Based on the Audit Commission's work (see above) the NFA estimates that £684 million is lost to fraud in local government or equivalent to 0.56% of local government expenditure for 2008-2009 – more than eight times less than the global average loss figures would indicate to be the case (as we shall see below).

### **The NHS:**

The NHS and its audit organisations in England, Wales, Scotland and Northern Ireland have provided the NFA with information indicating that only £263 million is lost to fraud. The exact origins of this figure are not clear in the NFA's 'Annual Fraud Indicator'. Given the published percentage loss levels in several different areas of NHS expenditure in England and Wales – as a result of statistically valid and accurate loss measurement exercises – it would be a great surprise if this figure was correct. It represents 0.28% of expenditure for 2008-2009 – almost 20 times less than the global average loss figures for healthcare would indicate to be the case (as we shall see below).

### **Central Government:**

In respect of central Government, the NFA's 'Annual Fraud Indicator', published in January 2010, comments that 'few areas of central Government spending have been reviewed to quantify known and unknown losses'. As a result, its estimate of £356 million losses, is based on the HM Treasury figures for 'internal' fraud (see above) plus various figures for detected fraud provided by a small minority of Departments and agencies. If correct, it would represent less than 0.14% of central government spending – 31 times less than the global average loss figures would indicate to be the case (as we shall see below).

### **HM Revenue and Customs (HMRC):**

HMRC provided estimates of the size of the 'tax gap' by considering how much tax was actually collected compared with how much they believe should have been. They estimate the tax gap to be £40 billion for 2007-2008 and further estimate that 37.5% of this gap (or £15 billion) is attributable to fraud-related behaviour – a 3% loss rate. HMRC also stated that losses to tax credit fraud were between £100-200 million out of £20 billion during 2007-2008. As is particularly obvious in the latter case, these estimates are not based on statistically valid, survey based loss measurement exercises.

### **Pensions:**

The final main element of the NFA's estimates concern pensions fraud. This figure, of £64 million, is taken from the fraud detected by the Audit Commission's National Fraud Initiative (NFI) data matching exercise for 2008-2009. While the NFI is an effective fraud detection program, any figures derived from it cannot represent actual losses unless we assume the unlikely event of a 100% detection rate.

### **Global survey figures**

'*The Financial Cost of Fraud Report*' and '*The Financial Cost of Healthcare Fraud Report*' excluded any figures based on detected or reported fraud or 'guesstimates' or surveys. Instead, the reports only considered loss measurement exercises where the work had been undertaken in a statistically valid (90 – 95% statistical confidence) and accurate (plus or minus 1 – 2.5%) manner. The reports documented an average overall percentage expenditure loss rate of 4.57% and a specific healthcare expenditure loss rate of 5.59%.

The difference between previous 'guesstimates' of fraud losses and the data from the statistically valid and accurate exercises applied in this Report is equivalent to the difference between navigation by the stars and navigation by satellite. Fraud can be measured like any other business cost and there is simply no need to rely on 'guesstimates', surveys and figures for detected fraud. These techniques underestimate the extent of fraud and thus also underestimate the potential benefits of reducing it.

In the next section of this Report we shall review what the global survey percentages show that the real losses to public expenditure fraud are likely to be.

<sup>5</sup> '*2008-2009 Fraud Report*' – HM Treasury – December 2009

<sup>6</sup> '*Annual Fraud Indicator*' – National Fraud Authority – January 2010

# Financial cost of public sector fraud

It is common sense that the first step to solving a problem is to know what it is. Equally, with fraud it is impossible to apply the correct solution and reduce losses until you know the true nature and scale of the problem.

## Official estimates v research results

The table on page 11 officially shows estimated losses for 2008-2009 for key areas of public expenditure compared to levels of losses indicated by the global survey percentages.

2008-2009 is the last year for which there are finalised figures for public expenditure, which has clearly grown since then. For 2010-2011, it is therefore the case that losses will have grown as well. However, for the purposes of this Report, the authors have decided to adopt a conservative approach to the losses and make projections on the basis of 2008-2009 expenditure and losses.

