INTERVIEW OF MALCOLM SPARROW BY SASHA ABRANSKY

The following Q&A is excerpted from an in-person interview on December 8th, 2010 in Cambridge, Massachusetts; and a follow-up phone interview on December 15th.

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Malcolm Sparrow, a professor of public management at Harvard's Kennedy School and the author of *License to Steal: How Fraud Bleeds America's Health Care System*, has long argued that government agencies underestimate the scale of a fraud epidemic that he believes costs taxpayers hundreds of billions of dollars annually. His work suggests that better fraud control systems can help significantly trim government budgets without impacting services. Such ideas are of peculiar importance in this era of public-sector austerity.

I recently spoke with Sparrow by phone about prospects for improving audits, the value of transparency in stimulus spending and what investigators can learn from chess strategy. Below is an edited transcript of our conversation. — Sasha Abramsky

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S.A. -- You have an interesting career trajectory. How did you go from being a police officer in the Kent County Constabulary, in the UK, to Harvard, as a graduate student, to sitting in the Littauer Building as faculty at the Kennedy School of Government?

M.K.S. -- I read math at Cambridge, Trinity College, 1974-77. When I graduated from Cambridge I was committed to the notion of public service. As a pure mathematician a life in academia in mathematics would be fun but as much practical use as playing chess for a living. I looked at the National Health Service and civil service and police service and a few other government jobs – cryptology. Some things that were vaguely mathematical as well as managerial.

I do remember my advisor at Trinity College, Cambridge, thought I was completely mad. I said the police service needs some good people, his argument was 'you're wasting your life doing this'. [But] I have no regrets about joining the police. I did the whole range of work; two and a half years on the beat as an ordinary uniformed constable, which was a requirement. Then a spell in CID as a detective. Then a year away, at the police Staff College at Bramshill. Then a year as a uniformed sergeant. Then a year as an inspector. Then a few other odd positions; I ran the West Kent Support Group, which includes the SWAT team, for a while, and did some work on complaints investigation. At the rank of inspector, along came the opportunity to apply for a Harkness Fellowship, which is what first brought me to the States.

I figured out what to do with my scholarship; one was come to the Kennedy School for one year for the Mid-Career Master of Public Administration program; and the other nine months I arranged to go to Washington and work with what was then the National

Bureau of Standards and is now the National Institute of Standards and Technology – a big government research operation. They did the pattern-recognition piece of the US research government agenda; [including] voice recognition, handwriting recognition, and fingerprint recognition. In my earlier police years I'd become quite curious about fingerprint matching, and why it was not computerized in Britain at the time. I'd never worked in fingerprints, but I'd been told the reason Britain did not have a fully automated system was nobody knew how to code fingerprints and match them on a computer. So I started having ideas about that and writing short papers. I ended up with six patents on fingerprint matching techniques [And, as a beneficial extra, a PhD from Kent University for his work on this]. *I worked in conjunction with the FBI, because they provided all the fingerprint files.*

When I was graduating from [the Kennedy School] they offered me a job on the faculty. I said 'thank you, but no. I'm committed to policing; I'm going back home.' I went back not intending to come back here; I worked at policing another two years. In that time the Kennedy School worked really hard to keep in touch, to keep bringing me back for conferences, to keep me interested in the school and its work, and to try and persuade me to switch. Two years later the time finally seemed right.

Let's move onto your current work. What is the common denominator linking math, risk management and public policy?

I still from time to time exercise my mathematical brain in strange things like writing fraud detection algorithms or focusing a lot on measurement of various problems. But actually the work I do on risk management is in a gap between risk literature and organizational theory literature. There's a lot of work done by experimental psychologists and behavioral economists that talks about how individuals perceive risk and react to it and how they behave either rationally or irrationally depending on biases of one kind or another. But that's all about individual perception and the brain. Then there's organizational theory that mostly comes from the private sector and has its original home in industrial manufacturing. Over the years it's covered service industries. And where it covers government it's with the service industry models in mind. But about half of what government does is not deliver services but deliver obligations, and produce protections against a broad range of harms or threats or risks. So we need the organizational theory piece that has to do with risk management. And the risk literature doesn't touch organizational behavior and the organizational theory literature doesn't cover the special task of identifying and controlling risks, or notions of vigilance and scanning for things that might or might not be there, and how much to spend and in what ways [on that task]. I regard myself as inhabiting the space between these disciplines, and it's a vast space. It's about the way regulatory agencies behave and how they divide their work and define their responsibilities.

