Public Procurement 2014

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Getting the Deal Through is delighted to publish the fully revised and updated 10th anniversary edition of Public Procurement, a volume in our series of annual reports, which provide international analysis in key areas of law and policy for corporate counsel, cross-border legal practitioners and business people.

Public Procurement 2014 addresses the most important issues facing private enterprise competing for government contracts. Following the format adopted throughout the series, the same key questions are answered by leading practitioners in each of the 33 jurisdictions featured. New jurisdictions this year include Croatia, Japan, Korea, Peru and Turkey.

Every effort has been made to ensure that matters of concern to readers are covered. However, specific legal advice should always be sought from experienced local advisers.

Getting the Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise.

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Defence procurement – understanding, identifying and addressing corruption risks

Tehmina Abbas

Transparency International UK, International Defence & Security Programme

This article summarises Transparency International’s (TI’s) views on the areas in the defence and security sector most vulnerable to corruption – in both defence companies and governments. The failure to address these risks can lead to losses in integrity, trust, resources, and lives.

Corruption in defence procurement

Global military expenditure, despite decreasing for the first time since 1998, amounted to a staggering US$1.75 trillion in 2012 – equal to 2.5 per cent of world GDP and approximate to the GDP of India, the world’s largest democracy.\(^1\) Up to one-third of military expenditure is generally allocated towards defence procurement or the purchase of arms and other defence equipment.\(^2\) In the experience of TI UK’s Defence and Security Programme, procurement is cited by defence officials as the area of greatest corruption in the defence and security sector.

In many ways, defence procurement departs significantly from general public procurement. The inherent secrecy and security considerations which accompany defence related purchases play a central part in increasing the procurement cycle’s susceptibility to impropriety and politicisation. The role of military arms and equipment in national security can be exploited beyond reasonable needs for confidentiality to avoid scrutiny. This is especially relevant given the wide acknowledgement and acceptance that national defence and security is often the most costly and complex part of the state apparatus and an enormous amount of money is assigned towards arms and defence equipment. Astonishingly, Greece continued to be the largest procurer of arms in the EU even as it was being bailed out by the EU and the International Monetary Fund, and had imposed stringent austerity measures on its citizens.\(^3\)

Arms deals are often highly complex, with ‘expert’ technical quantification and specification of requirements, elaborate and cumbersome tendering processes and the common involvement of brokers and subcontractors. Offsets, unique to arms contracts, deserve a special mention. Typically obscure and under-scrutinised, they are arrangements between the purchasing government and the contractor for the latter to reinvest a percentage of the value of the main contract into the importing country.

There is thus an environment of lessened transparency, secrecy, compromising of open competition regulation and increased discretion for contracting authorities which increases the potential for abuse.

Corrupt defence companies can face damaged reputation, reduction in stock prices, fines, blacklisting and even prison time for individuals. But it is with regard to soldiers and civilians that the consequences of corruption in defence procurement are particularly devastating. A nation’s soldiers are provided with inadequate equipment, compromising their safety on operations, increasing casualties and impeding their ability to protect their citizens or the local population in peacekeeping and other operations. Huge resources are wasted, compromising the economic interests of citizens. Money is diverted from socially productive national investments, which a country could be in dire need of. A well-known example is that of the £6 billion arms deal between South Africa and BAE and SAAB in 1999. The aircraft procured were initially estimated as unaffordable and were assessed as unaligned with the air force’s operational requirements and unnecessary for the nation from a strategic standpoint. In the same year, the government claimed it could not afford the life-saving antiretroviral treatment for its 6 million plus HIV-positive population.\(^4\)

As a consequence, the morale of defence and security personnel wavers and the public loses trust in its national defence and security establishments, and by extension, in the government as a whole.

Key areas of corruption: identification and quantification

TI has, on the basis of its experience with defence and security stakeholders and research, identified key areas prone to corruption in the government defence procurement cycle and within defence companies. An understanding of the most vulnerable stages in the defence procurement process where corruption can manifest is an initial attempt towards countering it.

A step further would be an accurate identification and quantification of the potential risks within the defence procurement process specific to countries and companies. TI’s Government Defence Anti-Corruption Index (GI) 2013, assessed, among other areas, the anti-corruption controls in place in the defence procurement processes of 82 countries.\(^5\) Its companion index, the Defence Companies Anti-Corruption Index (CI), studied the supply side – analysing the anti-corruption and ethics processes existing within 129 defence companies to ensure transparency and counter impropriety.\(^6\) Their results can be used as a starting point for reform and putting in place specific strategies to prevent and counteract corruption.