The difference between the figures based on the global survey percentages found across 132 exercises in 44 organisations in 9 countries (including the UK), and the current officially estimated

figures in the UK for losses, range from massive to highly significant.

If the current official estimates are to be accepted as correct then we should be clear that we are saying that we are up to 175 times better at protecting public expenditure against fraud than other countries - a somewhat difficult proposition.

The alternative proposition is that we are probably pretty much aligned to other countries - and losses in public expenditure are much greater than currently estimated. This could be a difficult thing to accept, especially for those running public sector organisations where there are great pressures not to admit that public funds go astray. However, the reality is that the first step to solving a problem is to stop being in denial about it.

If we accept for a moment that the UK is probably no worse or no better than most countries, then we are losing £22.407 billion in respect of public sector *expenditure*.

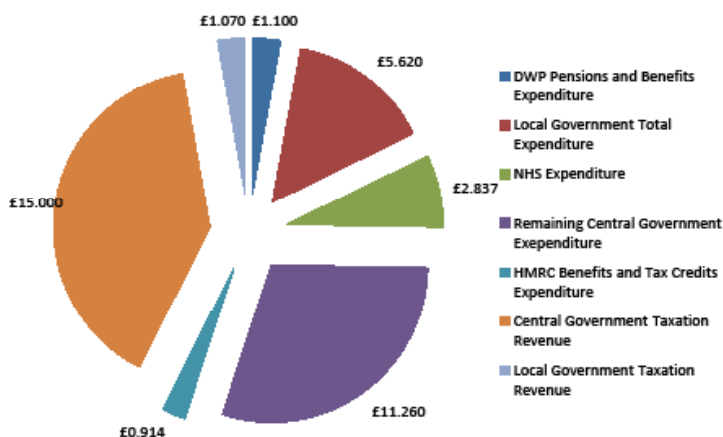
In addition we need to consider losses to *revenue* from taxation. No accurate or statistically valid measurement exercises have yet taken place in this area and neither do the global survey percentages relate to it. Thus we fall back on the official estimates.

The National Fraud Authority's (NFA) Annual Fraud Indicator, published in January 2010, reports HM Revenue and Customs' estimate that £15 billion (or 3.5%) of centrally collected taxation income was lost in 2007-2008 as a result of fraud-related behaviour. This estimate is applicable across different types of taxation and it is therefore reasonable in the absence of more accurate information to apply it more generally.

In 2008-2009, the main year which this Report focuses on, local authorities raised £30.768 billion in tax revenue. Applying the HMRC percentage estimate would mean that £1.07 billion of additional revenue went uncollected. Based on current official estimates, it may therefore be the case that over £16 billion of tax revenue was not collected as a result of fraud-related behaviour. This is a shocking figure.

Adding the losses across *all* expenditure and revenue together, we can calculate the *most extensive estimate* ever determined across public expenditure and revenue. By relying on the best quality estimates for the constituent losses and ensuring the application, to the greatest possible extent, of measured figures, we can also calculate the *most accurate estimate*.

**LOSSES TO UK PUBLIC EXPENDITURE (Billions)**



This Report believes that the financial cost of UK public sector fraud to be £38.477 billion.

The potential for savings, *without the pain of cutting public services* to the same extent, is highly significant.