In many ways, you seem still to be a detective. What sort of crime do you find most interesting? You write about intelligent opposition. It seems to me there are certain kinds of criminal brain that intrigue you.

The kind that's most interesting intellectually are the deliberate and well orchestrated fraud schemes. They definitely involve conscious opposition; it's a substitution for my chess playing life. You should assume the opponents are playing the counter intelligence game and studying carefully what you do…where the normal values of openness, transparency and predictability are in fact losing strategies, and where artfulness and creativity count most. They're also dynamic games rather than static. A lot of people think of fraud control as 'let me get the latest and best software and I'll be good for years.' Well the best software is good for weeks. That's how long it takes [for the opposition] to test it. Whoever wins this game is the one who knows best about what the opposition is up to and adapts to it. It makes it a dynamic and intelligent game. It's fascinating.

When I arrived in academia I had this other strand – the combination of experience with criminals, I knew the way criminals thought; and I'm a mathematician. That combination creates a natural space as well, about detection and monitoring and discovering what clever opponents might be up to. Jobs started coming my way. I worked with American Express on the detection of major organized credit card schemes, with Visa International, and then with the IRS. The IRS had this emerging problem with the Earned Income Tax Credit in the early 1990s. In 1993 all they could see was the level of detected frauds in EITC had doubled every year for four years, or more than doubled, and it was up to $165 million, detected, in 1993. But what really got their attention was an NBC Dateline show that did an expose on how easy it was to collect three or four thousand dollars under EITC. They filmed organized crime groups going around Texas paying people $400 cash for their name and social security number. Electronic tax returns were just coming in, and they cut the refund time from six weeks to three weeks. Then the banks had invented refund anticipation loans. So now you could get [tax refund] money in your hands in 24 hours. So this was easy money and fast. That's a beautiful fraud attractor. So this thing was growing fast, but they didn't know how fast.

I spent two or three weeks looking at internal IRS stuff, interviewing people, working with criminal investigators. I wrote a report saying this looks more like an eight or nine billion dollar problem, not $165 million. This is in a program that at the time was slated for rapid expansion by the Clinton administration. It was potentially devastating news. But I also said 'don't believe me. You should measure it.' We know how to do that; you pick a random sample, audit them rigorously, and analyze the results. They did that in the spring of 1994…[a program] run by criminal investigators, not by auditors; they picked 1,000 claims and sent a criminal investigator to the relevant doorstep unannounced. Most obvious, the houses weren't there; they were showing up at McDonald's restaurants, and hotel rooms and vacant parking lots. They compiled the results. It was horrendous. Thirty eight percent of the EITC was going into the wrong hands, was either unmerited or inflated. And at a fairly conservative estimation, nineteen percent at least was outright criminal fraud. It was being conducted by [some of] the financial intermediaries who were also the "Electronic Return Originators." The good news is the IRS discovered all this themselves, discovered how bad it was, didn't have to make it public, and didn't do so for 18 months; and in the meantime they had been able to act on it, put the facts on the table – they went to Congress and got a supplemental

appropriation in secret and built an EITC-specific prepayment fraud program, an audit program; and they repeated the measurement study a year later and had in one year cut the loss rate in half. And that's one of very, very few fraud control success stories that I can tell you. It's about the courage that it took to do a valid measurement program, to recognize the seriousness of what they'd discovered, to act on it. Once the facts [about loss-rates] are established it's usually not that hard to figure out what to do.

Describe your methodology.

I had a curious conversation with some colleagues trying to evaluate my work. They said 'we figured out what you do is forensic science.' I said 'you don't need to call it a forensic approach. It's more like the ordinary work of a natural scientist.' You need to understand the broader range of natural science enquiry methods. The natural scientist goes out into the world without too much of an idea of what the hypothesis might be. They observe phenomena, get curious about some, go back to the lab and run experiments, develop a theory about what might be happening in the world; now they go back out and look for more observations that either confirm or deny the theory or make it more complicated; they're constantly going back and forth between juggling the mental apparatus and making real world observations, in trying to devise general rules that can then be used to explain how the world works.

You're a scientist with a butterfly net, waving it and catching fraudsters. So, the next question is, why do we care about this? Why don't we just accept this as the price of creating new programs, as being an unsavory, but inevitable, part of the modern social compact?