Governments

According to TI’s corruption risk typology, the key areas to focus on in defence procurement are:

- technical requirements or specifications which are not well quantified, identified or linked to a transparent national strategy;
- single source or non-competitive procurement practised to a significant extent and without sufficient oversight;
- poorly regulated, undisclosed and under-scrutinised usage of agents and brokers;
- collusive bidding in the absence of relevant defence sector-specific laws and enforcement;
- complex, ill-defined and secretive financing packages;
- complicated, ill-monitored and under-publicised offsets arrangements;
- under-regulated tender boards, inadequate disclosure of supplier obligations and lack of mechanisms for companies to complain about corruption during contract award and delivery stages;
- standards expected from subcontractors or subsidiaries; and
- political influence from seller nations at the cost of legitimate defence needs.
The results of the 82 countries assessed by the GI, which together accounted for 94 per cent of global military expenditure in 2011, indicate that overall, government control of corruption risks in defence procurement was poor. A striking result was that a mere five countries were observed to have robust, long-standing and enforced legislation covering defence and security procurement. It was also found, interestingly, that it was the presence of features unique to defence procurement which heightened the risk for corruption and was primarily responsible for the weak result overall. Close to 60 per cent of governments have little or no transparency relating to offsets, while almost a third fail to impose due diligence on or audit such arrangements. In nearly 70 per cent of countries, there is no evidence that the main contractor is required, formally or informally, to ensure its subsidiaries have anti-corruption programmes in place. Furthermore, there is no public information regarding financing packages of defence procurement contracts in 45 per cent of the countries in the study. Only seven countries strongly regulated the use or forbade the participation of agents and brokers in the procurement cycle. The worst-performing region was the Middle East and North Africa, the only region where the growth rate of military expenditure accelerated substantially in 2012, followed closely by Sub-Saharan Africa.

TI recommends that:

- defence procurement is regulated through robust and well-established legislation and active, transparent oversight mechanisms;
- procurement decisions are open, derived from published national strategies and after purchase are subject to independent audits;
- competition regulation is ensured;
- offsets arrangements are subject to due diligence and audit;
- bidding companies guarantee appropriate integrity systems are set up in their subsidiaries and subcontractors; and
- there is public disclosure regarding the use of agents or brokers and financing packages.

Companies

TI’s typology to assess the ethics and anti-corruption systems in defence companies highlights five main corruption risks:

- limited commitment by the leadership and organisation to ethics, anti-corruption initiatives and associated monitoring systems;
- absence of risk assessment, monitoring and control of agents and due diligence of offsets;
- lack of clear company policies and codes covering all forms of corruption, gifts, hospitality, lobbying and facilitation payments;
- inadequate systems for general training all employees in general compliance (including anti-corruption) with targeted anti-corruption training for board members and employees in sensitive positions; and
- incompetent disciplinary measures for corrupt personnel and ill-defined or non-existent systems to support and protect whistle-blowers.

Of the 129 companies, together netting US$11 trillion in revenue, studied by the CI, almost half were assessed to not have basic systems in place to prevent corruption and promote strong ethics. Surprisingly, two-thirds, including companies from the major arms exporting nations, do not adequately disclose publically how they counter corruption.

On the basis of the study, internal information provided to us by defence companies and our own analysis, TI-DSP found seven major areas that characterised well-performing companies:

- the manner and focus of corruption risk assessments by the company;
- the mitigation of corruption risk in third parties (agents, subsidiaries, suppliers etc);
- the regularity, consistency and relevance of training of company employees, particularly those in exposed roles; and
- the company’s follow-up to whistle-blower information.

The role of integrity pacts in countering corruption in defence procurement

The integrity pact was developed by TI in the 1990s with the intention of aiding governments, civil society and companies to counter corruption in public procurement and has been widely used in public contracts with variability in approaches, processes and documents across countries and sectors.\(^{11}\)

Integrity pacts can be powerful incentives for companies to abstain from bribery with guarantees that: their competitors will do the same; and the government and licensing agencies will take steps to prevent corruption (including extortion by officials) and ensure transparency. Governments, are in turn, enabled to counter the distorting impact and soaring costs of corruption in the procurement and licensing processes. As a result, there is increased confidence among bidders and the public, potential reduction of costs and supplementation of weak legislation and enforcement.

Although mostly used during the bidding stage of contracting procedures, integrity pacts should ideally be applied at the execution phase as well to ensure there is no potential for misconduct after the contract is awarded. In order to ensure that they not become mere box-ticking exercises a credible, in-country independent monitor must oversee the entire process. The lack of one can render the entire exercise fruitless.

With the potential to be applied to various types of public contracts, there are examples of integrity pacts being used successfully in the field of defence procurement. Most recently, in January 2014, India terminated a US$770 million deal with Italian defence company Finmeccanica’s AgustaWestland unit for a breach of an integrity pact amid allegations of bribery. Similarly, in 2012, India blacklisted six Israeli defence companies on the basis of allegations of corruption in violation of an integrity pact. In this instance, a bank guarantee by the Israeli military industry was encashed by the Ministry of Defence as part of the sanctions.\(^{12, 13}\)

Conclusion

Governments and companies need to work individually and together to reinforce anti-corruption controls in defence procurement. The inability of one of the two to do so prevents the other following through in ensuring transparent standards of good practice and integrity, causing waste, conflict and endangerment.

Tools and sources

- Companies Defence Anti-Corruption Index (2012), http://companies.defenceindex.org/
- The Integrity Pact – A powerful tool for clean bidding’ (2009), www.transparency.org/files/content/tool/IntegrityPacts_Brochure_EN.pdf.

Other useful resources


Notes


6 Companies Defence Anti-Corruption Index (2012), http://companies.defenceindex.org/.


9 As compiled from Defense News 2010 Top 100, SIPRI Top 100 Arms-Producing and Military Services Companies 2010, and defence companies’ own financial reporting (CI 2012).