Officially estimated and likely actual losses 2008-2009						
No.	Area	Officially estimated losses	Current percentage loss estimate	Surveyed global loss percentage	Likely actual losses	Extent of current underestimate
1	DWP Pensions and Benefits Expenditure	£1.1 billion	0.8%	(See footnote <sup>7</sup> )	£1.10 billion	-
2	Local Government Total Expenditure	£684 million	0.56%	4.57%	£5.62 billion	1/8
3	NHS	£263 million	0.28%	3% (See footnote <sup>8</sup> )	2.837 billion	1/10
4	(Remaining) Central Government Expenditure	£356 million	0.14%	4.57%	£11.26 billion	1/31
5	Central Government Administrative Expenditure	£4.219 million	0.026%	4.57%	(See footnote <sup>9</sup> )	1/175
6	HMRC Benefits And Tax Credits Expenditure	£100 - £200 million	0.5 - 1% (See footnote <sup>10</sup> )	4.57%	£1.59 billion (See footnote <sup>11</sup> )	-
7	Central Government Taxation Revenue	£15 billion	3.5%	3.5%	£15 billion	-
8	Local Government Taxation Revenue	-	3.5%	3.5%	£1.07 billion	-
9	<b>Total</b>	<b>£17.6 billion</b>			<b>£38.477 billion</b>	<b>1/2</b>

<sup>7</sup> The Department of Work and Pensions have been measuring their losses accurately since the late 1990s and undertaking a range of work to reduce them over an even longer period. Given the derivation of their estimates, it is felt to be reasonable to accept them.

<sup>8</sup> The NHS Counter Fraud Service has been measuring and reducing losses since 1998. The losses figure they have provided for the NFA's 2010 Annual Fraud Indicator (£263 million) does not relate to the percentage figures found in loss measurement exercises undertaken between 1998 and 2006. However, despite this being (probably) a considerable underestimate of the actual losses, it is reasonable, considering the NHS's work in this area that losses are lower than the average found globally for healthcare fraud losses (5.59%). For the purposes of this Report, and to be conservative, the authors have felt it reasonable to assess them at the bottom of the range of what the global research shows for healthcare losses - 3%.

<sup>9</sup> Included in the line above.

<sup>10</sup> This is a Tax Credits only figure. HMRC spent £20 billion on Tax Credits for 2007-2008.

<sup>11</sup> This is a figure across all £34.9 billion HMRC Benefits and Tax Credits expenditure.

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# How much can losses be reduced by?

Work to measure losses can be highly cost-effective. The extent to which efforts to reduce losses are helped by greater knowledge about the problem is shown by the significantly lower (15%) average level of losses where they have been re-measured over a period of time<sup>12</sup>.

The research that led to the publication of *'The Financial Cost of Fraud Report'* quoted four representative examples where fraud losses have been reduced.

## Relevant examples

Where losses have been measured and the organisations concerned have accurate information about their nature and extent, there are examples, especially in the UK and U.S. where losses have been substantially reduced. These include:

- The UK's own National Health Service (the second largest organisation in the world) where losses were reduced by up to 60% between 1998 and 2006 and by up to 40% within 15 months<sup>13</sup>

- The U.S. Department for Education, which reduced its losses across a \$12 billion dollar grant program by 35% between 2001 and 2005<sup>14</sup>
- The U.S. Department of Agriculture, which reduced its losses across a \$12 billion dollar program by 28% between 2002 and 2004<sup>15</sup>
- The UK's Department of Work and Pensions which has successfully reduced its losses in Income Support and Job Seekers Allowance by 50% between 1997/98 and 2005/06<sup>16</sup>.

Both this and previous Reports have shown that fraud losses can be measured. The examples above show that, once measured, they can be reduced - and rapidly.

The speed of the reductions shown in these examples averages over 10% a year with the UK's NHS reducing their losses by up to 40% within 15 months.

## Reducing losses in UK public expenditure

Applying this data to determine the extent of a future possible reduction in losses in UK public expenditure is not straightforward. If we are conservative and assume that, in the current economic

context, there would be a national government focus on such reductions - to avoid cutting public services unnecessarily - it is reasonable to assume that progress would be better than the average. However, what was achieved in the NHS, one part of the public sector, would be unlikely to be replicated across the public sector as a whole - at least not as quickly. Losses would also be recurring and overall expenditure might grow over time.

The time period to consider this question has been taken as three years. A substantial commitment is needed to help reduce the public sector deficit well within the Government's commitment to reduce it by half over four years. Over that three year period, the level of reduction which has been chosen to exemplify what could be achieved, is 30%. This reflects the average speed of reduction of other organisations internationally.