Every dollar that goes into the wrong pockets is a dollar that's not available for people for whom it was intended and who are genuinely needy. In the end it can destroy major public programs. Costs have to be controlled; the projections make that perfectly plain. There's two ways of controlling them – in an indiscriminate fashion, by reducing reimbursement rates for doctors or tightening up on eligibility or excluding all kinds of services. The alternate method is to learn to tell the difference between the genuine purpose and the sideline attacks on the program, where you can get all the cost savings that you need and be a lot more generous at the same time. At the moment they're following more the indiscriminate approach. The danger is when you cut reimbursement rates you drive the best and most honest physicians out of the system. It doesn't hurt the unjust, because they're not bound by the truth – they'll just make more claims. So you can end up in a destructive cycle which will eventually cripple the program.

The higher level answer is "the word 'corrupt' means 'to bend.'" Normally we worry about corruption because of the other systems it bends out of shape. If it was supposed to be a meritocracy but is in fact nepotism, then that system is bent. If it was supposed to be the allocation of public contracts according to merit, but it's actually corrupt then you're not getting the same quality of work, the right people selected. It's the other systems that are bent out of shape that is the reason corruption counts. I have an alternate definition of corruption: a corrupted system is one where there's an ostensible system – the way

things are supposed to work—and an actual system—the way things really do work. And the actual system is known by a few and available only to a few, and everybody else is disadvantaged by it.

Let's talk about the four-person panel you were appointed to in March 2010, monitoring how stimulus money is being spent.

It was created under the provisions of the Recovery Act itself. We were appointed in March of this year[2010]. It's called the Recovery Independent Advisory Panel. Our job is to advise, or make recommendations to the Recovery Board. In brief, the Recovery Board itself consists of Inspectors General from the major federal agencies through which stimulus funding is flowing. The board convenes specifically to address issues of fraud, waste and abuse with respect to stimulus spending. Our panel has only one duty in law – to make any recommendations we deem appropriate to the Recovery Board itself. We also hold public hearings just to try and get some sense of views on the ground and all of the levels in between.

You're looking at whether the money is spent honestly or whether the mechanisms by which it is distributed are efficient?

Our job is not at all to assess the appropriate allocation of stimulus funds. That's a less technical and much more political discussion. Our job is solely limited to fraud, waste, and abuse – which means money not ending up delivering the desired product.

How do you hunt this down? There are terrific sums of money flowing in all kinds of directions, how do you track down where it's gone wrong?

It's not our job to find individual cases and to look in the weeds. They have systems up and running. Our job is to bring independent experience to bear in any way that we think is useful, in looking at the way they think about the job of fraud detection and control.

The stimulus funds are divided into three major categories; $288 billion is the total Recovery Act funds designated for tax benefits, including the Earned Income Tax Credit and the program, now finished, where money is distributed through the tax system for [first time] home purchasers; that's the biggest third. The next piece is contracts, grants, and loans, $275 billion; and that's the piece everybody is really aware of – because that's the piece around which you see the signs up on the highway or the airport. This work is being done by local contractors, by the private sector using stimulus funds. The big deal in terms of government transparency and accountability has been mostly oriented around that particular third, because the bulk of the reporting obligations involve private sector contractors, and states, and other recipients reporting on a regular basis into the website and the data being available in an easily searchable form to regular members of the public. You can look up in your zip code work that is supposed to be being done, and if you don't see the work being done or it doesn't look genuine or it's a useless project, there are reporting mechanisms built into the site. The third third is

entitlements, $224 billion; the biggest single piece under entitlements is Department of Health and Human Services, and its variances of federal share of Medicaid expenditures.

So you're not searching the weeds for fraud, because the mechanisms are already out there. What are the mechanisms like for monitoring waste or fraud within stimulus money?

That's a good question. For the first and third thirds, these funds are flowing through existing agency operations, with their own existing fraud abuse and control mechanisms in place already. At the Recovery Board level, there is relatively little insight into all of the myriad arrangements that already pertain to those funds. They are flowing through the same mechanisms and structures as a host of other federal funding. It's harder to parse them out; they don't have their own dedicated integrity protections. So that's a lot more opaque in terms of the different pieces of the expenditure. The thing that's new and is being trumpeted as a major step forward in terms of transparency and accountability relates to the middle third, where the contractors have to present all this new data and they can get excluded if they're persistently non-compliant. All of [that data] is available, right down to the project level, through this website [Recovery.gov]. It's a remarkable depth of accountability.

Are you confident it's working well in terms of identifying fraud?

I'm going to be quite cautious. It's too early to say that I'm confident. The news to date is that while there have been cases of fraud and abuse recognized and reported and investigated, and a moderate number of criminal investigations and prosecutions launched as a result, the overall volume that's visible at the moment seems remarkably low. Everyone's assuming that that's good news, and that this heightened degree of accountability is a causal factor in keeping down fraud and abuse. I'm not completely confident of that, because I know the nature of the fraud control challenge – and I know that fraud, if perpetrated well, remains invisible, and there are therefore endless circularity traps and ways of deluding yourself. We have talked [with the Board] about specific strategies that you need to adopt in order to make sure you're not being fooled just by the sliver of cases that come to light; to make sure it's not possible there are broader problems that have remained out of sight. They involve a lot of intelligence sharing amongst agencies, the identification of potentially troublesome personnel, however remotely connected to projects or contracts, and the proper use of rigorous audits on random, or representative, samples. These are discussions we have had.

There are some areas of the stimulus funding which are being distributed by computers in response to electronically submitted applications of one kind or another. For instance, tax credits in support of home purchase. The Inspector General for Tax at Treasury has issued a report explaining some of the abuses that came to light. They discovered home purchasers who were a few months old or had already died or otherwise clearly weren't legitimate. It sounds eerily familiar to anyone who's looked at what happens when you distribute funds this way in the healthcare system.

Has your panel made estimates as to what percentage of stimulus money is being lost to fraud?

No. That's an enormous challenge. Because when you look at the structure of stimulus spending it goes so many different ways, and through so many avenues and control mechanisms. You'd have to conduct valid measurement studies within each of those separate systems. Given the pace at which this is unfolding—the whole idea of a stimulus is an adrenaline shot in the arm to the economy—therefore you can't hang around and apply exactly the same level of prudence and caution that you might if there were to be a long term and permanent program.

So what can your expertise provide for the panel?

The best we can do on that front is to try to establish a conversation amongst the Inspectors General about best practice in fraud and abuse control, and have a more general conversation about how you would identify areas at high risk, how you would validate internally whether your controls were matched up to that heightened risk and, if not, what intervention opportunities you could find.

This might be a good place to move onto your main area of expertise, the healthcare system. Do you have a sense of the scale today of Medicare fraud and, more generally, healthcare fraud?

No we don't. Rule number one is measurement. One of my major criticisms, which I've been making for fifteen years, is that CMS [Center for Medicare and Medicaid Services] steadfastly fails to get valid measurements of the loss rate. It's not because we don't know how – we absolutely do know how. It's partly habit, and partly that this requires enormous courage. They do measure error rate…they have CERT [Comprehensive Error Rate Testing], and the Office of Inspector General has recently reviewed the way they use that program. But basically the audits that they're using on a random sample are desk audits; they're nothing like a fraud audit. The difference between a fraud audit and a medical review audit: with a medical review audit, you're taking all the information given to you as if it's true and testing whether the medical judgment seems appropriate. You can use these techniques to see where judgments are unorthodox or your payment rules have not been followed, but almost nothing in these methods tests whether the information you have is true. These fraud perpetrators know the value of the sweet spot; they aim their claims dead center, right in the middle of medical orthodoxy. It looks kosher every step of the way – except it's not true; it's an inflated procedure, or one that wasn't done, or an entire medical episode is being created and a completely fake diagnosis has been put on a patient's record. The stories are legion of people getting a Medicare explanation of benefits statement saying 'we've paid for this operation you had in Colorado.' And those people have never been in Colorado. And when they complain [to Medicare] about this nobody seems to care – there's not enough capacity in the system to investigate; a lot of people say 'it's probably just an error.' We'd prefer to imagine these are clerical errors rather than any systemic crime problem.

I have healthcare economists who say 'Sparrow, you're just too suspicious. You see fraud everywhere.' I just show them the latest couple of press releases: on an Armenian organized crime group who stole $165 million before they were shut down. That's one thing ten years in the police force does for you; you see the extremes of human nature, at its very best and very worst all day every day. So I'm realistic about human nature. One of the differences in the attitude of an investigator from an auditor or economist is the degree to which you trust your data sources to really represent what they purport to represent.