What might be achieved by such a reduction is indicated in the table below.

Let us be clear. This would mean that £11.213 billion *less* would be lost to fraud and error each year from 2013 - 2014, and that is a conservative figure because it is

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based on expenditure and revenue losses for 2008-2009. Uprated to take account of 2010-2011 levels of expenditure, this figure is likely to be in the order of £12 billion.

The cumulative savings would, of course, be much greater - £3.737 billion (Year 1) / £7.474 billion (Year 2) / £11.213 billion (Year 3) - a total of £22.424 billion. Again this is a conservative figure because, like the figure for annual savings, it is based on expenditure and losses for 2008-2009.

There will be those who deny that these savings can be made. They will be motivated by several factors - among these will be the fear of admitting the losses in the first place and the fear of failing to achieve the savings which are possible. The next section of this Report shows how the savings can be achieved.

<sup>12</sup> *The Financial Cost of Fraud Report* 2009.

<sup>13</sup> *UK NHS Counter Fraud and Security Management Service - 1999 to 2006 Performance Statistics*

<sup>14</sup> *U.S. Department of Education Performance and Accountability Reports 2001 - 2005*

<sup>15</sup> *U.S. Department of Agriculture Performance and Accountability Reports 2002 - 2004.*

<sup>16</sup> *UK Department of Work and Pensions - Fraud and Error in the Benefits System - April 2005 to March 2006*

<sup>17</sup> *Excluding HMRC Tax Credits and Benefits expenditure*

<sup>18</sup> *Stated for illustrative purposes only - included in losses under line 4 of the table*

<sup>19</sup> *Stated for illustrative purposes only - included in savings under line 4 of the table*

Prospective annual savings in public expenditure by 2013-2014			
No.	Area	Losses	Savings based on a 30% reduction over 3 years
1	DWP Pensions and Benefits Expenditure	£1.1 billion	Not included - see page 11, footnote 7
2	Local Government Total Expenditure	£5.62 billion	£1.686 billion
3	NHS	£2.837 billion	£851 million
4	(Remaining) Central Government Expenditure <sup>17</sup>	£11.26 billion	£3.378 billion
5	Central Government Administrative Expenditure	£741 million <sup>18</sup>	£222 million <sup>19</sup>
6	HMRC Benefits and Tax Credits Expenditure	£1.59 million	£477 million
7	Central Government Taxation Revenue	£15 billion	£4.5 billion
8	Local Government Taxation Revenue	£1.07 billion	£321 million
9	<b>Total</b>	<b>£38.477 billion</b>	<b>£11.213 billion</b>

# How can losses be reduced?

As the previous section of this Report shows, the 'size of the prize' to be delivered from reducing existing fraud losses is very significant. This is true both in purely financial terms and in terms of smaller cuts in services being needed.

## A proactive Government approach

Historically, the approach of most of the UK public sector to fraud has been reactive, detecting fraud once it is taking place and responding with investigations which potentially lead to the application of sanctions. This approach does not address the financial losses which fraud causes, for several reasons.

The extent to which fraud losses are detected is usually low – estimates vary but as little as 1/30 of the measured cost of fraud has been detected, even in organisations which have spent time and resources on the effort<sup>20</sup>.

It is high volume, low value fraud which is usually found to represent the greatest financial cost, rather than the large, high value cases which hit the headlines<sup>21</sup> (for the very reason that they are rare), and the visibility of this type of fraud is low.

The specific nature of fraud also makes it hard to detect. It is a form of undesirable

behaviour that is based on deception, disguise and the careful hiding of relevant facts. However, there is not a single criminal offence with a 100% detection rate – even murder – so the approach of mainly seeking to detect and react to such problems is, in the view of the authors of this Report, intrinsically flawed.

Another obvious reason why a reactive approach is not helpful is because the losses have already been incurred by the time action is taken. Some individual fraudsters may be pursued and punished but, if the opportunity for fraud exists, then there will always be others who will continue to drain the public finances.

In contrast, the last decade has seen the development (in the UK and beyond<sup>22</sup>) of a more comprehensive approach, with the clear goal of pre-empting fraud and losses. Examples of the success of this approach have been cited in the previous section of this Report.

It is also the case that, until very recently, with the Government's Fraud Review Report of 2007, and the creation of the National Fraud Authority (NFA), there hasn't been any coherent, cross-government, cross-economy approach. This initiative is still very young. Despite the hard work of its staff, the NFA is under-resourced, attached to one of the smallest Government departments<sup>23</sup>, tasked with addressing fraud across the entire economy and lacking in specific powers to ensure that

constituent parts of the economy work together to tackle the problem. Despite this, it has some good people who are very committed to this work, but it doesn't have the proactive focus on the financial cost of fraud that is needed. More prosecutions don't necessarily mean that there is less fraud, it might mean the opposite. The important thing is to generate beneficial outcomes not just activity.

In the view of the authors of this Report, what is needed is a Public Sector Counter Fraud Agency (PSCFA) linked to the department which is ultimately responsible for public expenditure in the UK - the Treasury - and with the defined remit, authority and resources to work specifically to reduce losses. The work of such an agency must be and be seen to be a major government priority. A defined structure will be needed which allows the unit to work effectively with all public sector organisations. We do not need to centralise all activities but we do need to ensure their effective coordination (and that will require the PSCFA to have relevant powers). Most importantly, such an agency must combine responsibility for both operational counter fraud work and the policy work which is essential to design and redesign processes and systems so that the opportunities for fraud are minimised.

However, organisational changes are only part of what is needed.

### The importance of accurate measurement of the problem

Accurate measurement of the nature and scale of public sector fraud losses is key to this Report and would be essential for their reduction. If one doesn't know what the problem is, how can the right solution be applied?

It is no longer reasonable to suggest that fraud losses cannot be measured. This has now been done at least 132 times across the world, and is a legal requirement in the U.S.

It is also no longer the case that such work costs too much. Efficiency developments in recent years mean that, within the levels of accuracy and statistical confidence described earlier in this Report, loss measurement can take place cost-effectively<sup>24</sup>, just as it has done in the U.S.

What is needed is a program of accurate measurement (and re-measurement to gauge progress) of losses across each major area of public expenditure.

### The importance of public accountability

Openness and transparency about the extent of losses is also very important. In the U.S. the Improper Payments Information Act of 2002 has advanced this process considerably. It requires designated major U.S. public authorities to estimate the annual amount of payments made where fraud and error are present and to report the estimates to the President, Congress and the public together with a progress report on actions to reduce them.

The guidance relating to the IPIA states "The estimates shall be based on the equivalent of a statistical random sample with a precision requiring a sample of sufficient size to yield an estimate with a 90% confidence interval of plus or minus 2.5%". This latter guidance is essential, providing for a standard approach which gives accurate, comparative information and prohibiting the 'measurement' of losses in such a way as to produce pre-designated results.

By virtue of this information being made public each year, the extent of public accountability for losses is much clearer and the resulting public pressure is a powerful force for their reduction. The UK needs its own Improper Payments Information Act.

<sup>20</sup> An example would be the NHS, even after several years tackling the problem

<sup>21</sup> Procedures to prevent fraud are often strongest where high value fraud might be perpetrated, whereas a comparable investment when the value of an individual fraud is smaller is less likely. This is because, unless fraud losses are measured, an organisation will not know the volume of such 'smaller' frauds that it is facing.

<sup>22</sup> See the NHS Counter Fraud Strategy of 1998, the National Audit Office's 'Good Practice in Tackling External Fraud' Guidance of 2004, European Healthcare Fraud and Corruption Declaration of 2005 and the Government's Fraud Review Report of 2006

<sup>23</sup> The Attorney-General's Office.

<sup>24</sup> Ten years ago a fraud loss measurement exercise could involve 6 people working full-time for 6 months; it can now be undertaken using less than 100 person days, or six times more efficiently.