You've said elsewhere that we might have to jack up the medical investigative resources within Medicare to 1% to 2% of the total to protect the integrity of the other 98%.

The average spending on medical integrity across the system is somewhere between one and two tenths of one percent of what the program costs. Meanwhile, they acknowledge it could be an eight-to-ten percent loss rate, and if you did the measurements properly it'd probably be much worse than that. You compare this with the credit card industry; they have a business acceptable loss rate [for fraud] of ten basis points; one tenth of one percent. We're at ten percent [in Medicare], maybe thirty percent. And we've seen some segments go completely rotten – ninety five percent. Look at durable medical equipment fraud in Florida. It's been the focus of much of the HEAT team in Florida's investigation. Wheelchairs, prosthetics, oxygen supplies. What often happens is that everybody knows a segment has gone bad; it might be DME in Florida or home health care in Texas, or community mental health clinics in Florida. For a good long time it was HIV infusion therapy. Then the authorities wake up and make one criminal case against one person, at which point you can sometimes see the whole billing for this procedure drop off by more than ninety percent. Why? Because one person was convicted of criminal fraud? But why would that change the behavior of any honest physician? This tells you something about the level to which such practices had become widespread before law enforcement paid attention.

Fraud by its nature is invisible. Therefore what you see is only the detected piece. The challenge is always to understand what you don't detect. So, it's an interesting question: what can you learn about what you don't detect from the things that you do detect?

If your control systems were working really badly, then when you find a fraud scheme it would have been running for years, would involve widespread conspiracies that take a long time to set up, would have already done substantial damage over many years, and you would have detected it by chance – because a jilted lover, or ex-business associate or whistle blower turned them in. And if it weren't for that tip-off there's nothing to suggest you would have found it otherwise.

The best case scenario, if your control systems are working well, then the cases that come to light would be very young, in the early stages, fledgling rather than well-established conspiracies; and you would have detected it through your ordinary audit systems – and would even have detected it twice, through redundant systems.

How do you make it politically unacceptable in the current climate to continue ignoring the fraud?

In part that work's already being done. The healthcare fraud problem, and the questions about how big it really is, have come back with a vengeance in the last couple years. For two reasons. They come back anytime medical inflation rate ticks up above ten percent and people can't explain it, and healthcare economists have a gap [to explain]; and cost inflation in the industry has become high enough again to get attention.

But then the political debate over healthcare reform also shines new light on this, for two reasons: one, whatever the Obama administration wants to provide that wasn't provided before, that will cost $200 billion over the next decade, and one question is can we find $200 billion…that we can save, and reinvest, if we can solve this problem? But the Republican Party is also interested in [shining a light on the fraud problem] now, because they say the Democratic proposition is expanded public health programs and why would anybody want to put more money into a system that is already so badly run? So all of a sudden it is politically visible again.

Presumably many of the billing scams apply equally to private healthcare systems?

That's absolutely right. And there doesn't seem to be much difference in the level of fraud control across the three sectors [public, non-profit, and for-profit]. It turns out the private sector generally doesn't do it any better, because if you can pass on the cost [in premiums]and not do any worse than anyone else [in fraud control] you don't suffer a competitive disadvantage. And there are powerful incentives not to alarm shareholders.

What kind of institutions or regulatory structures, or new bureaucracies need to be created to deal with this? And, a related question, in 2008, candidate Obama talked about the need to recreate Good Governance. Is it being done, and, if not, can it be done?

I wouldn't start by imagining new bureaucracies. I'd like to make existing ones function a lot better. How do you get sufficient public support and room to maneuver? Answer, find out how much is being lost and put the facts on the table. It's very simple, and it's transformative, if you can do it. The trouble is you can only do it if you are new; and I'm worried that Obama has lost his chance. If he had done it in his first nine months, then whatever he had discovered about how much is being lost wouldn't have been his fault. But after you've been there two or three years, then you're responsible.

Let me end with one last question. There's public cynicism about the role of government and suspicion of ceding more power to government agencies. What you're saying puts the problem in a worse light: under-funded, under-resourced agencies become magnets for fraud, and because everyone knows they're magnets for fraud public confidence continues to deteriorate. It's the opposite of a virtuous circle. How do you break that?

By establishing how much is being lost. Which, when it happens, would be a political firestorm. But it would move the discussion along to what should we do, what should we tolerate in terms of additional checks and controls, in order to eliminate this cancer.