### A comprehensive range of action to pre-empt fraud

Institutional change is not enough. The UK's public sector needs a real change in its approach to countering fraud.

The last decade has shown that fraud losses are rarely reduced by purely 'operational' work to detect, investigate and sanction fraudsters. There is an active 'supply line' of replacement fraudsters and always will be. However, what is not inevitable is that there will always be the weaknesses in processes and systems which allow fraud to take place.

It is also the case that the size of the honest majority can be grown and they can be mobilised to exert much stronger peer group pressure against fraud. Fraud is not a victimless crime; it deprives the citizens of this country of vital public services – and will continue to do so unless we urgently tackle it.

Correspondingly, the size of the dishonest minority can be shrunk and they can be deterred. Deterrence arises from the potential fraudsters' perceptions of the extent of public acceptability of the actions they are contemplating, the likelihood of their being prevented or detected, the likelihood of a professional investigation uncovering information and evidence about what has taken place, the proportionality

and certainty of the application of sanctions and the extent to which losses will be recovered. Each of these types of action are important in themselves, but even more so when publicised and visible.

The Government's Fraud Review accepted this comprehensive approach but, sadly, it has faded from view as the work of the NFA has proceeded.

#### What would this cost?

One of the key virtues of the comprehensive approach is its cost-effectiveness. Trying to simply detect a slightly higher proportion of fraud and conduct more investigations would be extremely costly, apart from being futile, for the reasons outlined above. The least costly types of counter fraud activity are those which are pre-emptive - communications programmes relating to culture and deterrence and the design and redesign of policy, processes and systems.

The UK's public sector needs a reorientation of its counter fraud work rather than a massive new investment, and the coordination of these resources to ensure much greater synergy and consequent impact on losses. However, the PSCFA would need to be of a size commensurate with its task. What size would this be and what cost would be involved?

The nearest example from the specific UK context is the NHS, which prior to 1998 had almost nothing in place to stop fraud or prevent losses. Since then, the NHS Counter Fraud Service (NHS CFS) has provided an example of how losses can be reduced – as we have seen above. Its funding level for 2008-2009, the year on which we have based the statistics in this Report, was a mere £10.298 million, employing 195 staff. This represents only 0.0137% of the NHS's expenditure!

If we apply that percentage to public expenditure as a whole it would mean the PSCFA would cost in the order of £80 million per year. Over the three year period during which savings referred to in this Report have been calculated, the total cost (taking account of reduced costs during the set up period) might be at the very most in the order of £200 million. The savings which have been shown to be possible would be over £22 billion – a ratio of 110 : 1.

Such a return on investment highlights the attractions of this proposition. The real question is not why would we do this, but why wouldn't we?

*“The least costly types of counter fraud activity are those which are pre-emptive - communications programmes relating to culture and deterrence and the design and redesign of policy, processes and systems.”*

# Conclusion and recommendations

This Report makes four clear recommendations to achieve the reductions in losses which are possible:

- That the Government should create a new Public Sector Counter Fraud Agency linked to the department which is ultimately responsible for public expenditure in the UK - the Treasury - and with the defined remit, authority and resources to work specifically to reduce losses
- That a program of accurate measurement (and re-measurement – to gauge progress) of losses should be implemented across each major area of public expenditure
- That the Government should urgently enact a new Improper Payments

Information Act to mandate the annual accurate measurement of losses and their public presentation

- That a major programme of work should be undertaken to reorientate existing public sector counter fraud resources to pre-empt fraud losses.

It would be possible to write a Report with many more recommendations than those which are stated here, however, the view of the authors of this Report is that 'less is more'. The detail is for an implementation programme. If the UK can take some simple clear steps forward then we can achieve the significant savings to public expenditure which are possible, and prevent unnecessary cuts in vital public services.

Why wouldn't we want to *do* this?

# About the Report authors

## Jim Gee is Director of Counter Fraud Services at MacIntyre Hudson LLP and Chair of the Centre for Counter Fraud Studies

Jim Gee is one of the leading counter fraud specialists in the UK. His accomplishments include leading the team which cleaned up London Borough of Lambeth in the mid to late 1990s; advising Right Honourable Frank Field M.P. during his periods as Chair of the House of Commons Social Security Select Committee and Minister for Welfare Reform; and being Director-General of the European Healthcare Fraud and Corruption Network between 2004 and 2006.

He was also a senior advisor to the Attorney-General concerning the Government's Fraud Review which has started to professionalise this country's approach to fraud. Gee's work in the NHS reduced fraud-related losses by up to 60 per cent, delivering financial benefits to the tune of more than £800 million and achieving a 12:1 return on the costs of the work.

## Mark Button is a Reader at University of Portsmouth and Director of the Centre for Counter Fraud Studies

Mark Button is a Reader in Criminology and Associate Head Curriculum at the Institute of Criminal Justice Studies, University of Portsmouth. He has also recently founded the Centre for Counter Fraud Studies of which he is Director.

He has written extensively on counter fraud and private policing issues, publishing many articles, chapters and completing four books with one forthcoming: *Private Security* (published by Perpetuity Press and co-authored with the Rt. Hon. Bruce George MP), *Private Policing* (published by Willan), *Security Officers and Policing* (Published by Ashgate), *Doing Security* (Published by Palgrave), and *Understanding Fraud: Issues in White Collar Crime* (to be published by Palgrave in early 2010 and co-authored). He is also a Director of the Security Institute, and Chairs its Academic Board, and a member of the editorial advisory board of 'Security Journal'.

Mark founded the BSc (Hons) in Risk and Security Management, the BSc (Hons) in Counter Fraud and Criminal Justice Studies and the MSc in Counter Fraud and Counter Corruption Studies at Portsmouth University and is Head of Secretariat of the Counter Fraud Professional Accreditation Board (CFPAB). Before joining the University of Portsmouth he worked as a Research Assistant to the Rt. Hon. Bruce George MP specialising in policing, security and home affairs issues.

He completed his undergraduate studies at the University of Exeter, his Masters at the University of Warwick and his Doctorate at the London School of Economics. Mark is currently working on a research project funded by the National Fraud Strategic Authority and ACPO looking at victims of fraud.

## Graham Brooks is a Course Leader at University of Portsmouth

Graham Brooks is Course Leader for the Counter Fraud and Corruption MSc. at the University of Portsmouth. He was previously the Course Leader for the Counter Fraud and Criminal Justice Studies BA from June 2007 to March 2009, and Head of Secretariat for the Counter Fraud Professional Accreditation Board from September 2007 to March 2009. He is also a member of the Centre for Counter Fraud Studies at the University of Portsmouth.

### About MacIntyre Hudson LLP

Established in 1880, MacIntyre Hudson is a growing and successful mid tier UK independent accountancy firm working with entrepreneurial businesses, groups and multinationals with operations in the UK.

The firm provides a comprehensive range of services and specialist advice, including audit and assurance, tax planning and compliance for both corporate and individual clients, payroll and VAT, corporate recovery, business strategy, counter fraud services and outsourcing. Other parts of the MacIntyre Hudson Group provide specialist advice on corporate finance and professional training.

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### The Centre for Counter Fraud Studies

The University of Portsmouth's Centre for Counter Fraud Studies (CCFS) was founded in June 2009 and is one of the specialist research centres in the University's Institute of Criminal Justice Studies. It was founded to establish better understanding of fraud and how to combat it through rigorous research. The Institute of Criminal Justice Studies is home to researchers from a wide cross-section of disciplines and provides a clear focus for research, knowledge transfer and educational provision to the counter fraud community. The Centre for Counter Fraud Studies makes its independent research findings available to support those working in counter fraud by providing the latest and best information on the effectiveness of counter fraud strategies.

[www.port.ac.uk/departments/academic/icjs/CentreforCounterFraudStudies/](http://www.port.ac.uk/departments/academic/icjs/CentreforCounterFraudStudies/)

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